Chapter Five

TAXES

LESSON 27
What Are Taxes?

First off, what are taxes? Well I'm glad you asked. Taxes are how a government gets money to run public services. For any country to be safe, run smoothly, and have public services such as healthcare, roads, and libraries, we need taxes. It costs hundreds of billions of dollars a year to run Canada. And the government doesn't just pull that money out of thin air. Compared with the United States, Canada has fairly high taxes, which pays for services that benefit many Canadians. In the United States, healthcare is mostly private and costs people money, whereas in Canada it's publicly funded. This can make a big difference to a family that might otherwise go into debt to pay the high costs of healthcare. Public libraries, schools, the military forces, national parks, and road construction are all made possible due to money collected from taxes.

The government collects tax in several ways. The biggest source is through income tax. When you have a real job with a paycheque, the government takes a portion of your earnings. To redistribute wealth and keep it fair, there are several tax brackets. Depending on your earnings, you will pay more or less taxes. In 2020 the first bracket of Canadian federal income tax rates was 15% on your first $48,535 of taxable income. The next bracket is 20.5% for the next $48,535 you earn. If you made $60,000, taxes would be calculated at 15% on the first $48,535 ($7,280.25) and 20.5% on the next $11,465 ($2,350.33) for total tax of $9,630.58. It keeps going on and on, with the third bracket having 26% on the next $53,404, and then 29% on the $63,895, and lastly 33% of everything over $214,368. Whether you earn $500,000 or $20,000,000, the portion above $214,368 is taxed at the same 33% rate. This model differs from country to country, but many use a similar approach.

Another form of tax is sales tax. When you go to the store and buy something, you see the price of the item. When you actually go to purchase it, the cost is a bit more; this is because of sales tax. In most parts of Canada, sales tax is between 5% and 15%. For example, in Ontario sales tax is 13%, so when you go to buy a $1 pack of gum you actually end up paying $1.13. This is the other main way the government makes money, through your spending.

LESSON 28
Tax Brackets

When you have a part-time job as a teenager, chances are you will be in the first tax bracket. It changes every year, but many governments allow people to earn a certain amount without paying taxes at all. In Canada, tax credits reduce the calculated tax amount that we discussed in the last section. In 2020, tax credits mean that Canadians could earn $13,229 tax-free. For the most part, we teenagers probably won't be making that much anyway. For jobs where you are paid a hourly wage (such as working as a waiter or at a grocery store) but don't work enough hours a year to make more than the non-taxable amount, you can get tax refunds at the end of the year for the taxes on your earnings since employers typically take it out of your paycheque anyway. So, for the most part, while you are young you won't encounter or even need to deal with taxes. However, it's important to know for the future how tax works, especially the ways to minimize it.

Like me, many kids earn money from side jobs and earn below the annual total that would be taxable. They are not required to file income tax in Canada, but may want to for reasons we'll discuss later. However, if they are earning enough on investment income to increase earnings to above the non-taxable bracket they will need to file.

Pay close attention to this next part. When you are growing your money through investing, you are taxed on half of your gains. Imagine if you were to invest $1,000, and over a few years it doubles. You now have $2,000 and think that it's a reasonable time to cash out. You sell your shares and make $1,000. Now don't get too excited. You still have to pay taxes on your gains. The good news is that many governments want to encourage investing, so they tax capital gains at lower rates than other income, thank goodness! Currently in Canada, they include only 50% of capital gains as income that they calculate tax on at the rate for your tax bracket. So of the $1,000 that you made you would be taxed only on $500. Where I live, the maximum combined provincial and federal income tax rate was 53.5% in 2020. So the very highest possible rate you'd pay on capital gains would be 50% of that, or under 27%. If you are under the top bracket, which for the most part teenagers are, you would be paying even less tax.

Say you were in a tax bracket of 20%. Do the math. You would then need to pay 20% of 50%, which is 10% of your total gains. These percentages can still have a big impact on your gains from investments. Say you were a lawyer, earning $250,000 a year, and in the highest tax bracket (50%). If you made $1,000 from an investment, $500 of that $1,000 would be taxed and you would lose $250. That may not sound too bad, but imagine if that thousand gain was actually a

million. All of a sudden, instead of bringing home a million dollars, you would be left with only $750,000. You would lose $250,000 in taxes, which would hit you a lot harder. Even though it may seem unfair, capital gains tax is a part of life. There's no getting around it—at least legally (except for a few tax savings plans that I describe below). And for those who do shady things to get around it, they can end up paying huge fines and spending time in prison with federal charges. You just have to accept that taxes exists and keep it in mind when planning your investments.

LESSON 29
Financial Tools to Help You Minimize Taxes and Increase Your Gains

This lesson might bore you, and the fact is that, unfortunately, it probably will. However, the information that we go over is so important in saving money. These tools will save the average person thousands of dollars (maybe millions) over a lifetime, and it is key to take advantage of them. I encourage you to push through and make note of the information here.

Thankfully in most countries there are ways to help minimize the taxes you pay on employment and investment income to save for emergencies, retirement, and education. In Canada, we have TFSAs, RRSPs, and RESPs. These are all financial aids and support that the Canadian government

gives to encourage people to save money. Other countries have similar plans (e.g., in the US they have 401-K, IRA, and 529 plans). In one way or another, these strategies allow you to save money and minimize the amount of taxes you pay—up to a certain limit, or no one would pay any tax! As an example, let's start with TFSAs.

A TFSA (Tax-Free Savings Account) is an account provided by the Canadian government to grow your money free of taxes. However, there are a few rules and regulations. To open a TFSA you must be at least 18 years old; this means it is not an option (yet) for many of us, but it will be soon. A TFSA is an account where investment income earned on money in the account isn't reduced by income taxes. As of 2020, the annual contribution limit is $6,000. The good news is that once you have opened an account, the amount you can contribute is rolled over to the next year. So say you are unable to put any money in the first year. The next year you would have an extra $6,000 of room from the past year. TFSAs offer two main advantages: You can put money into the account, and the money that grows in that account (i.e., the income from investing the money) is not taxed even after you take it out (savings #1), as you invest your money within a TFSA, growth in your investment's value (capital gains, dividends, interest income) is also not taxed (savings #2). So as soon as you turn 18, open up a TFSA. That is where all of your savings should go until you have reached the

contribution limit. Not doing so would basically be giving up free money, giving the government taxes that you don't need to pay. If you feel like it, ask your parents about their savings. Do they have a TFSA? Odds are they do, but if they don't, get them to read this book. They might need to learn a thing or two.

The next account that we will go into very briefly is an RRSP account, or a Registered Retirement Savings Plan, which is another savings and investing account in Canada that helps to defer taxes (in the US, an IRA is similar although details will differ). This account is meant particularly to be an aid in saving for retirement. The greatest advantage of an RRSP is that there is no age limit to when you can open an account. As young as you may be, you can open an RRSP account. The only problem is that there is a maximum of an 18% contribution of before-tax earned dollars from the previous year, up to an overall maximum of $27,830 in 2021. So if you make $1,000,000 in a year, you can add only $27,830 to your RRSP account and not $180,000. For most teens that isn't a problem. Most of us aren't making enough to add $27,830. An advantage for those who are earning more money, and are in higher taxable incomes, is the amount that they deposit to an RRSP each year is deducted from their taxable income (from employment and other investments), reducing the tax they have to pay that year. When you decide to take out your money from the account, the amount you

withdraw is taxed at the rate of your current income. This is to encourage people to take out their cash after they've retired. For the most part, people will be in a higher tax bracket when they were working than when they retire. When retired, you might be earning money through your investments (hopefully you are, otherwise you might be in a bad situation), but odds are you're not making as much as when you were working and had a salary, so you're in a lower tax bracket and pay less taxes.

Note: You must file an income tax return with the government in order to create RRSP contribution room. Don't worry, you don't need to hire an expensive accountant for this. You can do it yourself (especially since you are young and your income is likely simple), and it may even be a good learning experience for you! You can find instructions on the Government of Canada website. Filing an income tax return is an important consideration for kids and teens who often earn cash from odd jobs. Many kids in this situation do not file income tax returns because they are well below the $13,229 limit and would not be required to pay any taxes (the limit varies every year and may be different depending on where you live). However, keeping track of your income (through paper receipts or electronically) and filing income tax returns may be well worth the effort. It will create RRSP room, which has tax savings advantages for the future. This

is a good way to start investing in a tax-sheltered way before you are old enough to open a TFSA.

The third and final Canadian account that we will cover is the RESP (Registered Education Savings Plan). For us teens, this is no doubt the most important plan. The RESP is just what the name suggests. It's an account designed to help save for college, university or other post-secondary education. Just like an RRSP, earnings and growth within an RESP aren't taxed until taken out. There are different types of RESPs, but they are generally pretty similar. Most plans allow you to put money in whenever you want, but with a maximum of $50,000 per kid. For kids under seventeen, the government will also contribute some money for the account. Depending on the plan, you can either have the money invested for you or invest it yourself. The kid can access the money once they are enrolled in university, college, or other post-secondary institution. If you are planning on attending any sort of post-secondary education, an RESP is a really good strategy. Many parents (if they can afford to) will open one when their child is born. Otherwise, if they haven't, talk to them about it, and encourage them to do so. Look into government grants and support for your RESP; they can be a big help. The Canadian government currently offers grants (up to $7,200) where they match a certain percent of your RESP contributions—free money is always a bonus! If your

parents aren't able to maximize contributions, you should consider transferring your own savings into an RESP account if you plan to pursue post-secondary education. Investing in an RESP allows access to free money from the government, is a tax shelter, and will help reduce your debt load in college/university—a win, win, win in my opinion.

Now the question may sometimes arise: Do I put my money in this account or that one? Well, if you are saving that money for education, the answer is obvious. RESPs are the only plan where the government will contribute for education. Most kids wouldn't be thinking about the other two options (TFSAs or RRSPs). However, whether you are thinking about them or not, it's still good to know about them for the future. After you contribute to an RESP, I would suggest you to put your money into a TFSA. This is for a few reasons: One, before you start earning higher income and paying taxes at high rates, you can save some money where its growth is not taxed along the way, and two, the resulting higher cash balance is not taxed when you withdraw it to spend. In an RRSP, high income earners can save tax when they put money in, but it is taxed when you take it out. While a TFSA contribution is after tax income, there is no tax on the investment growth along the way, and no tax even when you take it out. If you are young and have long term investment growth potential, or if you are in a low

tax bracket, everything you are saving should be put into a TFSA first, and any remainder could go in an RRSP.

Example

Like the previous example, I will illustrate these concepts with a short story of two brothers. Jack and Aiden are each twenty-five years old. Jack just graduated from college and started working as an electrician. Aiden finished a degree in kinesiology and was hired to be a trainer for the Toronto Raptors. Although working completely different jobs, both Aiden and Jack earn the same annual salary: $80,000 (before tax). Coincidentally, they also have very similar spending and saving habits, as you will come to see. Both Aiden and Jack have no kids, no debt, and not many expenses to cover. All of their living expenses, including wants, vacations, and such, cost them $52,000 a year. Both Aiden and Jack plan out their expenses for the year and make sure they have the money available for when they need it. As similar as these brothers seem, there is a slight difference that will alter the courses of their financial success. Jack has always been smart with his money and has researched and learned a lot on the topic of personal finance. He knows all about plans such as TFSAs and RRSPs and takes full advantage of them. Aiden on the other hand hasn't really ever been into personal finance and has never bothered to do a bit of learning on the topic. He

does invest his money, but only in index funds that his brother Jack tells him about. Jack deposits his entire limit in his TFSA every year. As he earns money he puts it there until the annual limit of $6,000 is reached. From his $80,000 income he gets to deduct $2,500 for his RRSP contribution, leaving $77,500 taxable income. With other standard tax credits, he is left after income taxes with just under $61,000 to cover his $6,000 TFSA contribution, $2,500 RRSP contribution, and his $52,000 living expenses. His brother Aiden saves money only after all his earnings have been taxed—after provincial and federal taxes and CPP (Canada Pension Plan) and EI (Employment Insurance) deductions have been taken—he is left with about $59,580. Again, both brothers spend $52,000 a year, which leaves Aiden with $7,580 ($59,580 – $52,000) left to save. Already you can see a big difference in how much is saved between the brothers; Jack with $8,500 (from his TFSA and RRSP savings) and his poor brother Aiden with $7,580. Over 20 years that $1,000 difference would be $20,000. If they were to start investing that money, and with the power of compound growth, the gap would grow even wider as Aiden's growth is taxed every year and Jack's is tax-free.

Caution: I'm not a tax expert, but have done my best in this chapter to explain some ways to avoid paying more tax than you need to. Tax rules and rates change from year to year, so you should always check current regulations and seek expert advice if you are investing amounts that are significant to you.