LEARNING ABOUT TAXES WITH INTUIT PROFILE: 2016 TY

Chapter 1 - Basics of taxation

EDUCATION PROGRAM

Contents

Chapter 1 - Basics of taxation

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Introduction to Chapter 1

Estimated time

About 10-14 minutes

In this chapter, you will learn:

- what taxes are and why we pay them;
- how your tax dollars are spent;
- what the characteristics of a tax system are; and
- about Canada's tax system, including a brief history of taxation and the types of taxes we pay in Canada.

To illustrate the concepts and exercises presented in this course, we will introduce a fictitious individual who will be filing an income tax and benefit return for the first time.

Let's meet Paul

Our main character, Paul, is a 17-year-old high school student who spends most of his free time with his friends Omar and Anya. Paul doesn't really know anything about income tax although he has heard his parents talk about it.

To earn some extra money, Paul has started a part-time job at a local store. He works after school and on weekends.

Paul works 24 hours a week and is paid \$11.00 an hour. After two weeks of working, he is looking forward to getting his first cheque for \$264.00 (24 hours × \$11.00 × 2 weeks). He has already decided how he is going to spend his money.

On payday, Paul stops by his work with Omar to pick up his cheque. When he opens his pay envelope, he is disappointed to find that instead of getting \$264.00, he only received \$217.47.

"What's going on?" Paul asks, "Some of my pay is missing. They have taken \$46.53 in deductions." Paul shows his pay stub to Omar and there are deductions for employment insurance (EI) and income tax.

Paul Lebrun	Employee #: 9876543210	Employer #: 666-F	Pay from: 2015/10/10	To: 2015/10/23	Date: 2015/10/30

STATEMENT OF EARNINGS				DEDUCTIONS		
EARNINGS	HOURS	RATE	CURRENT AMOUNT	WITHOLDINGS	CURRENT AMOUNT	YEAR-TO-DATE
001 BASIC PAY	24.00	11.00/hr	264.00	EI	4.96	4.96
				CPP/QPP	0.00	0.00
				INCOME TAX	41.57	41.57

SUMMARY	GROSS PAY	DEDUCTIONS	NET PAY	CHEQUE #
CURRENT	264.00	46.53	217.47	0044853
YEAR-TO-DATE	264.00	46.53	217.47	

"What are these deductions for, like this EI?" asks Paul.

"I think they are taking money from your pay for some different taxes," offers Omar.

"Well, I don't know, but I am going to ask around. I want to find out where my money is going," says Paul, who is now determined to learn about taxes. "I would also like to know where this whole thing of making people pay taxes got started."

What are taxes?

Tax is a mandatory payment made by individuals and corporations to government. It can be levied upon things such as income, property, and sales. Taxes are used to support the government and the programs and services it provides.

Sometimes different levels of government collect tax. For example, in Canada individuals pay:

- federal taxes used for programs such as National Defence, Old Age Security, Canada child tax benefit, and transfers to provinces and territories;
- provincial and territorial taxes used for services such as bridges and highways, education, hospitals, and wildlife conservation; and
- municipal taxes for services such as police, ambulance and fire services, libraries, parks and playgrounds, public transportation, and garbage and recycling collection.

Without a tax system, a government would not have any money to provide services.

Citizens support the tax system by paying their fair share of taxes. In return, they benefit from the programs and services provided by the government.

How are your tax dollars spent?

Many of the benefits you enjoy today are made possible through taxes. The government collects taxes to pay for the facilities, services, and programs that it provides. Canada's tax system pays for such things as:

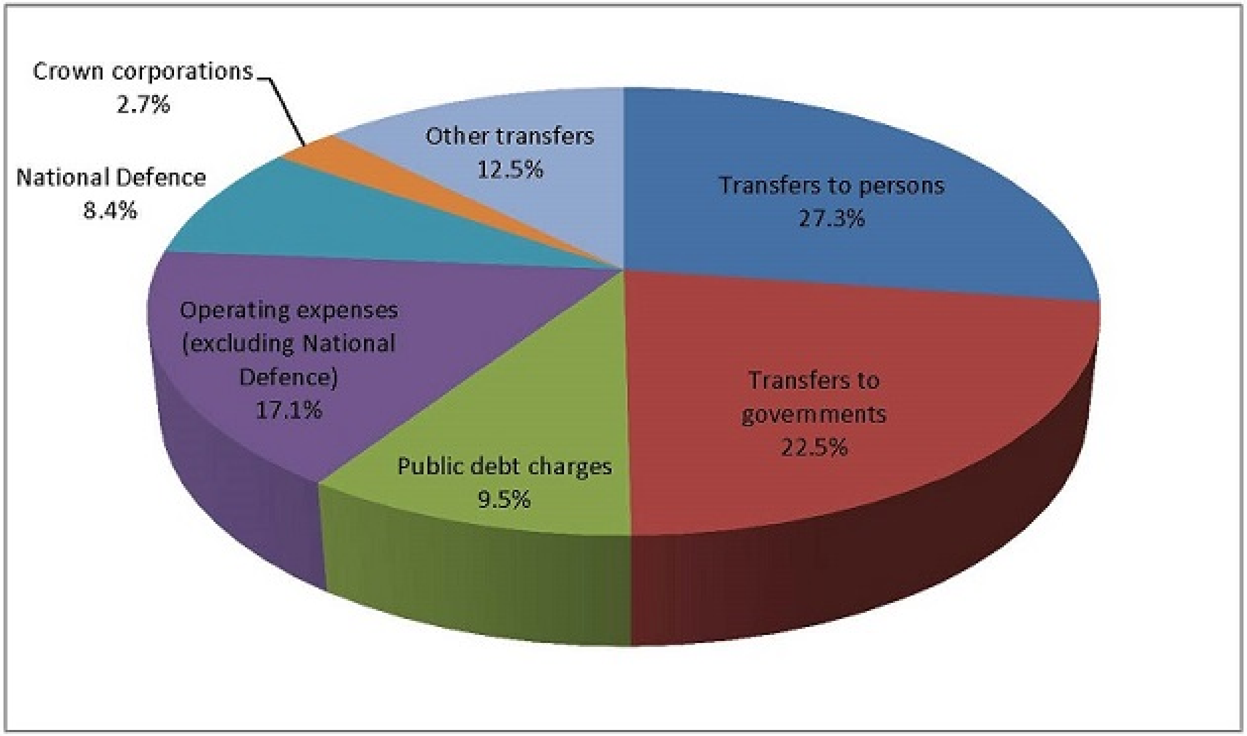
- roads;
- public utilities;
- education;
- health care;
- economic development;
- cultural activities;
- defence;
- law enforcement; and
- other programs and services.

Tax revenue also helps redistribute wealth to benefit lower-income families, students, seniors, and people with disabilities. Tax revenue funds social programs such as:

- Old Age Security;
- employment insurance;
- Canada child tax benefit;
- universal child care benefit; and
- working income tax benefit.

The tax system also supports businesses and boosts the economy in other ways.

Here's a look at the federal expenses for the fiscal year of 2014-2015.



More information on government expenditures for 2014-2015 is contained in the Annual Financial Report of the Government of Canada. http://www.fin.gc.ca/afr-rfa/2015/index-eng.asp

Characteristics of a tax system

A tax system is defined by six characteristics:

1. who pays the tax;
2. the tax base;
3. the rates to be applied to the base;
4. general exemptions;
5. general deductions; and
6. other measures, such as how tax is to be paid.

These characteristics determine how much revenue is produced, how fair the tax system is, and its ability to produce economic growth.

A tax system needs to benefit all and it should be flexible, so the government can use it to achieve specific social and economic objectives. Finally, the process for administering the tax system has to be practical, efficient and fair.

In Canada, the federal government follows these guidelines when it develops new tax legislation:

- **Fairness** - the tax system needs to ensure that all taxpayers share the tax burden equally. People with similar financial circumstances should receive the same tax treatment. In other words, all high-income earners whether they are individuals or corporations, should pay their fair share of tax. Also, similar products should be subject to the same rate of sales tax.
- **Stability** - the federal government needs a stable and dependable source of tax revenue so it can manage the country's economy.
- **Canadian priorities** - the tax system helps meet the national/provincial/territorial and economic needs that are priorities for most Canadians.
- **Consultation** - the federal government is committed to consulting Canadians before making final legislative proposals for tax amendments.

Canada's tax system has evolved over many years to accommodate the needs of an increasingly complex society. However, the guiding principle has always been the same: our elected Parliament must have ultimate control over tax legislation.

Canada's tax system is based on the self-assessment principle, which means that taxpayers complete their tax return each year to report their income and to calculate whether they owe tax or receive a refund. It is considered the most economical and efficient way to collect income tax.

We will learn more about the self-assessment system in Chapter 3.

History of taxes

Many people assume that taxes are a recent development and that our ancestors did not have to pay them, however, this is not the case.

Of course in the past, people did not always pay with money. Instead, most paid their tax bill with something they produced or gathered, such as grain, fish, minerals, or animals.

History of taxes in the world
Tax as we know it today, existed in various forms in different societies throughout civilization. Kings, queens, chiefs, rulers, and people in authority were responsible for imposing and collecting taxes from the people they ruled. What was taxed, when it was taxed, and how much tax was imposed varied from society to society?

The French and Latin of the 13th century were credited with the first use of a word similar to tax. The French had *Taxer* and the Latin used *Taxare* to describe the following acts: to estimate, to assess, or to touch repeatedly.

History of taxes in Canada

Before Confederation
The colonial governments collected taxes and sent them to the two mother countries, England and France. The colonial governments usually collected revenue by charging customs duties. In 1650, Louis XIV of France imposed the first recorded tax in Canadian history. It was an export tax of 50% on beaver pelts and 10% on moose hides leaving his colonies.

1867 - *The British North America Act* was passed, allowing the Canadian government to raise money by taxation. In the next 50 years, the federal government used only indirect taxes such as customs duties and excise taxes to raise the money it needed. Direct taxation was left to the only four provinces: Ontario, Quebec, Nova Scotia, and New Brunswick.

The Fathers of Confederation divided the governmental responsibilities of this new country between the federal and provincial governments. The most expensive areas of responsibility - building railways, roads, bridges, and harbours went to the federal government. The provincial governments were responsible for education, health, and welfare.

After Confederation

World War I - On August 4, 1914 Britain declared war on Germany and as a British colony, Canada joined in the Great War at Britain's side. The pressures of financing World War I soon brought major changes to the Canadian tax system.

1916 - The federal government used a new method of direct taxation by starting a corporation tax known as the business profit war tax. It affected corporations only if their profits were more than a certain percentage of their invested capital. Although this was not income tax as we know it today, it was a milestone in the history of Canadian taxation.

1917 - The federal government, led by Sir Robert L. Borden, introduced the *Income War Tax Act*. "I have placed no time limit upon this measure . . . a year or two after the war is over, the measure should be definitely reviewed," stated Sir Thomas White, Minister of Finance.

In July 1917, the federal government imposed a general tax on corporate and personal income that was collected by the Department of Finance.

1927 - The Department of National Revenue was created.

1952 - For the first time, the Department of National Revenue became involved in an area other than income tax when it began to collect old age security tax on personal and corporate income. The department assessed this tax under the *Old Age Security Act*.

At this time, the Department processed tax returns by hand. Gradually, computers came onto the scene, and programs were developed to process the returns.

January 1, 1991 - The federal government replaced the federal sales tax with the goods and services tax (GST).

May 2007 - The Government of Canada introduced the Taxpayer Bill of Rights, which outlines what a taxpayer can expect from the CRA.

Common Canadian taxes

In Canada, there are various taxes, tariffs, and duties. In this section, we will briefly explain the following common Canadian taxes and salary deductions:

- income tax;
- employment insurance (EI) premiums;
- Canada Pension Plan (CPP) contributions;
- provincial sales taxes (PST); and
- goods and services tax/harmonized sales tax (GST/HST).

But before we get started, let's check back in on Paul.

Paul and Omar now go to the bank where Paul deposits his cheque and takes out some money to go shopping. They head to the mall to buy video games. On the bus, the subject of taxes comes up again.

"So, if some of my money is taken off my cheque for these deductions, how come they didn't take any money off our cheques when we did that landscaping job in the summer?" Paul asks Omar.

"My dad told me that I am supposed to file a tax return at the end of the year and I might have to pay some taxes on that money then," replied Omar. "You're going to have to file a return too you know."

"I don't understand this stuff," replied Paul, "What are income tax and employment insurance?"

Let us answer this question.

Source deductions

Income tax is tax collected on behalf of the federal, provincial, and territorial governments. The amount of income tax that you must pay is based on the amount of your taxable income (money earned minus allowable deductions) for the tax year.

Income tax is collected in various ways. Paul's employer has deducted income tax from his pay and remitted it to the Canada Revenue Agency. This is called a source deduction because the tax was deducted directly from Paul's income by his employer.

Paul didn't have deductions taken from his summer landscaping job because in his particular case, he was not considered an employee (he and Omar were helping Omar's neighbour build a patio and landscape his backyard).

If Paul did not pay enough taxes through source deductions, he may have tax owing when he files his tax return. Individuals who regularly have a balance owing may have to pay their income taxes by instalments.

Employment insurance (EI) provides temporary financial assistance to unemployed Canadians who have lost their job through no fault of their own, while they look for work or upgrade their skills. Canadians who are sick, pregnant, or caring for a newborn or adopted child, as well as those who must care for a family member who is seriously ill with a significant risk of death, may also be assisted by EI.

EI premiums have been deducted from Paul's wages. If Paul becomes unemployed, he may be entitled to EI benefits.

The **Canada Pension Plan (CPP)** provides contributors with income when they lose income because of retirement, death, or disability. In the event of death, the plan provides benefits to the contributor's survivors. With very few exceptions, every person in Canada over the age of 18 who earns a salary must pay into the Canada Pension Plan. For employees in Quebec, the employer deducts Quebec Pension Plan (QPP) contributions instead of CPP contributions.

CPP contributions are not being deducted from Paul's wages right now because he is under 18. However, when Paul does turn 18, his employer will begin to deduct CPP contributions from his pay.

Now, let's check back in on Paul and Omar.

When Paul and Omar get to the gaming store they check out the latest games. They have, for the moment, forgotten their discussion about taxes.

Eventually, Paul decides to buy one new game. When the cashier rings up the sale the total is more than the price shown on the game. Paul says to the cashier, "The price sticker on the game says $29.95."

The cashier checks the receipt and responds, "Yes, that is how it rang up....$29.95 plus tax."

"Oh, I forgot about tax," says Paul. He pays the cashier and hurries out of the store with Omar, to go catch the bus home.

Other taxes

Provincial sales tax (PST) is a tax that is collected in most provinces when something is sold (like Paul's video game). It is paid on top of the purchase price of the item. The items that are taxed and the tax rate vary from province to province.

Goods and services tax (**GST**) is a federal tax that is charged on the sale of most property and services in Canada at a consistent rate of 5%. For example, if Paul's video game had cost $10, the GST would have been 50 cents.

In some provinces, the GST is combined with the PST and the two are collected together at a combined rate. This is known as **harmonized sales tax (HST)**.

NOTE: GST/HST is not charged on basic groceries, prescription drugs, most health care and dental services, and used residential housing, among others.

Chapter 1 - What we learned

Congratulations! You have completed Chapter 1. So far we have looked at:

- what taxes are and why you pay them;
- how your tax dollars are spent;
- characteristics of a tax system;
- the history of taxes in the world and Canada; and
- common Canadian taxes.

If you understand what we have covered, then go ahead and test your knowledge with the short quiz on the next page. If you need to, you can go back and review any of the topics in the course.

Chapter 1 Quiz

Now that you have finished this chapter, take a few minutes to answer the following quiz. This exercise will help you to review what you have learned.

The following statements are either **True** or **False**.

Quiz

1. The money collected by the federal government is spent on many things including:
    - payments to people;
    - transfers of money to provinces and territories for their health care services;
    - other transfers;
    - national defence;
    - transfers to Crown corporations;
    - operating and capital expenses; and
    - interest on the public debt.

    True False

2. A tax system has certain characteristics including:
    - who pays the tax;
    - the tax base;
    - the tax rates;
    - general deductions and exemptions; and
    - how tax is to be paid.

    True False

3. Taxes are a new concept and have only been collected since 1950.

    True False

4. Goods and services tax (GST) is applied to most goods and services sold in Canada.

    True False

5. If you are 18 years old or over and working, you may have to make contributions to the Canada Pension Plan.

    True False

Excellent! You can now continue on to Chapter 2.

Answers

Chapter 1 Quiz

Question 1: True

Question 2: True

Question 3: False

Question 4: True

Question 5: True