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What we mean when we talk about the 'tax rate' - and how to figure out what yours is

By Jamie Golombek

With all the recent changes to income tax rates, do you know what your actual tax rate will be in 2016? Here are all the factors that affect your...

There's been much discussion about tax rates this year, with a cut in the 2016 federal tax rate for middle-income Canadians and an increase in the tax rate for Canada's highest earners. Some provinces have also tinkered with their rates over the past few years. With all the recent changes, do you know what your actual tax rate will be in 2016? And, when we say "tax rate," what rate are we really talking about?

While it's true that the top marginal tax rate in more than half the provinces this year exceeds 50 per cent, that rate is literally payable only "at the margin." This means the rate of tax you would pay on an additional dollar of income. Contrast this with the average, or effective, tax rate, which is often much lower due to the progressive, graduated tax system and the effect of various tax deductions and credits that reduce your rate.

Individuals pay income tax at graduated rates, meaning that your rate of tax gets progressively higher as your taxable income increases. For example, on the first $45,282 of taxable income, an individual would pay federal tax at a rate of 15 per cent. On the next $45,282 of taxable income (i.e. from $45,282 to $90,563), there was a decrease of 1.5 per cent (from 22 per cent to 20.5 per cent) in the federal tax rate from 2015 to 2016, known as the "middle-income tax cut." In contrast, high-income individuals with taxable income exceeding $200,000 saw the applicable tax rate rise four per cent (from 29 per cent to 33 per cent) from 2015 to 2016.

While graduated tax rates are applied to "taxable income," not all income is included, and certain amounts may be deducted, thereby reducing the base to which marginal tax rates are applied. Capital gains are an example of income that is only partially taxed. Unlike interest income, which is fully included in taxable income, only 50 per cent of capital gains (less capital losses) are taxed. Common deductions that you may subtract from your total income, thereby decreasing your taxable income, include investment management fees for non-registered accounts, contributions to an RRSP and child care expenses.

Tax credits, on the other hand, directly reduce the tax you pay after marginal tax rates have been applied to your taxable income. With tax credits, most of which are non-refundable, a fixed rate is applied to eligible amounts and the resultant credit amount offsets taxes payable. The federal credit rate for nearly all amounts is 15 per cent. Common federal non-refundable tax credits include the basic personal amount, the amount for a spouse or partner, medical expenses, charitable donations and the dividend tax credit available to investors who receive Canadian dividend income.

To better understand how tax-preferred investment income can lower your effective tax rate, let's take the example of two Ontario brothers, Bob and Doug, each of whom is expected to earn $50,000 in 2016.

Bob's $50,000 consists entirely of employment income and, allowing for only the basic personal amount, he will pay about $8,400 in tax in 2016, yielding an average tax rate of 16.8 per cent ($8,400 divided by $50,000). His marginal tax rate, however, is significantly higher, at 29.7 per cent, on each additional dollar of income.

Now contrast this with his brother Doug, who earns $50,000 of investment income in 2016, comprised of $10,000 of interest income, $20,000 of realized (gross) capital gains and $20,000 of eligible dividends. Assuming only the basic personal amount as well as the applicable dividend tax credit, his total tax bill would be a mere $1,900 and his average tax rate only 3.8 per cent ($1,400 divided by $50,000). The reason for such a low rate stems not only from his capital gains, which are only half taxable, but also from the dividend tax credit, which not only entirely eliminates his tax bill on the dividend income but acts as a tax shield to recover some of the taxes he would otherwise pay on his interest income and capital gains.

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References

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