Foundational Income Tax Concepts

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[under development]

1. Introduction

Income Taxation has grown to be a very complicated area of law. However, as with any complicated system, it is built on foundational concepts and is animated by an inherent logic. By understanding these foundational concepts and grasping the animating logic, one is better able to navigate the maze, and avoid feeling as Justice Learned Hand did when he wrote (Hand, "Thomas Walter Swan" (1947) 57 Yale L J 167 at 169):

> In my own case the words of such an act as the Income Tax ... merely dance before my eyes in a meaningless procession; cross-reference to cross-reference, exception upon exception – couched in abstract terms that offer no handle to seize hold of – leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages of Hegel; that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness.

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2. Tax Policy

Tax law is not only challenging because of the difficulty of understanding *what the tax law is* at any given time, but also because of the need to know *why the tax law is as it is*. In order to understand the current rules and to spot potential tax issues, one has to understand the context and underlying principles of income tax law. By getting a grip on the logic animating income taxation - the purpose of the rules and the goals aimed at - the rules become understandable. This is the importance of tax policy in tax law.

When learning the rules, ask yourself why those rules exist - what do they aim at - what is their goal or purpose - what mischief do they aim to prevent - what good to they propose to advance?

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3. Value of Credit and Deduction

Canada's Income Tax legislation, like almost every other nation's tax legislation, allows taxpayers to reduce their liability to tax by taking advantage of tax credits and tax deductions. Whether a credit or a deduction is used has important tax-fairness implications. Both tax credits and tax deductions are considered Tax Expenditures - they are just another way for government to give money to some persons and not to others.

Credits and Deductions differ in "when" they come into the calculation of a taxpayer's tax liability. A tax deduction is a deduction from the taxpayer's "income", so as to get to the taxpayer's "taxable income". Therefore, it comes into play before the application of the tax rates to the income, as tax is payable only on taxable income. A tax credit, on the other hand, is a deduction from tax payable. It comes into play after the taxpayer's taxable income has been calculated, and the tax owing is determined by applying the tax rates to that income.

Because of the difference in when they come into the calculation, tax credits and tax deductions have different values to taxpayers.

A Tax Credit is worth the same amount to all taxpayers, no matter what that taxpayer's income or tax bracket it. It is important to note that a tax credit only has value to a taxpayer that would be liable to tax and only to the extent of the taxes otherwise owing. If a person has no income or has a low taxable income that results in no taxes being owed, then the credit is worthless to that taxpayer (unless the tax credit is a refundable tax credit). Whatever the benefit was the government intended to give to persons by putting the tax credit in, that benefit does not accrue to these persons.

A refundable tax credit is one that is worth the same to everyone, whether you end up owing taxes or not. If you owe no taxes, the government will write you a cheque and pay you the value of the credit (or excess credit).

Since most tax credits are meant to help those in financial difficulty so that they can pay for a good or service through to be essential or very important in our society, it seems strange to deny that benefit to the very people who need it most - those who don't have enough of an income to even be liable to tax. This is the reason why most tax scholars advocate for tax credits to be refundable - the opposite of most individual tax credits in Canada (note that many business tax credits are refundable; arguably an indication that government cares more about business interests than individuals' interests).

A Tax Deduction has a value that depends on the tax bracket of the particular taxpayer. This means that, under Canada's progressive income tax system, a deduction is worth more to a person with a higher income (and therefore in a higher tax bracket) than to a person with a lower income. A deduction is worth nothing to a person who has no income or has income below the basic exemption amount.

A tax deduction's worth is determined by multiplying the taxpayer's marginal tax rate by the amount of the deduction. The taxpayer's marginal tax rate is the rate of tax that applies to the last dollar of income that the taxpayer earns in that tax period. It is not the tax rate that applies to all of the taxpayer's income and is not the taxpayer's average tax rate. Take this circumstance, for example:

Amount of Income (Tax Bracket)	**Marginal Tax Rate**
$0 - $10,000	10%
$10,001 - $20,000	20%

Based on the above example, a taxpayer that earns any income up to and including $10,000 will have to pay tax at a rate of 10% on that income. Up to this amount, the marginal rate is 10%. However, any dollar that is above $10,000 but below (and including) $20,000 is taxed at a rate of 20%. Therefore the marginal tax rate on income above $10,000, but up to and including $20,000, is 20%.

NOTE that the 20% rate does NOT apply to the income below $10,001. Most people mistakenly believe that when they get "bumped into a higher tax bracket" all of their income is taxable at the higher rate. This is wrong, only the income in the higher tax bracket is subject to the higher tax rate.

Now, let us compare the value of a $1,000 deduction to two different people. Person A has a total income of $9,000, and Person B has an income of $12,000. The tax payable by each is:

Person A	$9,000 x 10% = $900
Person B	($10,000 x 10%) + $2,000 x 20%) = $1,400

Note that for Person B, the average tax rate is $1,400/$12,000 = 11.6%, which is much lower than the marginal rate of 20%. Taxpayer's average tax rates will always be lower than their marginal tax rates.

Now, if each gets a deduction of $1,000, their respective taxable incomes will be: Parson A, $8,000; and Person B, $11,000. Their tax payable will be:

Person A	$8,000 x 10% = $800
Person B	($10,000 x 10%) + $1,000 x 20%) = $1,200

Notice that the same $1,000 deduction reduced the tax payable for Person A by $100 while reducing the tax payable by Person B by $200. You would have obtained the same value for the tax deduction by multiplying the value of the deduction ($1,000) by the taxpayer's marginal tax rate (either 10% or 20%). So the same tax deduction was worth more to the person with the higher income.

This result seems strange, again because tax deductions are usually meant to provide financial help to people who otherwise do not have enough income to meet some important need. It makes little sense to give more help to a person that has a higher income and, therefore, needs the help less than the person with a lower income. The use of tax deductions has often been criticized as just a political ploy to 'buy-off' the wealthy while pretending to help the poor. It is for this reason that most tax scholars favour tax credits over tax deductions.

To recap:

- A deduction is only as valuable as a taxpayer's marginal tax rate - the higher the taxpayer's marginal tax rate, the more the deduction is worth;
- A deduction is worth nothing to a taxpayer who has no taxable income or who has a marginal rate of 0% (is below the basic exemption level);
- A credit is worth the same amount to all taxpayers as it is a dollar for dollar credit against taxes payable;
- A credit is worth nothing to a taxpayer that is not liable to tax, unless the credit is refundable;
- The tax savings to a taxpayer is equal to the revenue loss to the government - it is as if the government has given a subsidy of that amount to that taxpayer; and
- The higher the marginal rates and the more generous the tax savings, the greater the incentive for taxpayers to engage in questionable transactions so as to claim the deductions or credits.

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4. Time Value of Money

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