CHAPTER 10: LEGISLATION IN LABOUR MARKETS

Introduction to Discrimination in Labour Markets

What you'll learn to do: analyze the economic implications of discrimination and immigration policies

Discrimination occurs in a labour market when employers pay workers with the same economic characteristics, such as education, experience, and skill, are paid different amounts because of race, gender, religion, age, or disability status. In the United States, female workers on average earn less than male workers, and black workers on average earn less than white workers. There is controversy over the extent to which pay differences are caused by differences in factors like education and job experience, or by pure discrimination.

Free markets can allow discrimination to occur, but the threat of a loss of sales or a loss of productive workers can also create incentives for a firm not to discriminate. A range of public policies can be used to reduce earnings gaps between men and women or between white and other racial/ethnic groups: requiring equal pay for equal work, and attaining more equal educational outcomes.

In this section, we will examine these policies as well as the economic take on immigration.

Attribution

10.1 - TAXES AND TAX PLANNING

Learning Objectives

Sources of Taxation and Kinds of Taxes

- Identify the levels of government that impose taxes.
- Define the different kinds of incomes, assets, and transactions that may be taxed.
- Compare and contrast progressive and regressive taxes.

The Canadian Federal Income Tax Process

- Identify the taxes most relevant for personal financial planning.
- Identify taxable incomes and the schedules used to report them.
- Calculate deductions and credits.
- Compare methods of tax payment.

Record Keeping, Preparation, and Filing

- Identify sources of tax information.
- Explain the importance of verifiable records and record keeping.
- Compare sources of tax preparation assistance.
- Trace the tax review process and its implications.

Taxes and Financial Planning

- Trace the tax effects of life stages and life changes.
- Identify goals and strategies that provide tax advantages.
- Identify tax advantages that may be useful in pursuing your goals.

- Discuss the relationship of tax considerations to financial planning.

Introduction

The design of a tax system reflects the society's view of both the government's responsibilities toward its citizens and of its citizens toward their government. It is an important source of revenue for all governments, and it is largely used to pay for public programs and services.

The federal and provincial governments were granted the authority to make laws under the Constitution Act, 1867. Provinces and territories may assign some law-making authority to municipalities. Since federal, provincial or territorial, and municipal governments can all enact different tax laws, "this leads to a complex and diverse system of taxation in Canada" (Wadden, 2016, p. 128).

The authority of the federal government to make laws pertaining to "Indians, and lands reserved for Indians" has been questioned by Indigenous peoples, many of whom argue that there is no foundation for this in the treaties (Wadden, 2016, p. 128). This brings into question the Indian Act itself and its authority to define the rights of Indigenous peoples. Section 35 of the Constitution Act, 1982 recognizes the inherent Aboriginal right of self-government. The Indian Act will become less relevant as more Indigenous communities move toward self-government (Wadden, 2016).

Link It Up

Visit the Financial Consumer Agency of Canada's webpage 8.1.3 What taxes you pay [New Tab] (https://www.canada.ca/en/financial-consumer-agency/services/financial-toolkit/taxes/taxes-1/4.html) for an illustration of the total amount of revenue that governments in Canada collect from each type of tax.

According to the CBC, in the 2013–2014 fiscal year, the Canadian government spent $276.8 billion, "and 80 per cent of it, or $219.9 billion, came from tax revenue" (CBC, 2015).

Many people tend to focus on taxes only in the lead-up to the April 30 deadline to file personal income tax.

But successful financial planning requires an effective tax strategy throughout the whole year, as well as a basic understanding of the tax rules and regulations. As Kapoor et al. (2015) point out, there are common goals related to tax planning:

- knowing the current tax laws and regulations that affect you,
- maintaining complete and appropriate tax records, and
- making employment, purchase, and investment decisions that leave you with the greatest after tax cash flows and net wealth (p. 172).

Manny Jules, the chief commissioner and one of the creators of the First Nations Tax Commission, an institution that helps securitize property tax revenues and oversee the bylaw approval process, suggests that "taxation is a mechanism to promote the economic independence, and stability of Aboriginal communities" (Wadden, 2016, p. 126). Jules believes that taxation is a fundamental government power that can help bands advance by creating a better, more accountable system, one that helps them to generate their own revenue; "otherwise, you're always depending on someone else to do something for you" (Gerson, 2012). Taxation is an important means for Indigenous governments to generate their own independent revenues instead of relying on federal transfer funds or "Indian monies" under the Indian Act. Indigenous governments have wide discretion to apply tax revenues to their own priorities. During the past twenty-five years, many Indigenous governments in Canada "have enacted laws imposing direct taxes within their reserves or settlement lands. Aboriginal government taxes may include real property tax, sales tax, income tax and certain provincial-type commodity taxes" (INAC, 2014).

We will review the different types of taxes utilized by Indigenous, federal, provincial or territorial, and municipal governments throughout this chapter.

Sources of Taxation and Kinds of Taxes

Any government that needs to raise revenue and has the legal authority to do so may tax. Tax jurisdictions reflect government authorities. Taxation is used by governing bodies to fund public services such as "water, sewer, roads, garbage collection, education, and health care" (Wadden, 2016, p. 125).

In Canada, federal, provincial or territorial, and municipal governments impose taxes. Many Indigenous governments also impose taxes. Individuals and businesses in Canada must pay the following taxes: property tax, income tax, and sales tax. Similarly, in many countries there are national, provincial or state, county, and municipal taxes. Regional economic alliances, such as the European Union, may also levy taxes. The following are common taxes paid by people in Canada every year:

- Income taxes on employment and other income that you receive

- Sales taxes such as the Goods and Services Tax (GST) or Harmonized Sales Tax (HST) and the Provincial Sales Taxes (PST)
- Property taxes, usually charged by local governments on the value of land and buildings
- Customs duties or tariffs on certain imported and exported products
- Contributions by employers and employees to social security plans such as the Employment Insurance (EI) system, the Canada Pension Plan (CPP), the Québec Pension Plan (QPP), or the Québec Parental Insurance Plan
- Health services taxes charged in some provinces for access to the provincial health-care system
- Other taxes such as motor vehicle licences and natural resource taxes. (FCAC, 2017)

Governments tax income because it is a way to tax broadly based on the ability to pay. Most adults have an income from some source, even if it is a government distribution. Those with higher incomes should be able to pay more taxes, and, in theory, they should be willing to do so, for they have been more successful in or have benefited more from the economy that the government protects.

According to the Financial Consumer Agency of Canada, the following are definitions of different types of taxes:

Tax: A compulsory financial contribution imposed by law to raise government revenue.
Tariff: A charge (or list of charges) imposed by a government on imports or exports.
Duty: A specific tax imposed by law on imports or exports (same as tariffs).
Fee: A payment for services or for a particular privilege. (FCAC, 2017)

Income tax is usually a **progressive tax**: the higher the income or the more to be taxed, the greater the tax rate. The percentage of income that is paid in tax increases as income rises. Those income categories are called **tax brackets**.

Income tax is the main source of revenue for the federal government and is a direct tax on the income of individuals and businesses. Income tax can be levied by the federal, provincial or territorial, and Indigenous governments. The Income Tax Act provides the federal government with the authority to collect income tax. Through tax-collection agreements with most of the provinces and territories, the federal government has the authority to collect provincial or territorial income taxes on their behalf. **First Nations Personal Income Tax Administration agreements** have been entered into by a number of First Nations with the Government of Canada. According to Wadden (2016), these agreements allow self-governing First Nations "to exercise their power of direct taxation, to impose taxes on the income of individuals, and to enter into tax-collection agreements with Canada to collect taxes payable under the First Nations Tax Act" and remit them back to the applicable First Nation (p. 134).

With regard to the federal and provincial or territorial governments, your income, minus the deductions for which you qualify, must be calculated in order to arrive at a taxable income. You are taxed first by the federal government and then by your provincial or territorial government.

In Canada, we operate under a marginal tax rate system. **Marginal tax** is the amount of tax paid on an additional dollar of income. Unlike the flat tax rate, where you pay the same rate of tax no matter what your income, a marginal tax rate system increases the tax rate as income rises. Knowing one's marginal tax rate can help you make effective long-term financial decisions.

For example, if you know you will be taxed at a much higher rate because you will be earning significantly more income in the coming year, you might want to consider investing in an RRSP. However, this strategy only makes sense if you can reasonably assume that you will be earning a much lower income in retirement and therefore paying a lower income tax in retirement. (Please see Chapter 11 for more information on RRSPs.)

The rate at which you are taxed is categorized into tax brackets and is determined by the government. Table 10.1a shows an overview of 2018 federal tax brackets.

Table 10.1a Canadian Income Tax Brackets in 2018
Data Source: Canada Revenue Agency, 2018. Table created by Bettina Schneider, 2018.

If your taxable income was between	Federal Marginal Tax Rate
$0-$46,605	15%
$46,606 up to $93,208	20.5%
$93,208 up to $144,489	26%
$144,489 up to $205,842	29%
$205,842 and up	33%

Federal tax and tax for all provinces and territories (except Quebec) is calculated the same way. Marginal tax rates calculate the amount of combined federal and provincial taxes payable on the next dollar of income. To calculate your combined federal and provincial tax bill in each province and territory as of June 15, 2018, you can use the 2018 Personal tax calculator [New Tab] (https://www.ey.com/ca/en/services/tax/tax-calculators-2018-personal-tax)found on Ernst & Young's website.

Link It Up

For a list of provincial and territorial tax rates, visit the Government of Canada's Provincial and territorial tax rates for individuals [New Tab] (https://www.canada.ca/en/revenue-agency/services/tax/individuals/frequently-asked-questions-individuals/canadian-income-tax-rates-individuals-current-previous-years.html#provincial) webpage.

Tax is levied on income from many sources:

- wages (selling labour),
- interest, dividends, and gains from investment (selling capital),
- self-employment (operating a business or selling a good or service),
- property rental,
- royalties (rental of intellectual property), and
- “other” income such as alimony, gambling winnings, or prizes.

A **sales tax** or **consumption tax** taxes the consumption financed by income. In Canada, sales taxes are imposed by the federal and provincial governments. Sales taxes are said to be more efficient and fair in that consumption reflects income (income determines one’s ability to consume and therefore one’s level of consumption). Consumption is also hard to hide, making sales tax a good way to collect taxes based on one’s ability to pay. Consumption taxes typically tax all consumption, including nondiscretionary items such as food, clothing, and housing. Opponents of sales tax argue that it is a **regressive tax**, because those with lower incomes must use a higher percentage of their incomes on nondiscretionary purchases than higher-income people do. In Canada, there are three types of sales taxes:

1. **Provincial Sales Tax (PST)**: currently collected in British Columbia, Saskatchewan, Manitoba, and Quebec.
2. **Goods and Services Tax (GST)**: a value-added tax (general consumption tax) levied by the federal government on most products except for essentials such as groceries, rent, and medical services. GST is an example of an excise tax, an indirect tax imposed on the sale of a particular product.
3. **Harmonized Sales Tax (HST)**: also a value-added tax that is a single, blended combination of PST and GST, collected by Ontario, New Brunswick, Newfoundland and Labrador, Nova Scotia, and Prince Edward Island.

Sales tax is an example of an indirect tax because it involves an intermediary that collects tax from a person or organization and remits it to the entity that is imposing it (Wadden, 2016, p. 128). The seller (the taxation body) collects the tax from the buyer.

The **value-added tax (VAT)** or GST is a consumption tax, but it differs from the sales tax, which is paid only by the consumer as an end user. With a VAT or GST, the value added to the product is taxed at each stage of production. Governments use a VAT or GST instead of a sales tax to spread the tax burden among producers and consumers, and thus to reduce incentive to evade the tax. A consumption tax is a regressive tax. When travelling abroad, you should be aware that a VAT may add substantially to the cost of a purchase (i.e. a meal, accommodations, etc.).

Excise taxes are taxes on specific consumption items such as alcohol, cigarettes, motor vehicles, fuel, or highway use. In some provinces, excise taxes are justified by the discretionary nature of the purchases and may be criticized as exercises in "social engineering"—using the tax code to dictate social behaviours. For example, people addicted to nicotine or alcohol tend to purchase cigarettes or liquor even if an excise tax increases their cost and are therefore a reliable source of tax revenue.

Property taxes are used primarily by local—municipal, provincial or territorial, state, and county—governments, and are most commonly imposed on real property (land and buildings), but also on personal assets such as vehicles and boats. Property values theoretically reflect wealth (accrued income) and thus one's ability to pay taxes. Property values are also a matter of public record (real property is deeded, whereas boats or automobiles are licensed), which allows more efficient tax collection. First Nations property may be taxed under bylaws passed by band councils, which may have authority under section 83 of the Indian Act or the 2005 First Nations Fiscal and Statistical Management Act. Most of these bylaws exempt property that is owned by band members (Wadden, 2016).

First Nations and Tax Exemptions

First Nations individuals and businesses are subject to the same tax rules as other Canadian residents unless income is eligible for tax exemption under section 87 of the Indian Act and paragraph 81(1)(a) of the Income Tax Act. As of 2011, 55 per cent of the 1.4 million Indigenous people in Canada followed the same tax rules as other Canadians (Sagan, 2015). Exemption is meant to protect the property of those living on reserves. Those who have moved off reserve do not qualify for section 87 tax exemptions. EI premiums are mandatory deductions that on-reserve employers must make while CPP contributions are not. On-reserve employers can provide their employees with optional CPP coverage; however, they are not required to deduct CPP from non-taxable income (CRA, 2018). If goods are bought on, or delivered to, a reserve, they are also tax exempt. Section 87 of the Indian Act does not apply to First Nations that have self-government agreements.

The following factors are considered by the Canada Revenue Agency (CRA) with regard to employment income tax exemption:

- Name

- Address
- Whether address is located on reserve
- Whether the individual is registered or entitled to be registered under the Indian Act
- Proportion of duties that are performed on reserve
- Residence is also a factor (CRA, 2017)

Furthermore, according to Sagan (2015), businesses and self-employed individuals can be tax exempt if they meet several factors outlined by the CRA, including:

- Where the business or person carries out revenue-generating activities
- Where its customers are located
- Whether or not an office or books and records are kept on a reserve (Sagan, 2015)
- The interest of an Indian or a band in reserve lands or surrendered lands; and
- The personal property of an Indian or a band situated on reserve (Indian Act, 1985).

According to section 90, "certain items of personal property are protected from taxation or seizure by deeming that the property is situated on the reserve" (Wadden, 2016, p. 135). Currently, Métis and Inuit are not eligible to use the tax exemptions noted in the Indian Act. Tax exemptions are granted only to those individuals who meet the definition of "Indian" under the Act. Section 2 defines an Indian as "a person who pursuant to this Act is registered as an Indian or is entitled to be registered as an Indian" (Wadden, 2016, pp. 136–137). Those who have been removed from the Indian Register, or from a band list, may apply to be added. According to the CBC, "tax exemption for First Nations serves in part to protect aboriginal land and 'to make sure tax does not erode the use of Indian property on reserves' " (Sagan, 2015).

Whitecap Dakota First Nation levies a variety of different taxes on reserve that status and non-status First Nations must pay. Chief Darcy Bear believes First Nations communities that levy their own taxes "are following in the tradition of the 'sharing model' that's always been a part of First Nations culture" (Sagan, 2015). According to Chief Bear, "If your best hunter killed 10 buffalo, he doesn't eat 10 buffalo himself. He shares with the whole community" (Sagan, 2015). Chief Bear believes it is important to generate income through taxation so a First Nation can invest in its people (Sagan, 2015).

The following information, taken directly from the Indigenous and Northern Affairs Canada webpage Facts Sheet—Taxation by Aboriginal Governments, highlights the different types of First Nations government taxes currently in place:

- **First Nations Sales Tax (FNST)** (levied only by Indian Act bands): A tax that applies to on-reserve sales of alcoholic beverages, motor fuels or tobacco products.
- **First Nations Goods and Services Tax (FNGST)** (levied by Indian Act bands or Aboriginal self-

governments): A tax on the consumption that occurs within reserve or settlement lands.

- **First Nations Personal Income Tax (FNPIT)** (levied only by Aboriginal self-governments): To date, fourteen self-governing Aboriginal groups have enacted personal income tax laws and concluded related tax administration agreements with Canada.
- **Real Property Tax** under the Indian Act or the First Nations Fiscal Management Act: section 83 of the Indian Act provides a power for Indian Act bands to make bylaws for the taxation of land or interest in land in the reserve.
- **Self-Government Agreements**: The area of tax powers is also generally one of the subject matters addressed in self-government negotiations. Following the conclusion of self-government negotiations, many final agreements provide the Aboriginal government with the authority to impose direct taxes (e.g., real property tax, sales tax) on their citizens/members within their reserves or settlement lands.
- **Provincial-Type Taxes** (Indian Act bands or Aboriginal Self-Governments): The federal government has repeatedly expressed its willingness to facilitate tax administration agreements between *Indian Act* bands and provinces or territories. In 2006, the *First Nations Goods and Services Tax Act* was amended to enable the council of an *Indian Act* band that is listed in Schedule II to that Act to enact a law that imposes a direct tax like a particular provincial tax, if that province agrees and is also listed in the Schedule. A number of *Indian Act* bands and provinces have concluded such agreements. (INAC, 2016)

In August 2017, the Prime Minister announced that Indigenous and Northern Affairs Canada (INAC) would be dissolved and two new departments—Crown-Indigenous Relations and Northern Affairs Canada, and Indigenous Services Canada—would take INAC's place over time, after engagement with Indigenous peoples and others.

As you can see, there are a number of different taxes that exist in Canada. It is critical to understand which taxes apply to you so you can develop a taxation strategy that will help you to be successful in your financial planning.

Exercises

1. The T1 tax form is what individual Canadians use to complete their personal income tax

return. Please review the video Preparing T1 Returns – Reporting income and inputting T-slips on the T1 tax return (Part 2 of 5) [New Tab] (https://www.youtube.com/watch?v=x2N9D-jwnvA) (12:47) by CanadianTaxAcademy.com on how to complete a T1 General form. After watching this video, try completing the T1 General form [New Tab] (https://www.canada.ca/en/revenue-agency/services/forms-publications/tax-packages-years/general-income-tax-benefit-package.html).

2. Examine the tax returns that you filed last year. Alternatively, estimate your tax return based on your present financial situation. On what incomes were you (or would you be) taxed? What tax bracket were you (or would you be) in? How did (or would) your provincial, federal, and other tax liabilities differ? What other types of taxes did you (or would you) pay, and to which government jurisdictions?
3. There are six types of tax: property, consumption, value-added or goods and services tax, income tax, excise tax, and sales tax. Match the type of tax to the description below:
   • Tax on the use of vehicles, gasoline, alcohol, cigarettes, highways, etc.
   • Tax on purchases of both discretionary and nondiscretionary items
   • Tax on wages, earned interest, capital gain, and the like
   • Tax on home and land ownership
   • Tax on purchases of discretionary items
   • Tax on items during their production as well as upon consumption
4. In your financial planning journal, record all the types of taxes you will be paying next year and to whom. How will you plan for paying these taxes? How will your tax liabilities affect your budget?

The Canadian Federal Income Tax Process

The Canadian government relies most on income tax to provide for various types of government services. Income tax is the most relevant tax to consider for personal financial planning, as everyone has some sort of income over a lifetime. Most provinces and territories model their tax systems on the federal model or base their tax rates on federally defined income.

Taxable Entities

There are three taxable entities in the federal system: the individual or family unit, the corporation, and the trust. Personal financial planning focuses on your decisions as an individual or family unit, but other tax entities can affect individual income. Corporate profit may be distributed to individuals as a **dividend**, for example, which then becomes the individual's taxable income. Likewise, funds established for a specific purpose may distribute money to an individual that is taxable as individual income. A **trust**, for example, is a legal arrangement whereby control over property is transferred to a person or organization (the trustee) for the benefit of someone else (the beneficiary). In Canada, the estate pays the taxes owed to the government, not the beneficiaries.

Peace Hills Trust (PHT) is considered Canada's first and largest First Nation trust company. It is owned by the Samson Cree Nation of Maskwacis, Alberta, and has its head office in Maskwacis, Alberta. PHT was established in 1980 in order to serve "the financial needs of First Nations and their members, corporations, institutions and associations both on and off reserve" (PHT, 2017). It currently offers a wide range of financial and retail banking to more than twenty thousand personal and business customers, from both Indigenous and non-Indigenous backgrounds, in most regions of Canada through a network of eight regional offices and electronic services (PHT, 2017). As PHT states, "First Nation trusts have evolved a great deal over recent years. Now they may include impact benefit arrangements and economic development structures that provide growth and educational opportunities for First Nations" (PHT, n.d.).

While Canadian tax rules do not allow spouses to file joint income tax returns, couples in Canada can reduce the total amount of taxes they have to pay. If you choose to use tax preparation software, it may include an option to prepare a "coupled" return that maximizes your benefits while still generating two separate returns.

All taxable entities, including non-residents who receive income from sources in Canada, have to file a declaration of incomes and pay any tax obligations annually. Under Canada's tax system, what you pay in income tax is based on your residency status.

But not everyone who files a tax return actually pays taxes. For example, individuals with low incomes and tax exempt, non-profit corporations typically do not. All potential taxpayers nevertheless must declare income and show their obligations to the government. For the individual, that declaration is filed on the T1 General form, which can be accessed on the Canada Revenue Agency website.

Income

For individuals, the first step in the process is to calculate total income. Income may come from many sources, and each income must be calculated and declared. Some kinds of income have a separate form or schedule to show their more detailed calculations. The following schedules are the most common for reporting incomes separately by source.

Interest and Dividend Income

Interest income is income from selling liquidity. For example, the interest that your savings account, guaranteed investment certificate, and bonds earn in a year is income. You essentially are earning interest from lending cash to a bank, a government, or a corporation (though not all your interest income may be taxable). Dividend income, on the other hand, is income from investing in the stock market. Dividends are your share of corporate profits as a shareholder, distributed in proportion to the number of shares of corporate stock you own.

Employment Income

Employment income is payment received for personal effort, including salaries, wages, commissions, tips, bonuses, and taxable employee benefits.

Business Income

Business income is income from any sole proprietorship, partnership, corporation, or profession. For sole proprietors and partners in a partnership, business income is the primary source of income. Many other individuals rely on wages, but have a small business on the side for extra income. Business expenses can be deducted from business income, including, for example, business use of your car and home. If expenses are greater than income, the business is operating at a loss. Business losses can be deducted from total income, just as business income adds to total income.

The tax laws distinguish between a business and a hobby that earns or loses money. The CRA defines a business as "any activity that you do for profit," and any profit from your hobby is considered business income (Ward, 2017). In addition, the self-employed must pay estimated income taxes in quarterly installments based on expected income depending on your earnings. According to the CRA, quarterly income tax installments are required if your net tax owing will be above the threshold for your province or territory and/or if your net tax owing in previous years was above the threshold for your province or territory.

Adam is thinking about turning his hobby into a business. He has been successful at selling his artwork at different tradeshows and online. He thinks he has found a large enough market to support a business enterprise. As a business, he would be able to deduct the costs of website promotion, his art sales trips, his home office, and shipping, which would reduce the taxes he would have to pay on his business income. Adam decides to enroll in online courses on becoming an entrepreneur, how to write a business plan, and how to find capital for a new venture.

Capital Gains (or Losses)

Gains or losses from investments derive from changes in asset value during ownership between the asset's original cost and its market value at the time of sale. If you sell an asset for more than you paid for it, you have a gain. If you sell an asset for less than you paid for it, you have a loss. Capital losses are subtracted from capital gains in the same calendar year, and 50 per cent of the resulting amount is taxable, which means less tax is paid on capital gains than on income. Recurring gains or losses from investment are from returns on financial instruments such as stocks and bonds. One-time gains or losses, such as the sale of a home, are also reported.

When you invest in financial assets, such as stocks, bonds, mutual funds, property, or equipment, be sure to keep good records by noting the date when you bought them and the original price. These records establish the **cost basis** of your investments, which is used to calculate your gain or loss when you sell them.

Rental and Royalty Income; Income from Partnerships and Trusts

Rental or royalty income is income earned from renting an asset, either real property or a creative work such as a book or a song. This can be a primary source of income, although many individuals rely on wages and have some rental or royalty income on the side. Home ownership may be made more affordable, for example, if the second half of a duplex can be rented for extra income. Rental expenses can also be deducted from rental income, which can create a loss from rental activity rather than a gain. Unlike a business, which must become profitable to remain a business for tax purposes, rental activities may generate losses year after year. Such losses are a tax advantage, as they reduce total income. In Canada, any capital gained on a home (house, condominium, or a share in a co-operative housing corporation) is tax exempt as long as it is your primary residence. The revenue sale of a rental home is subject to capital gains tax.

Partnerships are alternative business structures for a business with more than one owner. For example, partnerships are commonly used by professional practices, such as accounting firms, law firms, medical practices, and the like, as well as by family businesses.

The partnership is not a taxable entity, but the share of its profits distributed to each owner is taxable income for the owner and must be declared.

Other Taxable and Non-Taxable Income

Other taxable income includes spousal support, retirement fund distributions from pension plans and RRSPs, as well as payments from government plans such as the Canada Pension Plan, Employment Insurance, or Old Age Security.

According to the CRA, income that is not taxed by the Canadian government and does not have to be reported as income includes the following:

- any GST/HST credit, Canada child benefit, or Canada child tax benefit payments, including those from related provincial and territorial programs;
- child assistance payments and the supplement for handicapped children paid by the province of Quebec;
- compensation received from a province or territory if you were a victim of a criminal act or a motor vehicle accident;
- most lottery winnings;
- most gifts and inheritances;
- amounts paid by Canada or an ally (if the amount is not taxable in that country) for disability or death due to war service;
- most amounts received from a life insurance policy following someone's death;
- most payments of the type commonly referred to as strike pay you received from your union, even if you perform picketing duties as a requirement of membership;
- elementary and secondary school scholarships and bursaries;
- post-secondary school scholarships, fellowships, and bursaries are not taxable if you received them in 2016 for your enrollment in a program that entitles you to claim the full-time education amount in 2015 or 2016, or if you will be considered a full-time qualifying student for 2017. (CRA, 2018)

Note, however, that income earned on any of the above amounts (such as interest you earn when you invest lottery winnings) is taxable.

Any amount contributed to a Tax-Free Savings Account (TSFA) as well as any income earned in the TSFA (for example, investment income and capital gains) is generally tax-free, even when it is withdrawn. For more information, see RC4466 Tax-Free Savings Account (TFSA), Guide for Individuals [New Tab] (https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4466.html) (CRA, 2018).

Deductions and Credits

Deductions are tax breaks created by government that allow individuals to reduce their overall taxable income by deducting certain expenditures.

Other deductions involve financial choices that the government encourages by providing an extra incentive in the form of a tax break. For example, one can deduct investment interest on borrowed money for the purpose of earning income from a business or property; this deduction is meant to encourage investment.

Deductions are also created for expenditures that may be considered nondiscretionary, such as court-ordered child support, spousal support, or medical expenses that you are required to pay. You have to read the instructions carefully in order to know what expenditures qualify as deductions. The following list provides examples of common deductions permitted in the calculation of net income:

- Contributions to deferred income plans such as registered pension plans, individual pension plans, and RRSPs are deductible. Income from these plans is taxed later down the road when withdrawals are made. Contributions to a tax-free savings account or a registered education savings plan (RESP) are not tax-deductible.
- Union and profession dues
- Child-care expenses
- Disability supports
- Moving expenses
- Other deductions include deductible business investment losses, spousal and child support payments, interest paid on loans (excluding loans for RRSP and RESP contributions), and employment expenses if, for example, one's employer requires the employee to pay for travel or other costs of employment.

For a list of medical expenses that are tax-deductible, visit the CRA Lines 330 and 331 – Eligible medical expenses you can claim on your tax return [New Tab] (https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/deductions-credits-expenses/lines-330-331-eligible-medical-expenses-you-claim-on-your-tax-return.html).

Some deductions require an additional form to calculate specifics, such as unreimbursed employee or job-related expenses and investment interest. Once deductions are subtracted from total income, **net income** can be determined. Additional deductions and losses from previous years can be carried forward to determine taxable income once net income has been calculated. The final step in determining your taxable income is to factor in tax rates and tax credits.

A **tax credit** directly reduces the amount of tax you'll pay versus a deduction which reduces your overall taxable income. A tax credit can be viewed as a deduction from the tax that is owed. Each taxpayer receives the same tax relief with a tax credit no matter the tax bracket one falls into as long as the credit can be used. Credits can be in the form of refundable credits or non-refundable credits. Refundable credits can be fully refunded if used. Even if you don't owe any tax, you will still receive what is owed through the tax credit. An example of a refundable tax credit is the Working Income Tax Credit which provides tax relief for eligible working low-income individuals and families. In terms of nonrefundable tax credits, all taxpayers can claim a basic non-refundable tax credit, known as the **personal amount,** which can reduce your tax liability. If any portion from the non-refundable tax credit remains after your taxable income reaches zero, it is automatically forfeited by the taxpayer. Each province and territory also sets a personal amount for provincial or territorial taxes. A tax credit is applied to the amount of tax owed by the taxpayer after all deductions are made from his or her taxable income, and reduces the total tax bill of an individual.

Deductions reduce taxable income, while credits reduce taxes owed.

Deductions and credits are some of the more disputed areas of the tax code. Because of the depth of dispute about them, they tend to change more frequently than other areas of the tax code. As a taxpayer, you want to stay alert to changes that may be to your advantage or disadvantage. Usually, such changes are phased in and out gradually so you can include them in your financial planning process. Learn more about deductions and credits [New Tab] (https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/deductions-credits-expenses.html).

Payments and Refunds

Once you have calculated your tax obligation for the year, you can compare that to any taxes you have paid during the year and calculate the amount still owed or the amount to be refunded to you.

You pay taxes during the tax year by having them withheld from your paycheque if you earn income through wages, or by making quarterly estimated tax payments if you have other kinds of income. When you begin employment, you fill out a form (Form TD1) that determines the taxes to be withheld from your regular pay. You may adjust this amount, within limits, at any time. If you have both wages and other incomes, but your wage income is your primary source of income, you may be able to increase the taxes withheld from your wages to cover the taxes on your other income, and thus avoid having to make estimated payments. However, if your non-wage income is substantial, you will have to make estimated payments to avoid a penalty and/or interest. The self-employed must pay estimated income taxes in quarterly installments based on expected income depending on your earnings. According to the CRA, quarterly income tax installments are required if your net tax owing will be above the threshold for your province or territory and/or if your net tax owing in previous years was above the threshold for your province or territory (CRA, 2017).

The government requires that taxes are withheld or paid quarterly during the tax year because it uses tax revenues to finance its expenditures, so it needs a steady and predictable cash flow. Steady payments also greatly decrease the risk of taxes being uncollectible. Provincial, territorial, and local income taxes must also be paid during the tax year and are similarly withheld from wages or paid quarterly.

If you have paid more during the tax year than your actual obligation, then you are due a refund of the difference. You may have that amount directly deposited to a bank account, or the government will send you a cheque.

If you have paid less during the tax year than your actual obligation, then you will have to pay the difference, and you may have to pay a penalty and/or interest, depending on the size of your payment.

The deadline for filing income tax returns and for paying any necessary amounts is April 30, following the end of the tax year on December 31. If you are self-employed, or the spouse or common-law partner of someone who is, the deadline to file your income tax and benefit return is June 15, although any balance owing is due April 30. You may file to request an extension of that deadline. Should you miss a deadline without filing for an extension, you will owe penalties and interest, even if your actual tax obligation results in a refund. It really pays to get your return in on time.

Exercises

1. Do you have to file a tax return for the current year? Why or why not? (Identify all the factors that apply.) Which tax form(s) should you use?
2. Go to the Government of Canada webpage Income Tax Folio S1-F2-C3, Scholarships, Research Grants and Other Education Assistance [New Tab] (https://www.canada.ca/en/revenue-agency/services/tax/technical-information/income-tax/income-tax-folios-index/series-1-individuals/folio-2-students/income-tax-folio-s1-f2-c3-scholarships-research-grants-other-education-assistance.html) to find answers to the following questions:
   • Is financial aid for university subject to federal income tax?
   • Can federal and provincial or territorial education grants be taxed as income?
   • Are student loans taxable?
   • When is a scholarship tax exempt?
   • Do you have to be in a degree program to qualify for tax exemption?
   • Can the amount of a scholarship used for tuition be deducted?
   • Can living expenses while on scholarship be deducted?
   • Is the income and stipend from a teaching fellowship or research assistantship tax exempt?

Record Keeping, Preparation, and Filing

The CRA is responsible for the collection of tax revenues. To collect revenues, the CRA must inform the public of tax obligations and devise data collection systems that will allow for collection and verification of tax information so that collectible revenues can be verified. In other words, the CRA has to determine how to inform the public and collect taxes while also collecting enough information to be able to check that those taxes are correct.

To inform the public, the CRA has published numerous publications covering various aspects of the tax code. In addition, the CRA provides website and telephone support to answer questions and assist in preparing tax filings.

By far, most income taxes from wages are collected through withholdings as earned. For most taxpayers, wages represent the primary form of income, and thus most of their tax payments are withheld or paid as wages are earned. Still, everyone has to file to summarize the details of the year's incomes for the CRA and to calculate the final tax obligation. It is important that everyone file a tax return, even if an individual owes no money. Everyone needs to file a return in order to get, for example, the GST rebate, the Canada child benefit, or Old Age Security. For further information on the benefits of filing a return [New Tab] (https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/you-have-file-a-return.html) through the CRA.

Keeping Records

The individual filer must collect and report the information on tax forms and schedules. Fortunately, this is not as difficult as the volume of data would suggest. Employers are required to send Form T4 to each employee at the end of the year, detailing the total wages earned and taxes and contributions withheld. Depending on your tax situation, you may need to refer to other guides, or complete some schedules and other forms that have more detailed information. You can find this information on other guides, schedules and forms you may need to complete your income tax and benefit return [New Tab] (https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/other-guides-schedules-forms-you-may-need-complete-your-income-tax-benefit-return.html).

The system for filing tax information has purposeful redundancies. Where possible, information is collected independently from at least two sources so it can be verified. For example, your wage data is collected both from you and from your employer; your interest and dividend incomes are reported by both you and the bank or brokerage that paid them, and so on. Those redundancies, wherever practical, allow for a system of cross-references so that the CRA can check the validity of the data it receives.

Incomes may be summarized and reported to you, but only you know your expenses. Expenditures are important if they are allowed as deductions, such as job-related expenses, and so on, so data should be collected throughout the tax year. If you do nothing more than keep a chequebook, then you will have to go through it and identify the deductible expenses for the tax year. Financial software applications will make that task easier; most allow you to flag deductible expenses in your initial setup.

You should also keep receipts of purchases that may be deductible; credit or debit card statements and bank statements provide convenient backup proof of expenditures. Proof is needed in the event the CRA questions the accuracy of your return.

Tax Preparation and Filing

After you have collected the information you need, you fill out the forms. The tax code is based on the idea that citizens should create revenues for the government based on their ability to pay—and the tax forms follow that logic. Most taxpayers need to complete only a few schedules and forms to supplement their Form T1. Most taxpayers have the same kinds of taxable events, incomes, and deductions year after year, and file the same kinds of schedules and forms.

Many taxpayers prefer to consult a professional tax preparer. Professional help is useful if you have a relatively complicated tax situation: unusual sources of income or expenditures that may be deductible under unusual circumstances. Some taxpayers use a tax preparer simply to protect against making a mistake and having the error, however innocent, prove costly to fix. Fees for tax preparers depend on how complex your return is, the number of forms that need to be completed, and the type of professional you consult.

Professional tax preparers may be lawyers, accountants, personal financial planners, or tax consultants. You may have an ongoing relationship with your tax preparer, who may also be your accountant or financial planner working with you on other financial decisions. Or you may consult a tax preparer simply on tax issues. You may want your tax preparer to fill out and file the forms for you, or you may be looking for advice about future financial decisions that have tax consequences. Tax preparers may be independent practitioners who work during tax season, or employees of a national chain that provide year-round tax services.

There is no standard certification to be a professional tax preparer. A **chartered public accountant (CPA)** has specific training and experience in accounting. When looking for a tax preparer, your lawyer, accountant, or financial planner may be appropriate, or they may be able to make a recommendation. If your information is fairly straightforward, you may minimize costs by using a preparer who simply does taxes. If your situation involves more complications—especially involving other entities such as businesses or trusts, or unusual circumstances such as a gain—you may want to consult a professional with a range of expertise, such as an accountant or a lawyer who specializes in taxes. Many professionals also offer a “guarantee” that they will also help you if the information on your return is later questioned by the CRA.

Whether you prepare your tax return by yourself or with a professional, it is you who must sign the return and assume responsibility for its details. You should be sure to review your return with your tax preparer so that you understand and can explain any of the information found on it. You should question anything that you cannot understand or that seems contrary to your original information. You should also know your tax return because understanding how and why tax obligations are created or avoided can help you plan for tax consequences in future financial decisions.

You may choose to prepare the return yourself using a tax preparation software application. There are many available, and several are compatible with personal financial software applications, enabling you to download or transfer data from your financial software directly into the tax software. Software applications are usually designed as a series of questions that guide you through Form T1 and the supplemental schedules, filling in the data from your answers. Once you have been through the "questionnaire," it tells you the forms it has completed for you, and you can simply print them out to submit by mail or "e-file" them directly to the CRA. Most programs also allow you to enter data into the individual forms directly.

Link It Up

Many tax preparation software packages are reviewed in the business press or online. Some popular programs are listed in the article Top Canadian Tax Software Programs [New Tab] (https://www.thebalancesmb.com/top-canadian-tax-software-programs-2948660).

Software can be useful in that it automatically calculates unusual circumstances, limitations, or exceptions to rules using your complete data. Some programs even prompt you for additional information based on the data you submit. Overlooking exceptions is a common error that software programs can help you avoid. The programs have all the forms and schedules, but if you choose to file hard-copy versions, you can download them directly from the CRA website, or you can call the CRA and request that they be sent to you. Once your return is completed, you must file it with the CRA, either by mail or by e-file, which has become increasingly popular.

Following Up

After you file your tax return it will be processed and reviewed by the CRA. If you are owed a refund, it will be sent; if you paid a payment, it will be deposited. The CRA reviews returns for accuracy, based on redundant reporting and its "sense" of your data. For example, the CRA may investigate any discrepancies between the wages you report and the wages your employer reports. As another example, if your total wages are $23,000 and you show a charitable contribution of $20,000, that contribution seems too high for your income—although there may be an explanation.

The CRA may follow up by mail or by a personal interview. It may just ask for verification of one or two items, or it may conduct a full **audit**—a thorough financial investigation of your return. In any case, you will be asked to produce records or receipts that will verify your reported data. Therefore, it is important to save a copy of your return and the records and receipts that you used to prepare it. The CRA recommends saving your tax data for six years in case the CRA decides to review your tax returns and/or audit your small business. The best protection against a possible audit is to have verification—a receipt or a bill or a cancelled cheque—for all the incomes and expenses that you report.

If you have a personal interview, your tax preparer may accompany you to help explain and verify your return. Ultimately, however, you are responsible for it. If you have made errors, and if those errors result in a larger tax obligation (if you owe more), you may have to pay penalties and interest in addition to the tax you owe. You may be able to negotiate a payment schedule with the CRA.

The CRA randomly chooses a certain number of returns each year for review and possible audit even where no discrepancies or unusual items are noticed. The threat of a random audit may deter taxpayers from cheating or taking shortcuts on their tax returns. Computerized record keeping has made it easier for both taxpayers and the CRA to collect, report, and verify tax data.

Filing Strategies

Most citizens recognize the need to contribute to the government's revenues but want to avoid paying more than they need to. **Tax avoidance** is the practice of ensuring that you have no excess tax obligations. Strategies for minimizing or avoiding tax obligations are perfectly legal. However, **tax evasion**—fraudulently reporting tax obligations, for example, by understating incomes and gains or overstating expenses and losses—is illegal.

Timing can affect the value of taxable incomes. If you anticipate a significant increase in income—and therefore in your tax rate—in the next tax year, you may try to defer a deductible expense. Likewise, if you anticipate a decrease in income that will decrease your tax rate, you may want to defer receipt of income until the next year, when it will be taxed at a lower rate. In addition, some kinds of incomes are taxed at different rates than others, so how your income is created may have a bearing on how much tax it creates. The definition of expenses and the way you claim them can affect the tax one saves. For example, suppose you are a high school Cree or French teacher. You also tutor students privately. You buy Cree or French books to improve your own language skills and to keep current with the published literature. Are the costs of those books an unreimbursed employee expense related to your job as a teacher? Or are they an expense of your private tutoring business? They may be both, but you can only claim the expense once or in one place on your tax return.

Exercises

1. Gather a current sample of the kind of records you will use to calculate your tax liability this year and to verify your tax return. List each type of record and identify exactly what information it will give you, your tax preparer, and the CRA about your tax situation. What additional records will you need that are not yet in your possession?
2. Use your spreadsheet program, or download a free one, to develop a document showing monthly cash flows for income and expenses to date for which you have written records. If you continue to develop this document for the remaining months, how will it help you prepare your tax returns?
3. Research how you can reduce your tax liability and/or avoid paying taxes when you file this year. Work with classmates to develop a tip sheet for students on tax avoidance.

Taxes and Financial Planning

You may anticipate significant changes in income or expenses based on a change of job or career, or a change of life stage or lifestyle. Not only may the amounts of income or expenses change, but the kinds of incomes or expenses may change as well. Planning for those changes in relation to tax obligations is part of personal financial planning.

Tax Strategies and Life Stages

Tax obligations change more broadly as your stage of life changes. Although everyone is different, there is a typical pattern to aging, earning, and taxes, as shown in the following table.

Table 10.1b Life Stages and Tax Implications

	Young Adulthood	Middle Adulthood	Older Adulthood	Retirement
Source of Income	Wages	Wages/ Investments	Wages/ Investments	Investments
Asset Base	None/Low	Accumulating	Growing	Depleting
Taxable Income	Low	Higher	Highest	Lower
Deductions, Credits	Low	Higher	High	Low

In young adulthood, you rely on income from wages, and you usually have yet to acquire an asset base, so you have little income from interest, dividends, or capital gains. Your family structure does not include dependents, so you have few deductions but also low taxable income.

As you progress in your career, you can expect wages, expenses, and dependents to increase. You are building an asset base by buying a home, possibly saving for your children's education, or saving for retirement. Because those are the kinds of assets encouraged by the government, they not only build wealth, but also create tax advantages—for example, an RRSP or an RESP.

In older adulthood, you may begin to build an asset base that can no longer provide those tax advantages that are limited or may create taxable income such as interest, dividends, or rental income. In retirement, most people can anticipate a significant decrease in income from wages and a significant increase in reliance on incomes from investments, such as interest, dividends, and gains. Some of those assets may be retirement savings accounts, such as an RRSP, that created tax advantages while growing, but will create tax obligations as income is drawn from them.

Generally, you can expect your income to increase during the middle years of adult life, but that is when many people typically have dependents and deductions such as job-related expenses to offset increased tax obligations. As you age, and especially when you retire, you can expect less income and also fewer deductions.

The bigger picture is that at the stages of your life when income is increasing, so are your deductions and tax credits, which tend to decrease as your income decreases. Although your incomes change over your lifetime, your tax obligations change proportionally, so they remain relative to your ability to pay.

The tax consequences of such changes should be anticipated and considered as you evaluate choices for financial strategies. Because the tax code is a matter of law it does change, but because it is also a matter of politics, it changes slowly and only after much public discussion. You can usually be aware of any tax code changes far enough in advance to incorporate them into your planning.

Tax Strategies and Personal Financial Planning

Tax advantages are sometimes created for personal financial strategies as a way of encouraging certain personal goals. In Canada, for example, home ownership, retirement savings, and education are seen as personal goals that benefit society as well as the individual. In most cases, tax advantages are created to encourage progress toward those goals.

Retirement saving is encouraged, so some savings plans such as a **registered retirement savings plan (RRSP)** or a **registered pension plan (RPP)** create tax advantages. For example, an RPP is a pension plan that has been set up by your employer, and registered by the CRA, in order to provide you with a pension upon retirement. You can deduct the total of your RPP contributions to reduce your taxable income. Income from this plan will be taxed at a later date.

There are also retirement savings strategies that do not create tax advantages, such as saving outside of a tax-advantaged account. A **tax-free savings account (TFSA)** is a flexible investment account that can help you meet both your short- and long-term goals. Your investment income in a TFSA—interest, dividends, or capital gains—is not taxed, even when withdrawn. This tax-free compound growth means that your money grows more quickly inside a TFSA than in a taxable account. In addition to the investment income earned, any amount contributed to the TFSA is not taxed when it is withdrawn. However, initial contributions to a TFSA are not deductible for income tax purposes. The following are important facts about contributions to your TFSA:

- The current contribution limit is $5,500 per year; contributions to your RRSP/RPP do not limit your TFSA contribution.
- Any unused room can be carried forward.
- You can contribute up to your TFSA contribution limit. A tax applies to all contributions exceeding your TFSA contribution limit.
- Withdrawals will be added to your TFSA contribution room at the beginning of the following year.
- You can replace the amount of the withdrawal in the same year only if you have available TFSA contribution room.
- Direct transfers must be completed by your financial institution. (Government of Canada, 2016)

A **registered education savings plan (RESP)** is an education savings account registered with the Government of Canada. It is an investment vehicle used by parents to save for their children's post-secondary education in Canada. The key advantage of an RESP is the access it provides to the Canada Education Savings Grant (CESG) no matter what your family income. This grant is 20 per cent of any eligible contributions in an RESP account; the maximum annual grant by the government is $500. There are currently no annual contribution limits; however, you can receive the grant only on the first $2,500 in contributions per year, and the lifetime contribution limit is $50,000 (Government of Canada, 2017).

Although contributions are not tax-deductible, all investment income generated in the RESP is tax-free as long as it remains in the plan (Government of Canada, 2016). Once the recipient withdraws the money from the plan, he or she will be taxed. However, many students have little or no income and therefore the student would pay little to no tax on the withdrawal.

RESPs also provide access to the Canada Learning Bond, which is an important benefit for low-income families. The Canada Learning Bond is money that the Government of Canada deposits into an RESP for Canadian residents born on or after January 1, 2004, in order to help low-income families save for a child's education after high school. The government deposits can be up to a maximum of $2,000 and will not affect any other benefits that you or an eligible child receives (Government of Canada, 2018).

Planning Your Strategy

Where you have a choice, it makes sense to use a strategy that will allow you to make progress toward your goal and realize a tax advantage. Your enthusiasm for the tax advantage should not define your goals, however. Taxes affect the value of your alternatives, so recognizing tax implications should inform your choices without defining your goals.

Unanticipated events such as lottery winnings, casualty and theft losses, or medical expenses can also have tax consequences. They are often unusual events (and therefore unanticipated) and may be unfamiliar and financially complicated. In those circumstances, it may be wise to consult an expert.

Your financial plans should reflect your vision for your life. You will want to be aware of tax advantages or disadvantages so that you can make the most tax-advantageous decisions. Like any costs, you want to minimize your tax costs of living and of life events, but tax avoidance is only a means to an end. You should make your life choices for better reasons than avoiding taxes.

Exercises

1. Review your list of personal financial goals. For each goal, how does the Canadian tax code help or hinder you in achieving it?
2. Investigate tax strategies that would benefit you in your present life stage. What tax strategies would benefit you in your next life stage? Share your findings and strategies with

others in your life stage.

Key Takeaways

Sources of Taxation and Kinds of Taxes

- Governments at all levels use taxes as a source of financing.
- Taxes may be imposed on the following:
  • Incomes from wages, interest, dividends, and gains (losses), and rental of real or intellectual property.
  • Consumption of discretionary and nondiscretionary goods and services.
  • Wealth from asset ownership.
- Taxes may be progressive, such as the income tax, in which you pay proportionally more taxes the more income you have, or regressive, such as a sales tax, in which you pay proportionally more taxes the less income you have.

The Canadian Federal Income Tax Process

- The most relevant tax for financial planning is the income tax, as it affects the taxpayer over an entire lifetime.
- Different kinds of income must be defined and declared on specific income schedules and are subject to tax.
- Deductions reduce taxable income.
- Credits reduce tax obligations.
- Payments are made throughout the tax year through withholdings from wages or quarterly payments.

Record Keeping, Preparation, and Filing

- Information about the tax code is available from the CRA.
- Verifiable records must be kept for all taxable incomes and expenses or other taxable events and activities.
- Professional tax assistance and tax preparation software are readily available.
- The CRA reviews tax returns for errors and may follow up through an informal or formal audit process.
- Tax avoidance is the legal practice of minimizing tax obligations.
- Tax evasion is the illegal process of fraudulently presenting information used in calculating tax obligations.
- Tax-avoidance strategies can involve the timing of incomes and/or expenses to take advantage of changing tax circumstances.

Taxes and Financial Planning

- Tax strategies may change as life stages and family structure changes.
- Some personal finance goals may be pursued in a more or less tax-advantaged way, so you should evaluate the tax effects on your alternatives.
- Tax strategies are a means to an end—that is, to achieving your personal finance goals with a minimum of cost.

Attribution

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10.2 - EMPLOYMENT DISCRIMINATION

Learning Objectives

- Analyze earnings gaps based on race and gender
- Explain the impact of discrimination in a competitive market
- Identify U.S. public policies designed to reduce discrimination

Discrimination involves acting on the belief that members of a certain group are inferior solely because of a factor such as race, gender, or religion. There are many types of discrimination but the focus here will be on discrimination in labour markets, which arises if workers with the same skill levels—as measured by education, experience, and expertise—receive different pay receive different pay or have different job opportunities because of their race or gender.

Earnings Gaps by Race and Gender

A possible signal of labour market discrimination is when an employer pays one group less than another. Figure 14.15 shows the average wage of Black workers as a ratio of the average wage of White workers and the average wage of female workers as a ratio of the average wage of male workers. Research by the economists Francine Blau and Laurence Kahn shows that the gap between the earnings of women and men did not move much in the 1970s, but has declined since the 1980s. According to the U.S. Census, the gap between the earnings of Blacks and Whites diminished in the 1970s, but has not changed in 50 years. In both gender and race, an earnings gap remains.

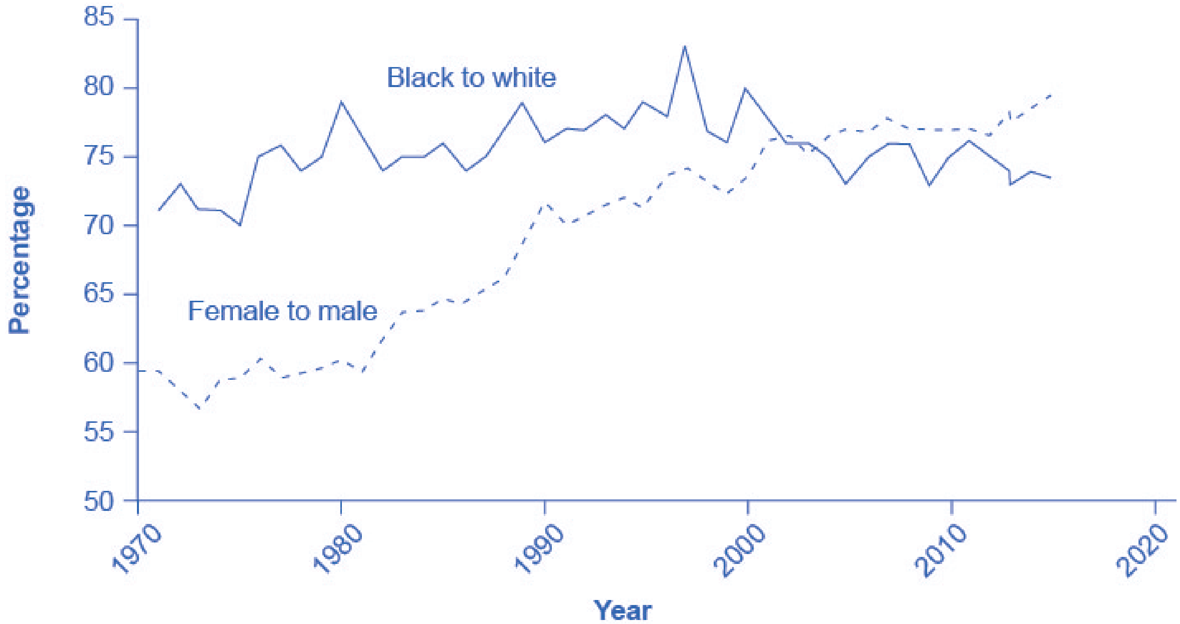

Figure 10.2a. Wage Ratios by Sex and Race. The ratio of wages for Black workers to White workers rose substantially in the late 1960s and through the 1970s, but has not changed much since then. The ratio of wages for female to male workers changed little through the 1970s, but has risen substantially since the 1980s. In both cases, a gap remains between the average wages of Black and White workers and between the average wages of female and male workers. Figure by Steven A. Greenlaw & David Shapiro, licensed under CC BY 4.0. Data Source: U.S. Department of Labor, Bureau of Labor Statistics.

An earnings gap between average wages, in and of itself, does not prove that discrimination is occurring in the labour market. We need to apply the same productivity characteristics to all parties (employees) involved. Gender discrimination in the labour market occurs when employers pay women less than men despite having comparable levels of education, experience, and expertise. (Read the Clear It Up about the sex-discrimination suit brought against Wal-Mart.) Similarly, racial discrimination in the labour market exists when employers pay racially diverse employees less than their coworkers of the majority race despite having comparable levels of education, experience, and expertise. To bring a successful gender discrimination lawsuit, a female employee must prove the employer is paying her less than a male employee who holds a similar job, with similar educational attainment, and with similar expertise. Likewise, someone who wants to sue on the grounds of racial discrimination must prove that the employer pays him or her less than an employee of another race who holds a similar job, with similar educational attainment, and with similar expertise.

The FRED database includes earnings by earnings by age, gender and race/ethnicity [New Tab] (https://fred.stlouisfed.org/categories/33501).

Clear It Up

What was the sex-discrimination case against Wal-Mart?

In one of the largest class-action sex-discrimination cases in U.S. history, 1.2 million female employees of Wal-Mart claimed that the company engaged in wage and promotion discrimination. In 2011, the Supreme Court threw out the case on the grounds that the group was too large and too diverse to consider the case a class action suit. Lawyers for the women regrouped and are now suing in smaller groups. Part of the difficulty for the female employees is that the court said that local managers made pay and promotion decisions that were not necessarily the company's policies as a whole. Consequently, female Wal-Mart employees in Texas are arguing that their new suit will challenge the management of a "discrete group of regional district and store managers." They claim these managers made biased pay and promotion decisions. However, in 2013, a federal district court rejected a smaller California class action suit against the company.

On other issues, Wal-Mart made the news again in 2013 when the National Labor Relations Board found Wal-Mart guilty of illegally penalizing and firing workers who took part in labour protests and strikes. Wal-Mart has already paid $11.7 million in back wages and compensation damages to women in Kentucky who were denied jobs due to their sex.

Investigating the Female/Male Earnings Gap

As a result of changes in law and culture, women began to enter the paid workforce in substantial numbers in the mid- to late-twentieth century. By 2014, 58.1% of adult women held jobs while 72.0% of adult men did. Moreover, along with entering the workforce, women began to ratchet up their education levels. In 1971, 44% of undergraduate college degrees went to women. By 2014, women received 56% of bachelor's degrees. In 1970, women received 5.4% of the degrees from law schools and 8.4% of the degrees from medical schools. By 2014, women were receiving 47% of the law degrees and 48.0% of the medical degrees. These gains in education and experience have reduced the female/male wage gap over time. However, concerns remain about the extent to which women have not yet assumed a substantial share of the positions at the top of the largest companies or in the U.S. Congress.

There are factors that can lower women's average wages. Women are likely to bear a disproportionately large share of household responsibilities. A mother of young children is more likely to drop out of the labour force for several years or work on a reduced schedule than is the father. As a result, women in their 30s and 40s are likely, on average, to have less job experience than men. In the United States, childless women with the same education and experience levels as men are typically paid comparably. However, women with families and children are typically paid about 7% to 14% less than other women of similar education and work experience. (Meanwhile, married men earn about 10% to 15% more than single men with comparable education and work experience.)

We possibly could call the different patterns of family responsibilities discrimination, but it is primarily rooted in America's social patterns of discrimination, which involve the roles that fathers and mothers play in child-rearing, rather than discrimination by employers in hiring and salary decisions.

Link it up

Visit Catlyst Inc. [New Tab] (http://www.catalyst.org/) to read more about the persistently low numbers of women in executive roles in business and in the U.S. Congress.

Investigating the Black/White Earnings Gap

Blacks experienced blatant labour market discrimination during much of the twentieth century. Until the passage of the Civil Rights Act of 1964, it was legal in many states to refuse to hire a Black worker, regardless of the credentials or experience of that worker. Moreover, Blacks were often denied access to educational opportunities, which in turn meant that they had lower levels of qualifications for many jobs. At least one economic study has shown that the 1964 law is partially responsible for the narrowing of the gap in Black–White earnings in the late 1960s and into the 1970s. For example, the ratio of total earnings of Black male workers to White male workers rose from 62% in 1964 to 75.3% in 2013, according to the Bureau of Labor Statistics.

However, the earnings gap between Black and White workers has not changed as much as the earnings gap between men and women has in the last half century. The remaining racial gap seems related both to continuing differences in education levels and to the presence of discrimination. Table 10.2a shows that the percentage of Blacks who complete a four-year college degree remains substantially lower than the percentage of Whites who complete college. According to the U.S. Census, both Whites and Blacks have higher levels of educational attainment than Hispanics and lower levels than Asians. The lower average levels of education for Black workers surely explain part of the earnings gap. In fact, Black women who have the same levels of education and experience as White women receive, on average, about the same level of pay. One study shows that White and Black college graduates have identical salaries immediately after college; however, the racial wage gap widens over time, an outcome that suggests the possibility of continuing discrimination. Another study conducted a field experiment by responding to job advertisements with fictitious resumes with either very African American sounding names or very W sounding names and found out that White names received 50 percent more callbacks for interviews. This is suggestive of discrimination in job opportunities. Further, as the following Clear It Up feature explains, there is evidence to support that discrimination in the housing market is connected to employment discrimination.

Table 10.2a Educational Attainment by Race and Ethnicity in 2015
(Source: http://www.census.gov/hhes/socdemo/education/data/cps/2014/tables.html)

	White	Hispanic	Black	Asian
Completed four years of high school or more	93.0%	66.7%	87.0%	89.1%
Completed four years of college or more	36.2%	15.5%	22.5%	53.9%

Clear It Up

How is discrimination in the housing market connected to employment discrimination?

In a recent study by the Housing and Urban Development (HUD) department, realtors show Black homebuyers 18 percent fewer homes compared to White homebuyers. Realtors show Asians are shown 19 percent fewer properties. Additionally, Hispanics experience more discrimination in renting apartments and undergo stiffer credit checks than White renters. In a 2012 U.S. Department of Housing and Urban Development and the nonprofit Urban Institute study, Hispanic testers who contacted agents about advertised rental units received information about 12 percent fewer units available and were shown seven percent fewer units than White renters. The $9 million study, based on research in 28 metropolitan areas, concluded that blatant “door slamming” forms of discrimination are on the decline but that the discrimination that does exist is harder to detect, and as a result, more difficult to remedy. According to the Chicago Tribune, HUD Secretary Shaun Donovan, who served in his role from 2009-2014, told reporters, “Just because it’s taken on a hidden form doesn’t make it any less harmful. You might not be able to move into that community with the good schools.”

The lower levels of education for Black workers can also be a result of discrimination—although it may be pre-labour market discrimination, rather than direct discrimination by employers in the labour market. For example, if discrimination in housing markets causes Black families to live clustered together in certain poorer neighborhoods, then the Black children will continue to have lower educational attainment then their White counterparts and, consequently, not be able to obtain the higher paying jobs that require higher levels of education. Another element to consider is that in the past, when Blacks were effectively barred from many high-paying jobs, obtaining additional education could have seemed somewhat pointless, because the educational degrees would not pay off. Even though the government has legally abolished labour market discrimination, it can take some time to establish a culture and a tradition of valuing education highly. Additionally, a legacy of past discrimination may contribute to an attitude that Blacks will have a difficult time succeeding in academic subjects. In any case, the impact of social discrimination in labour markets is more complicated than seeking to punish a few bigoted employers.

Competitive Markets and Discrimination

Gary Becker (b. 1930), who won the Nobel Prize in economics in 1992, was one of the first to analyze discrimination in economic terms. Becker pointed out that while competitive markets can allow some employers to practice discrimination, it can also provide profit-seeking firms with incentives not to discriminate. Given these incentives, Becker explored the question of why discrimination persists.

If a business is located in an area with a large minority population and refuses to sell to minorities, it will cut into its own profits. If some businesses run by bigoted employers refuse to pay women and/or minorities a wage based on their productivity, then other profit-seeking employers can hire these workers. In a competitive market, if the business owners care more about the color of money than about the color of skin, they will have an incentive to make buying, selling, hiring, and promotion decisions strictly based on economic factors.

Do not underestimate the power of markets to offer at least a degree of freedom to oppressed groups. In many countries, cohesive minority groups like Jews and emigrant Chinese have managed to carve out a space for themselves through their economic activities, despite legal and social discrimination against them. Many immigrants, including those who come to the United States, have taken advantage of economic freedom to make new lives for themselves. However, history teaches that market forces alone are unlikely to eliminate discrimination. After all, discrimination against African Americans persisted in the market-oriented U.S. economy during the century between President Abraham Lincoln's Emancipation Proclamation, which freed the slaves in 1863, and the passage of the Civil Rights Act of 1964—and has continued since then, too.

Therefore, why does discrimination persist in competitive markets? Gary Becker sought to explain this persistence. Discriminatory impulses can emerge at a number of levels: among managers, among workers, and among customers. Consider the situation of a manager who is not personally prejudiced, but who has many workers or customers who are prejudiced. If that manager treats minority groups or women fairly, the manager may find it hurts the morale of prejudiced co-workers or drives away prejudiced customers. In such a situation, a policy of nondiscrimination could reduce the firm's profits. After all, a business firm is part of society, and a firm that does not follow the societal norms is likely to suffer. Market forces alone are unlikely to overwhelm strong social attitudes about discrimination.

Link it up

Read the CNBC article, New Census data reveals no progress has been made on closing the overall gender pay gap [New Tab] (https://www.cnbc.com/2020/09/18/new-census-data-reveals-no-progress-has-been-made-closing-the-gender-pay-gap.html), to learn more about wage discrimination.

Public Policies to Reduce Discrimination

A first public policy step against discrimination in the labour market is to make it illegal. For example, the Equal Pay Act of 1963 said that employers must pay men and women who do equal work the same. The Civil Rights Act of 1964 prohibits employment discrimination based on race, color, religion, sex, or national origin. The Age Discrimination in Employment Act of 1967 prohibited discrimination on the basis of age against individuals who are 40 years of age or older. The Civil Rights Act of 1991 provides monetary damages in cases of intentional employment discrimination. The Pregnancy Discrimination Act of 1978 was aimed at prohibiting discrimination against women in the workplace who are planning to get pregnant, are pregnant, or are returning after pregnancy. Passing a law, however, is only part of the answer, since discrimination by prejudiced employers may be less important than broader social patterns.

These laws against discrimination have reduced the gender wage gap. A 2007 Department of Labor study compared salaries of men and women who have similar educational achievement, work experience, and occupation and found that the gender wage gap is only 5%.

In the case of the earnings gap between Blacks and Whites (and also between Hispanics and Whites), probably the single largest step that could be taken at this point in U.S. history to close the earnings gap would be to reduce the gap in educational achievement. Part of the answer to this issue involves finding ways to improve the performance of schools, which is a highly controversial topic in itself. In addition, the education gap is unlikely to close unless Black and Hispanic families and peer groups strengthen their culture of support for educational achievement.

Affirmative action is the name given to active efforts by government or businesses that give special rights to minorities in hiring and promotion to make up for past discrimination. Affirmative action, in its limited and not especially controversial form, means making an effort to reach out to a broader range of minority candidates for jobs. In its more aggressive and controversial form, affirmative action required government and companies to hire a specific number or percentage of minority employees. However, the U.S. Supreme Court has ruled against state affirmative action laws. Today, the government applies affirmative action policies only to federal contractors who have lost a discrimination lawsuit. The federal Equal Employment Opportunity Commission (EEOC) enforces this type of redress.

An Increasingly Diverse Workforce

Racial and ethnic diversity is on the rise in the U.S. population and work force. As Figure 14.16 shows, while the White Americans comprised 78% of the population in 2012, the U.S. Bureau of the Census projects that Whites will comprise 69% of the U.S. population by 2060. Forecasters predict that the proportion of U.S. citizens who are of Hispanic background to rise substantially. Moreover, in addition to expected changes in the population, workforce diversity is increasing as the women who entered the workforce in the 1970s and 1980s are now moving up the promotion ladders within their organizations.

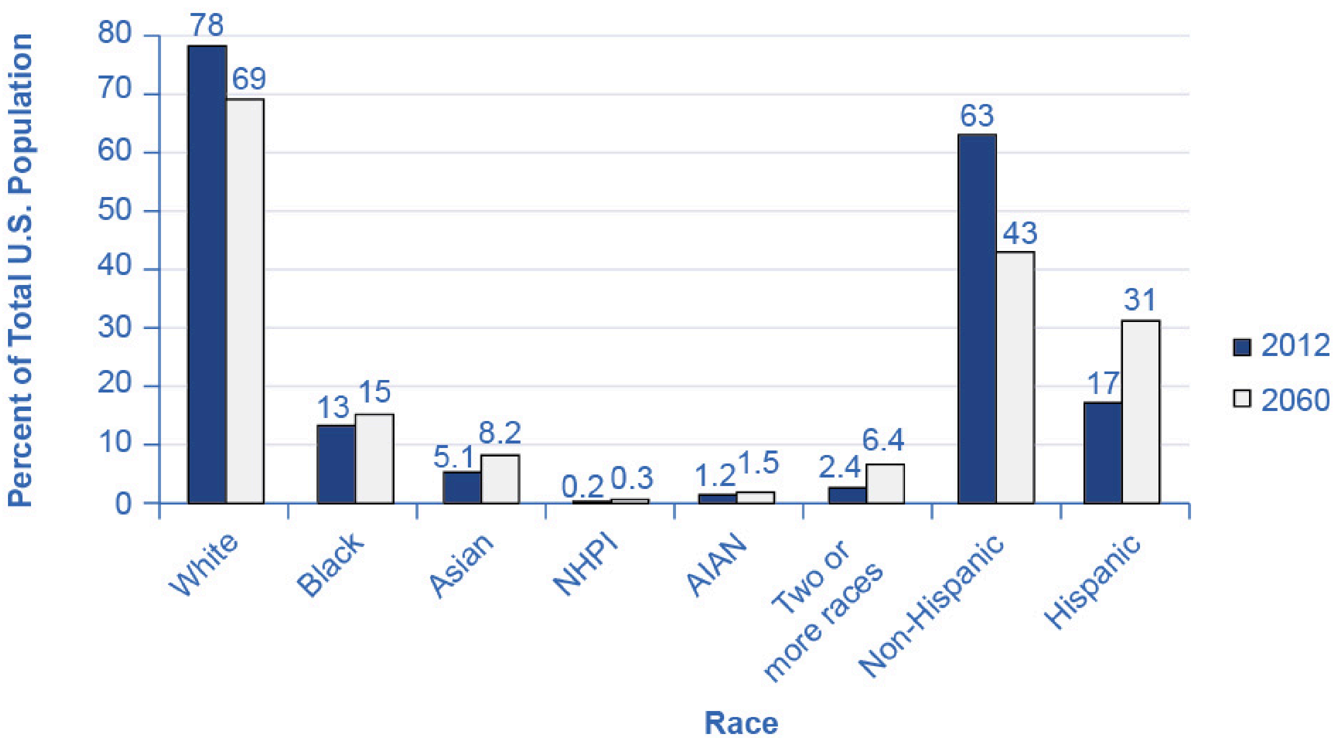

Figure 10.2b Projected Changes in America's Racial and Ethnic Diversity. This figure shows projected changes in the ethnic makeup of the U.S. population by 2060. Note that "NHPI" stands for Native Hawaiian and Other Pacific Islander. "AIAN" stands for American Indian and Alaska Native. Figure by Steven A. Greenlaw & David Shapiro, licensed under CC BY 4.0 Data Source: US Department of Commerce

Figure 10.2b Projected Changes in America's Racial and Ethnic Diversity
The vertical axis is Race and the horizontal axis is Percent of Total U.S. Population in 2012 and 2060 data is outlined in the graph below.

Table 10.2b Projected Changes in America's Racial and Ethnic Diversity. Based of Figure 10.2b Data Source: US Department of Commerce

Race	Percent of Total U.S. Population 2012	Percent of Total U.S. Population 2060
White	78	69
Black	13	15
Asian	5.1	8.2
NPHI	0.2	0.3
AIAN	1.2	1.5
Two or more races	2.4	6.4
Non-Hispanic	63	43
Hispanic	17	31

Regarding the future, optimists argue that the growing proportions of minority workers will break down remaining discriminatory barriers. The economy will benefit as an increasing proportion of workers from traditionally disadvantaged groups have a greater opportunity to fulfill their potential. Pessimists worry that the social tensions between men and women and between ethnic groups will rise and that workers will be less productive as a result. Anti-discrimination policy, at its best, seeks to help society move toward the more optimistic outcome.

The FRED database includes data on foreign and native born civilian population [New Tab] (https://fred.stlouisfed.org/categories/104) and labour force [New Tab].

Key Concepts and Summary

Discrimination occurs in a labour market when employers pay workers with the same economic characteristics, such as education, experience, and skill, are paid different amounts because of race, gender, religion, age, or disability status. In the United States, female workers on average earn less than male workers, and Black workers on average earn less than White workers. There is controversy over to which discrimination differences in factors like education and job experience can explain these earnings gaps. Free markets can allow discrimination to occur, but the threat of a loss of sales or a loss of productive workers can also create incentives for a firm not to discriminate. A range of public policies can be used to reduce earnings gaps between men and women or between White and other racial/ethnic groups: requiring equal pay for equal work, and attaining more equal educational outcomes.

Attribution

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