TAX MATTERS

Deductions, credits and the facts about tax savings

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Tax deductions and credits come and go. Some last for a little while, others last forever. One credit that disappeared in 2017 was the Manitoba Odour-Control Tax Credit. I was disappointed to see this one go. Not that I was eligible to claim it – I just enjoyed telling people there was such a thing. We're officially into tax season, and two common questions I hear regularly are these: "Which is better, a deduction or a credit?" and "What deductions and credits will save me the most tax?" Here's a primer for you.

DEDUCTIONS AND CREDITS

How they work: Both deductions and credits can save you tax, but they work differently. Let me simplify it here. A tax deduction will reduce your taxable income. If, for example, you earn $100,000 and claim a $20,000 deduction, your taxable income will be $80,000. You'd then apply the appropriate tax rate to that taxable income and you'd arrive at your tax bill. At an effective tax rate of, say, 25 per cent, that $80,000 of taxable income would result in taxes of $20,000 (the nationwide average tax rate is 23.8 per cent on $80,000 of taxable income). A tax credit does not reduce your taxable income, but rather is claimed directly against your tax bill owing. So, a $5,000 tax credit would reduce your $20,000 tax bill in my example to just $15,000 in taxes owing. Make sense?

Taxes they save: Tax deductions save you tax at your marginal tax rate. Your marginal tax rate is the amount of tax you pay on your last dollar of income. If, for example, your marginal tax rate is 50 per cent (which is about correct if you're in the highest tax bracket in most provinces), then a $10,000 tax deduction will save you $5,000 in taxes ($10,000 times 50 per cent). Tax credits, on the other hand, are usually calculated as a fixed percentage (generally 15 per cent federally, plus some provincial percentage) of some eligible amount. If, for example, you claimed $10,000 of eligible medical expenses, the federal tax credit would be $1,500 ($10,000 times 15 per cent) and there'd be some provincial credit on top of that (typically about another 5 per cent or so, depending on your province).

Here’s the bottom line: The total federal and provincial tax savings for a tax deduction can be up to about 54 per cent of the amount deducted, depending on your province and income level, and about 20 per cent of the eligible amount for a tax credit.

DEDUCTIONS

Although we can’t focus on every deduction today, let me share the “Big Four” (meaning the most common and often significant deductions) and then mention some others. For the discussion here, let’s assume taxable income of $80,000 and someone living in Ontario (the differences between provinces won’t be significant).

RRSP deduction: If you contributed to a registered retirement savings plan (RRSP) for 2018 on or before March 1, 2019, within your contribution limits, you can claim a deduction. Using our assumptions, a $10,000 deduction would save $3,148 in taxes at a marginal tax rate of 31.48 per cent.

Split-pension deduction: If you had eligible pension income in 2018, you can transfer up to one half of that income to your spouse or common-law partner. Do this by filing Form T1032 with your tax return and deducting the transferred amount on Line 210. A $30,000 deduction in our example would save you $9,444 in taxes at the same 31.48-per-cent marginal tax rate (albeit your spouse will face some tax).

Child care expenses: The lower income spouse generally needs to claim any child care expenses, but if you had a child under the age of 7 in 2018, file Form T778, and claim the maximum $8,000 for expenses incurred for care for that child to allow you to work, you’d save $2,518 in taxes at the same marginal rate. Be sure to read the criteria to claim these costs (see cra.gc.ca and search the term “child care expenses”).

Employment expenses: Employees don’t get a lot of breaks, but if you had to use your own vehicle in your work, or otherwise paid for supplies, travel, an assistant, or worked more than half the time from home, among other things (do a search for “employment expenses” at the same website above), you may be entitled to deductions. Employment deductions of $5,000 will save you $1,574 in 2018 under our assumptions.

Other deductions: If you want an exhaustive list of other deductions, check out Page 3 of your personal tax return. Don’t forget to consider: Annual union or professional dues, interest or carrying charges, moving expenses, stock option deductions, capital losses, the clergy residence deduction, the lifetime capital gains exemption or business investment losses.

Next time, I’ll finish the conversation by talking about tax credits.

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