

British Columbia :: July 2012 Tax Rates

The Value of an Interest Deduction

THE ISSUE

A tax deductible interest expense on a personal income tax return reduces an individual's taxable income, and therefore reduces the individual's income tax payable.

An individual's taxable income comprises various types of income taxed at different effective tax rates.

How does the value of an interest deduction change when it is applied against different types of income?

WESTWARD'S VIEW

Types of Income

- **Ordinary income** such as employment income, interest income, rental income and pension income is taxed at the "ordinary" tax rate. The top marginal ordinary tax rate in 2012 is 43.7% in British Columbia.
- **Capital gains** are effectively taxed at one-half the ordinary tax rate, or a top marginal rate in 2012 of 21.9%. This is accomplished by excluding half the capital gain from the individual's taxable income, and then applying the ordinary tax rate to the taxable half of the capital gain.
- **Eligible dividends** are effectively taxed at 25.8% in the top marginal bracket in 2012. This is accomplished by applying the ordinary tax rate to 138% of the dividend, and then giving the individual a tax credit of approximately 34% of the dividend.
- **Non-eligible dividends** are effectively taxed at 33.7% in the top marginal bracket in 2012. This is accomplished by applying the ordinary tax rate to 125% of the dividend, and then giving the individual a tax credit of approximately 21% of the dividend.

In all cases, the individual's income is *first* converted to taxable income, and *then* the tax is calculated by applying the ordinary tax rate to taxable income.

An interest deduction reduces taxable income dollar for dollar. Since tax is calculated by applying the ordinary tax rate to taxable income, an interest deduction recovers tax at the ordinary tax rate, *regardless of the type of income* that created the taxable income.

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Illustration

The following table illustrates the 2012 tax applicable to \$100,000 of various types of income computed at the top marginal tax bracket for an individual in BC.

	Ordinary Income	Capital Gains	Eligible Dividends	Non-Eligible Dividends
Income	\$ 100,000	\$ 100,000	\$ 100,000	\$ 100,000
Effective tax rate	43.7%	21.9%	25.8%	33.7%
Tax	\$ 43,700	\$ 21,850	\$ 25,776	\$ 33,705

The following table illustrates the tax on the same income after applying a \$10,000 interest deduction.

	Ordinary Income	Capital Gains	Eligible Dividends	Non-Eligible Dividends
Income	\$ 100,000	\$ 100,000	\$ 100,000	\$ 100,000
Non-taxable		(50,000)		
Gross-up			38,000	25,000
	100,000	50,000	138,000	125,000
Interest expense	(10,000)	(10,000)	(10,000)	(10,000)
Taxable income	90,000	40,000	128,000	115,000
Ordinary tax rate	43.7%	43.7%	43.7%	43.7%
Tax before credit	39,330	17,480	55,936	50,255
Tax credit	-	-	(34,530)	(20,920)
Tax after interest expense	\$ 39,330	\$ 17,480	\$ 21,406	\$ 29,335
Tax saved	\$ 4,370	\$ 4,370	\$ 4,370	\$ 4,370
Rate of tax saved	43.7%	43.7%	43.7%	43.7%

CONCLUSION

The amount of tax saved by the interest deduction is the same regardless of the type of income the interest deduction is applied against. The interest deduction always reduces tax at the ordinary tax rate.

Only alternative minimum tax (AMT) can change this result. AMT may apply if there is relatively little ordinary income and/or the interest deduction is a relatively large portion of the income.

