

TAX BULLETIN

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Failure to Pay Tax Instalments Can Be Costly

With the 2012 tax return season almost here, we want to remind you of the importance of paying personal income tax instalments. This could apply to you if you receive or earn any kind of income that is not subject to any tax withholding at source, such as business or investment income, or is subject to a low rate of withholding at source, such as pension income. The cost of ignoring your instalment obligations can be high.

Who has to make tax instalments?

If your total tax liability, less the portion that was withheld at source, is greater than \$3,000 for both the current year and either of the two preceding years, you must make instalments for the current year. In Québec where provincial tax is collected by the province, the threshold is \$1,800 for both federal and provincial tax. Note that the Canada Revenue Agency (CRA) collects provincial tax in other provinces under the tax on income system.

With such low thresholds, it's easy to see that even individuals with only moderate amounts of income may be caught by the rules. A middle-income taxpayer with \$10,000 of interest income could be required to pay tax by instalment. Fortunately, you don't have to check this test yourself.

The CRA determines who's required to pay instalments from prior years' tax returns and mails instalment reminders to these taxpayers. There are two important points to note about this system.

First, you only have to make instalment payments if the CRA sends you an instalment reminder. If you don't receive one, you don't have to make instalments, even if your tax liability clearly exceeds the \$3,000 limit.

Second, if you do receive a reminder, remember that it's based on past information. If you're certain that your current year's unpaid tax liability when you file your return will not exceed \$3,000, then you're not required to make instalments and you can ignore the reminder notices. A similar system applies in Québec.

Where required, instalment payments are due quarterly, on the 15th day of March, June, September and December. The CRA sends out the instalment reminders twice a year; in February for the March and June payments, and

in August for the September and December payments. These notices are also available in the CRA My Account online service. The instalments must either be received by the CRA, or sent by first class mail by these dates, for them to be considered paid on time. Alternatively, you can make your instalment payment at any financial institution by the due date.

The rules are different if your main source of income is from farming or fishing. In particular, you'll be required to make a single instalment payment on December 31, 2012 if in each of 2010, 2011, and 2012, your net tax owing is more than \$3,000 (\$1,800 if you live in Québec). The CRA will mail you a notice in November 2012. Similar rules apply in Québec.

In any case, your final tax liability for a year is determined when you file your tax return and any balance of tax owing over and above the instalments must be paid by April 30th of the following year.

Where instalments have to be paid quarterly, cash-flow problems may arise if you ordinarily receive your income late in the year. For example, you may receive interest annually from Canada Savings Bonds in November, but you have to pay tax quarterly starting in March. Also, you may only receive your instalment reminder in late February. If this is your situation, plan ahead to ensure you have sufficient funds on hand to meet your instalment obligations.

How are instalments calculated?

If you're over the \$3,000 threshold, there are three methods that are allowed in the *Income Tax Act* to calculate your instalment payments.

The method the CRA uses bases the first two instalments for the year on your second preceding year's tax liability. The final two instalments are then adjusted so that the total of the four instalments equals your last year's tax liability. For example, for 2012, your first two instalments are based on 2010, with the final two payments bringing the total up to your 2011 liability.

You have the option, however, of basing your instalment payments on either of the other two methods allowed:

1. Estimate your current year's tax (less amounts paid through withholding at source) and pay this amount in four equal instalments.
2. Pay an amount equal to last year's tax (less amounts withheld at source) in four equal instalments.

Your instalment payments are calculated based on your net tax owing plus any Canada Pension Plan (CPP) contributions payable and voluntary Employment Insurance (EI) premiums payable on self-employment and other eligible earnings. Note that for Québec purposes, instalment payments cover income tax plus the health contribution and, as applicable, contributions to the Québec Pension Plan and the health services fund as well as premiums to the Québec prescription drug insurance plan and the Québec parental insurance plan.

The CRA's method of calculating instalments may result in an overpayment of your instalment obligations, particularly if your income has been decreasing over the past two years. Also, you may receive instalment reminders because you had an extraordinary receipt of income in one year, such as a capital gain, which did not have any tax withheld.

If this applies to you, consider using one of the other two methods. There is a cost to overpaying your instalments, since the CRA does not pay interest on overpayments. The government will have free use of your money until they assess your income tax return for that year.

If your main source of income is from farming or fishing, and you have an instalment requirement, your instalment will be due on December 31, 2012. The amount that the CRA will calculate will be equal to 2/3rds of the total of your 2011 net tax owing plus CPP contributions payable and any voluntary EI premiums payable. If you believe that the total of your net tax owing, CPP contributions and any voluntary EI premiums for 2012 will be

lower than 2011, then you can pay 2/3rds of this amount. When your personal income tax return is prepared, your BDO advisor will inform you of your instalment obligations for the upcoming year. They will use whichever method is better for you, depending on your circumstances.

When you receive an instalment reminder from the CRA, compare the amounts in the reminder to the amounts that your BDO advisor recommended when your personal tax return was prepared. If the amounts in the reminder are the same or less than BDO's recommendations, pay the amounts in the reminder. Remember that as long as the amounts specified in the reminder are paid, no instalment interest or penalties will be charged by the CRA. If BDO's recommended instalments are less than the amounts in the reminders, contact your BDO advisor to ensure your instalment obligations are being met.

Why pay instalments?

If you fail to pay the required amounts on time, you could be charged substantial interest and penalties by the CRA.

First, there's instalment interest calculated at the CRA's prescribed rate plus 4%. The prescribed rate approximates short-term money market rates as set by the Bank of Canada. For the first quarter of 2012, it's 1%, so instalment interest is charged at 5%. The additional 4% is charged to discourage the non-payment of tax.

Second, instalment interest charges are compounded daily. Therefore, the 5% interest rate for the first quarter of 2012 is effectively an annual rate of 5.13%.

And finally, there is a steep penalty for making late instalments or remitting less than the required amount if instalment interest for 2012 is more than \$1,000. To calculate the penalty, determine which of the following amounts is higher:

- \$1,000; or

- 25% of the instalment interest that would payable if you had not made any instalment payments for 2012. Then, subtract the higher amount from the actual instalment interest charges for 2012. Divide the difference by two and the result is the penalty amount.

In Québec, additional interest of 10% per annum, compounded daily, is applicable where the amount of an instalment payment is less than 75% of the amount the taxpayer is required to pay. This brings the effective annual interest rate to approximately 17% (the current interest rate charged on amounts owing is 6% in Québec).

The combined effect of these measures means that it's advisable to pay all required instalments on time, even if you must borrow to do so. Because the interest rates for underpaid taxes are set higher than short-term borrowing rates, you should be able to get a better rate at a financial institution.

You can reduce or eliminate the interest charges and penalties on late instalments by overpaying subsequent instalments or paying them before their due dates. Interest earned on early or excess payments will offset any interest charges on late payments, with only the net interest being payable. And since instalment penalties are charged on the net interest, they will also be reduced.

And remember, if you have a choice between borrowing to pay instalments and borrowing for business or other income-earning purposes (such as investments), always use your cash to pay your instalments and borrow for income earning purposes. This will generally ensure that the interest is tax deductible.

The cost of ignoring your instalment obligations can be expensive. Contact your BDO advisor for information about your personal instalments.

The information in this publication is current as of January 16, 2012.

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