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Your guide to income tax & financial planning

FAST TRACK

The Loneliest Man in Town

As demonstrated in the accompanying article about mortgages and the new rules that have been introduced by the government regulating the maximum amount for which an individual can apply, it makes you ponder about the role that our government plays in our daily lives.

No one would argue that the government is

In this Issue:

Legalizing and Taxing Marijuana

Everyone remembers how Justin Trudeau's campaign promise in the last Federal election concerning the legalization of marijuana helped propel him to become our Twenty-third Prime Minister. Later on this year he will implement the legislation to make it a reality.

As of July 1, 2018, marijuana will become a taxed consumer good available to the public. This article will not examine health or social issues surrounding the subject. They have been written about extensively elsewhere. It will consider some of the taxation and other financial issues for the government and all Canadians:

(a) **market:** the government estimates that 4600000 Canadians will purchase marijuana in the first year after legalization. They will likely consume 655 tonnes of the product; (b) **medical vs recreational consumption:** Current proposals do not differentiate between the two and both will be sold for exactly the same price; (c) **pricing:** marijuana will be sold by the gram. The Parliamentary Budget Office has determined that the going price on the black market today is \$8.84/gram. If this is correct, we can expect legalized marijuana to sell for between \$8.00 and \$10.00 per unit; (d) **taxation:** the government has proposed an excise tax of \$1.00 per gram on purchases of less than \$10.00 and a 10% tax on purchases greater than \$10.00. HST and other provincial taxes where HST does not apply, is extra. So a purchase of 10 grams of cannabis will cost \$99.44 (see accompanying table) which is comparable to what the current price appears to be (except for the HST!!); and (e) **still to be determined** is how the revenues from the new taxation stream will be divided between the various levels of government. The current split for tobacco taxes is 50-50 on the excise taxes and a 75-25 split on the HST and provincial sales taxes weighed in favour of the provinces.

Fun with Figures

(a) How much will cannabis cost?

	1 gram \$	10 grams \$	150 grams \$
price	8.00	80.00	1,200.00
excise tax	1.00	8.00	120.00
	9.00	88.00	1,320.00
HST	1.17	11.44	171.60
	10.17	99.44	1,491.60

(b) How much revenue will the government "take in"?

There are 1000000 grams in a tonne and the expected sales in the first year are 655 tonnes. This translates to 655 million grams and if the excise tax is \$1.00 per gram, government coffers will increase by \$655 million plus whatever is realized through HST and other provincial levies.

In other words, there are billions of dollars in tax revenue for the government to collect and individual Canadians to pay.

(c) How much will the "average" user consume in one year?

Government figures indicate that more than four million Canadians currently use the product, and this number is expected to increase marginally once legalization is in place.

If we divide say 650 tonnes by 4 million Canadians, the "average" consumer uses 150 grams each year. This will cost him/her \$1492 per annum.

However, compared to tobacco consumption by the "average" consumer, this figure seems unrealistically low. It is fair to say that he/she will be spending more than \$1492 per annum but how much more is impossible to say at this time.

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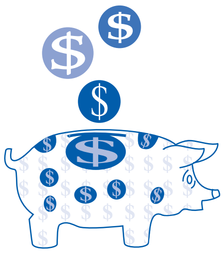


necessary to provide the safety of law and order while protecting citizens from each other and foreign enemies.

Another governmental role, universally acknowledged, is the provision of goods and services that individuals cannot provide for themselves. Obvious examples include the construction of our infrastructure and the provision of education. Basic social assistance to help vulnerable members of our community who are faced with circumstances beyond their control is now considered a right of our citizenry.

Finally the government should play a part in regulating the economy. Very few of us have first-hand knowledge of the Great Depression of the last century, but history has taught us that our elected representatives have a responsibility to make sure that such an economic catastrophe never occur while on their watch.

That being said, govern-

Are You In the Market for a New Home?

As of January 1, 2018 home owners, or those hoping to become one, will be subject to new mortgage rules. Here is how they work:

Home buyers are classified into two categories: (a) those who "put down" less than 20% of the cost of the property as a downpayment and therefore must purchase "mortgage insurance" at time of closing and (b) those with downpayments in excess of 20% of the purchase price who are not required to purchase this insurance.

This classification of buyers will continue into the foreseeable future, but the mortgage rates to which they will qualify will change.

The "stress test" concept is designed to assure mortgagors that customers in category (a) will be able to withstand mortgage rates in the future that may be higher than those they are currently available.

Consider the following scenario:

The Smith household is currently in the market to become first time home buyers. They enjoy an annual family income of $100000 and must now consider how much of a "home" they can afford to purchase.

Step One: Look at Mortgage Affordability

Lenders look at two ratios when determining the amount of mortgage funds they would be willing to lend to prospective customers. They are based on the Canada Mortgage and Housing Corporation's mortgage affordability rules.

(i) the first rule considers what is termed the Gross Debt Service Ratio. To satisfy this condition, "housing costs", defined to include mortgage principal and interest, property taxes and heating expenses, must not exceed 32% of the borrower's gross annual income. In the case of condominium purchases, one-half of the monthly fees are also added as a housing cost; and (ii) the second rule considers what is termed the Total Debt Service Ratio. It looks at the borrower's total debt load, including housing costs, credit card interest, car payments and other loan expenses. It must not exceed 40% of the borrower's annual income.

The Smiths, once they move into their new home, expect their property taxes will be $5000/ year and their heating costs to be $2000/year.

To apply the affordability index, under (i) above, look at the Smith's annual gross income of $100000 and multiply by 32/100. This gives them $32000 to "play with".

The property taxes and heating costs will cost $7000, so they can afford a mortgage with blended monthly payments of $25000 per annum or $2083 per month.

Step Two: Figure Out Your Downpayment

Before going into specifics, the Smiths must determine how much of a downpayment they should put down. If it is at least 20% of the cost of the house, they will not need to purchase mortgage insurance. If they decide to make a smaller downpayment, the premium paid on the insurance will be added to the mortgage proceeds and paid off along with the "rest" of the mortgage. This may be a good choice as it allows them to keep some funds back for emergencies or perhaps furnishing the home.

Step Three: Look at your Mortgage Alternatives

<u>Downpayment of at least 20%</u>

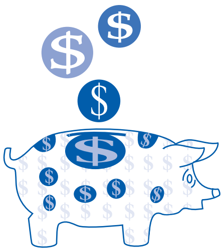
(a) Under the pre-2018 rules, the Smiths could put down $115000 and obtain a five-year fixed mortgage with a 25 year amortization at 2.83% interest (the current rate). Monthly payments would be $2085 (within their mortgage guidelines) and they could afford to buy a home that would cost them $560000.

(b) Under the new 2018 rules, the Smiths could put down $100000 and obtain a five-year fixed mortgage with a 25 year amortization at 4.89% interest (the Bank of Canada's five-year "Benchmark rate"). Monthly payments would be $2085 and the house they could afford to buy could be as much as $460000.

<u>Downpayment of less than 20%</u>

(c) Under the pre-2018 rules, the Smiths could put down $50000 and obtain a five-year fixed mortgage with a 25 year amortization at 3.09% interest (the current rate). Monthly payments would be $2150 as they would have to pay for the mortgage insurance. They could afford a $485000 home.

(d) Under the new 2018 rules, the Smiths could put down $50000 and obtain a five-year fixed mortgage with a 25 year amortization at 5.09% interest (2% higher than the "contractual rate" they would otherwise be paying). Monthly payments would be $2150 as they have to pay for



ment involvement in our daily lives has reached well beyond areas to which many of us are comfortable. It has crept into every aspect of our lives from the time we awaken in the morning to the time we "hit the sack" at night.

Government philosophy has become very much a "we" versus "you" mentality. It believes that it "knows more" than the average individual who cannot be trusted to make the "right" decisions that affect his life. Since that is the case, they will provide their guidance every step of the way,

They have a very low opinion of the "common man" and his ability to bear responsibility for the choices he makes and the actions he takes. They do not understand that with almost universal access to the internet, individuals have more and better opportunities to research available options and decide for themselves how they want to live their lives.

the mortgage insurance. The house they could afford to buy could be as much as $405000,

Step Four: Look at the Big Picture

The Smiths must consider two more things: (a) under the new rules, can they find a house that they would consider buying for $460000 with a downpayment of $100000 or $405000 with a $50000 downpayment, keeping in mind that the "average price" of a new home in Canada is $485000?; and (b) the "new rules" only pertain to financing obtained from "federal" financial institutions under the jurisdiction of the Office of the Superintendent of Financial Institutions. They may be able to qualify for additional funds from private lenders or institutions that are governed by provincial regulators. These institutions will have their own set of rules and the Smiths will have to see what they are and if they qualify.

Step Five: Decision Time!!

The last point to consider is "if not now, when". All new home buyers wonder about the timing of their purchase. Are housing prices likely to drop in the near future and they should perhaps wait a little while longer or are they going to continue to increase and it would be better to bite the bullet now. Everyone has their opinion. We'll have to ask the Smiths how they feel and the course of action they will take.

HST and Small Business (Part One)

The traditional method of determining an entity's liability for HST can be summarized as follows:

(a) **determine HST collected:** the entity, when issuing a sales invoice, must segregate the "sales price" of the item from the HST that it is collecting on the sale. This allows it to easily determine the amount of HST collected during any given period;

(b) **determine HST paid** (termed ITC's or"input tax credits"): the entity must separate the actual cost of the item and the HST that is associated with it;

(c) **calculate (a) - (b)**: if positive, the entity owes HST to the government and if negative, it can claim back this amount as a refund.

In the example at hand (see Part Two below) the entity collected $83065 times 13% or $10798 in HST and paid out input tax credits of $20412 times 13% or $2653. The entity's HST liability is $8145.

As a concession to small business, two other methods are allowed:

(i) **The "quick method"** is available to entities with revenues of less than $400000 except for registrants who provide legal and accounting services, hospitals, charities and other non-profit organizations. The entity must "elect" to use this method but can revoke the election at any time.

It concentrates on the HST collected by the entity by allowing registrants to total up their revenues without having to separate out the HST. They then apply the following formula and rules (using the example at hand):

The company's revenues were $83065 and the HST collected at 13% was $10798.

When added together the sum is $93863. The first $30000 attracts HST at rate of 7.80% or $2340 and the remainder calls for a rate of 8.80% or as applied to the example at hand, $63863 times .088 or $ 5620. The HST liability is therefore $7960.

However, since the company collected $10798 and "only" has to pay back $7960, the difference is added to the revenues for income tax purposes. Their reported revenues now become $2838 plus $83065 or $85903. Reported expenses are also adjusted by allowing the actual expenses and the HST component or $23065.

Note: It is not always obvious whether the quick method will be "cheaper" than the traditional method in your particular circumstances. You may have to work out both calculations and see which one saves you the most money

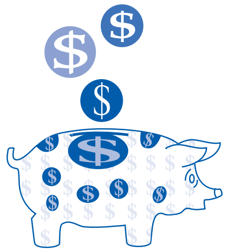
(ii) **The "simplified method"** is available to entities with revenues of less than $1000000 and Canadian purchases of less than $4000000.

It concentrates on the HST paid by the entity by allowing registrants to total up their "HSTable" purchases without having to separate out the HST. They then multiply the total amount spent by 13/113 to arrive at the input tax credits (in Ontario).

In the example at hand, the total expenditures of the company were salaries on which there is no HST of $60000 and HSTable expenses of $23065.

By multiplying $23065 by 13/113 we determine the ITC's are $2653 and actual expenses incurred were $20412.

HST and Small Business (Part Two)



We have a well-educated and mature citizenry, capable of making informed choices without being "spoon fed" every step of the way. Each successive elected government feels it is their responsibility to build on what other administrations have legislated in the past. It is time that they understand that just because they have gained the confidence of the people, they do not necessarily know what is "best" for them in all circumstances. They should show true leadership by cutting back on some of the "red tape" that is already in place and be pleasantly surprised how our society will continue to function effectively without all their interventions.

Here's a reason that HST registrants should use the Quick Method whenever possible.

The accompanying simplified financial statements show revenue earned of $83065 and HST collected of $10798.

In the first column, HST is reported according to the "regular method". The entity's input tax credits of $2653 are compared to the HST collected and it must remit $8145 to the government.

You will note that expenses are reported without their respective HST amounts so income before salaries is $62653. The $60000 salaries bring the income before taxes to $2653. Corporate taxes are $398.

The shareholder's remuneration for the year is made up of the $60000 salary and the dividend that equals the net income for the year ($2255).

Total taxes total $12078 as per the accompanying table.

In the second column, HST is reported according to the "quick method". The entity's HST liability is determined according to the mathematical formula applied on revenues earned. The amount owing is then calculated and the difference between the amount owing and the amount collected is brought into income. In this example the amount included in income is $2838.

On the other hand, expenses are recorded with their HST's included. Here they now total $23065. Add the $60000 salaries and income before taxes is determined to be $62838 and corporate taxes are $426.

The shareholder's remuneration for the year is made up of the $60000 salary and the dividend that equals the net income for the year ($2412).

Total taxes are $12134 but the entity "saved" $185 in HST ($7960 vs $8145). When this is factored in, the total taxes remitted to the government are $11948 which is $130 less than the amount calculated under the "regular method".

	Regular Method $	Quick Method $
Balance Sheet		
Cash	10898	10898
HST Liab	8145	7960
I/T Liab	398	426
Due to Sh	2255	2412
	10798	10798
Sh Cap	100	100
Ret Earn	NIL	NIL
	100	100
	10898	10898
Income Statement		
Revenue	83065	83065
HST incl in income		2838
	83065	85903
Expenses (not incl salaries and HST)	20412	
Expenses (not incl salaries)		23065
Inc bef salaries	62653	62838
Salaries	60000	60000
Inc bef inc taxes	2653	2838
Corp I/T	398	426
Net income	2255	2412
Dividend paid	-2255	-2412
R/E	NIL	NIL
Total Taxes Paid to Government		
Personal taxes	11680	11707
Corp taxes	398	426
HST "savings"		-185
	12078	11948