

Understanding Average and Marginal Tax Rates and Using Them to Your Advantage

Prudent tax planning requires a good understanding of the difference between marginal and average tax rates. Tax planning theory involves an attempt to reduce tax payable based on one's marginal tax rate. However understanding how average tax rates are calculated also helps to reinforce why tax planning is so important.

The first part of this article will discuss the difference between marginal and average tax rates. The latter part of this article will explain how the differences between marginal and average tax rates create some of the underlying advantages of RRSPs and income splitting.

Graduated Tax System

In Canada we have a graduated tax system. This means the more you earn the higher your tax rate will be.

Federal tax rates for 2007 are:

2007 Taxable Income	Tax Rate
first \$37,178	15.50%
over \$37,178 up to \$74,357	22.00%
over \$74,357 up to \$120,887	26.00%
over \$120,887	29.00%

Marginal Tax Rate

The marginal tax rate is the rate of tax applied to the last dollar added to your taxable income. As you can see from the above table, as your income increases more taxes are paid on this "top" level of income. For example, the income you earn from investments is added to your income from all other sources. As a result, each additional dollar of investment income is taxed at the highest rate applicable to your total income.

Average Tax Rate

The average tax rate is calculated by dividing the total income taxes paid by your total income. The average tax rate incorporates taxes paid at all levels of income so naturally it will be less than the marginal rate, although a person's average and marginal tax rate will be close to equal for very high income earners.

Using This To Your Advantage

The planning around the use of spousal RRSPs is a great example of how having knowledge about marginal tax rates can help maximize the tax effectiveness of one's financial planning.



In the case of spousal RRSP contributions, the higher income spouse contributes to the lower income earning spouse's RRSP. The higher income earner receives the tax deduction. The RRSP will then accumulate in the lower income spouse's name and future income will be paid to this spouse. This will result in more evenly distributed income between spouses. This will also result in reducing the total tax paid by the couple because less income is taxed at the higher income earners marginal tax rate as income is shifted to the spouse with the lower marginal tax rate.

Non-Registered Investments

If a couple has investments outside of their RRSPs in the name of the higher income earning spouse, then the investment income is likely being taxed at a higher rate than need be. The "Income on Income" strategy can be used to reduce the tax rate which such income is subject to. The attribution rules tax income earned on money transferred to a spouse back to the transferring spouse. However, this income becomes the capital of the spouse receiving it and can be reinvested in the receiving spouse's name. The income earned on this reinvested capital (Income on Income) is not attributed back to the transferring spouse. The income earned on the original money transferred will continue to be taxed each year in the hands of the transferring spouse. Over time, this strategy is a very effective method of transferring capital from a spouse in a high marginal tax bracket to a spouse in a lower marginal tax bracket.

Consider an example. Mr. Jones whose income is subject to the highest marginal tax rate decides to give Mrs. Jones, who is in a lower marginal tax bracket, \$100,000 to invest in her name in order to earn income in her hands. Mrs. Jones invests the money and receives a 10% return each year for 10 years. The following table shows the effect on the Jones family.

Yr.	Gift	Income taxed to Mr. Jones	Mrs. Jones Capital	Mrs. Jones Income
1	\$100,000	10,000	10,000	nil
2		10,000	21,000	1,000
3		10,000	33,100	2,100
4		10,000	46,410	3,310
5		10,000	61,050	4,641
6		10,000	77,156	6,105
7		10,000	94,872	7,716
8		10,000	114,359	9,487
9		10,000	135,759	11,436
10		10,000	159,375	13,580

After 10 years, Mrs. Jones has accumulated \$159,375 of her own capital which is comprised of the \$10,000 earned each year on the original gift, plus \$59,375 of Income on Income. This example assumes that Mr. Jones pays the tax liability on the attributed income from other sources.

Conclusion

Reducing ones taxable income and therefore the amount of tax you pay is not easily achievable. However, through effective tax planning, considerable tax savings can be realized using basic income splitting strategies as outlined above.

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