

DISABILITY, POVERTY, AND THE INCOME TAX: THE CASE FOR REFUNDABLE CREDITS¹

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RÉSUMÉ

Les politiques fiscales à l'égard des personnes handicapées ont été sensiblement améliorées au cours des dernières années, mais elles n'ont pas aidé les plus démunis, qui n'ont pas un revenu suffisant pour profiter des crédits et déductions établis. L'article qui suit plaide en faveur du crédit d'impôt remboursable comme solution partielle à ce problème, tout en faisant ressortir que les mesures fiscales doivent s'accompagner d'interventions gouvernementales directes pour entraîner une véritable participation des personnes handicapées à la vie sociale et économique. On y examine le crédit d'impôt remboursable en tant que soutien destiné aux personnes handicapées à faible revenu par opposition aux crédits non remboursables existants et aux mesures non fiscales telles que les dépenses de programmes directes. L'auteur explique ensuite comment les crédits d'impôt remboursables pourraient être conçus de façon à éviter les lacunes des dépenses fiscales sur le plan de la politique générale et les obstacles constitutionnels que suppose un programme de soutien pancanadien à l'intention des personnes handicapées. Elle s'oppose à l'adoption d'un programme de crédits subordonnés au revenu comparable à la Prestation nationale pour enfants du gouvernement canadien ou au crédit d'impôt pour personnes handicapées instauré par l'Angleterre. Son article fait plutôt l'éloge d'un crédit universel accordé à chaque personne handicapée et remboursable en cas de faible revenu. Cette mesure de soutien est le plus susceptible de nous permettre d'atteindre les objectifs fixés en matière de lutte contre la pauvreté, en plus de rendre l'impôt sur le revenu plus simple et équitable. On suggère un moyen de concevoir un tel soutien de manière à tenir compte des différences de sexe, de race et de classe sociale, ainsi que des idées et de la compétence mêmes des personnes visées.

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I. INTRODUCTION

The past several years have seen steady improvements in the tax treatment of people with disabilities. Every federal budget since 1996 has in some way increased the amount of tax recognition for the costs of living with or accommodating disabilities. In the year 2000 the federal government made further promises to raise the Disability Tax Credit by over 30% across the board, and by over 100% for children with disabilities.² These advances can be credited to the work of advocacy groups and researchers who have targeted the income tax system as a key instrument for improving disability supports, and also to the responsiveness of tax policy makers working under the leadership of Finance Minister Paul Martin. Disability tax reform is far from complete, however, and many gaps remain to be filled. The most glaring problem is that existing tax measures are almost all "non-refundable," and therefore do not benefit the lowest income members of the community.

For those with sufficient taxable income to absorb them, the disability-related deductions and credits in the *Income Tax Act*³ can reduce an individual's tax payable, leaving them with a higher after-tax income. For a person who is too poor to owe income tax, however, these provisions are of no benefit. A non-refundable deduction or credit cannot be received as a cash payment from government by individuals whose tax liability is already nil. Given the high rates of poverty among people with disabilities, this can only be seen as a gaping hole in the system of disability supports and a serious inequity in the tax system.⁴

This problem has not gone unnoticed among commentators, and many have called on governments to make disability-related tax measures refundable.⁵ Yet none has exam-

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2. These increases were announced in the spring 2000 federal budget and the fall 2000 pre-election "mini-budget": see Canada, Department of Finance, *Budget 2000: The Budget Plan* (February 28, 2000); and *Id.*, *Economic Statement and Budget Update* (October 18, 2000). For detailed proposals see Canada, Department of Finance, *Legislative Proposals and Explanatory Notes Relating to Income Tax* (released December 21, 2000) [hereinafter *Legislative Proposals*], clause 62 (discussed *infra*).
 3. R.S.C. 1985 (5th Supp.), c. 1, as am. [hereinafter *ITA*]. Unless otherwise indicated, all statutory references in this paper are to the *ITA*.
 4. See G. Fawcett, *Living with Disability in Canada: An Economic Portrait* (Hull, QC: Office for Disability Issues, Human Resources Development Canada, 1996), at 129-145. Fawcett's study is based on the 1991 Statistics Canada Health and Activity Limitation Survey (HALS), the latest available data. It indicates that 21.9% of people with disabilities aged 15 years and over had incomes below Statistics Canada's Low Income Cut-offs, a widely accepted measure of poverty, compared to 12.6% of those without disabilities. This likely understates the poverty rate among people with disabilities, because it is based on income figures before taking into account any extra disability-related living costs and medical expenses. Further, the 1991 statistics indicate that the chances of living in poverty are even greater than 21.9% if the person with a disability is a woman, is living alone, is unemployed or not participating in the paid labour force, did not complete high school, lives in an urban setting, has a moderate or severe (as opposed to mild) disability, or receives social assistance. Note that the 2000 federal budget allocated funding for a new HALS to be carried out as part of the 2001 national census: Canada, Department of Finance, *Budget 2000: The Budget Plan* (February 28, 2000).
 5. See, for example, D. Baker & H. Beatty, *Consultant's Report on Taxation and Disability: Recom-*

ined in detail how such provisions might be designed and administered. In this article I take up this challenge. I begin in Part II by evaluating refundable tax credits as a policy instrument for improving disability supports to low-income people. I compare the non-refundable mechanisms used in the current *Income Tax Act (ITA)* to refundable credits in terms of their technical operation and their distributive impact on taxpayers. I then step back to consider whether a new disability support program is best delivered through the tax system at all, or whether a direct transfer or some other instrument would be preferable. I conclude that a refundable tax credit could play a highly progressive role in delivering disability supports, provided that it is designed creatively to mitigate some of the drawbacks of tax based programs. I also caution against over-reliance on refundable tax credits alone to assist those with low incomes. Individualized cash benefits must be coordinated with direct investments in the supply of needed goods and services, and with regulatory measures to promote the full participation of people with disabilities in all aspects of social, political, and economic life.

Part III considers in more detail how best to design and administer refundable tax credits for people with disabilities. I first discuss some key policy choices that will affect the design of such a program, such as what needs it is meant to address and whom exactly it is meant to assist. I explain why, in designing a refundable credit, policy makers will need to attend carefully to differences of class, gender, and race among people with disabilities. Part III then turns to examine three possible models for reform, placed on a continuum from more incremental to more innovative approaches:

1. Rework existing refundable credits to take better account of disability-related needs
2. Add refundability to existing disability-related deductions and credits
3. Create a new refundable tax credit that would improve upon and replace some of the existing disability-related provisions

I evaluate each of these models against objectives of reducing poverty, enhancing autonomy, providing access to disability-related goods and services, and integrating people with disabilities more fully into all aspects of society. I also consider how well

mended Reforms (Ottawa, Federal Task Force on Disability Issues, 1996), at 8-11; J. Berman, "Commissioners' Personal Comments" in *Fair Taxation in a Changing World: Report of the Ontario Fair Tax Commission* (Toronto, University of Toronto Press, 1993), at 987-92; D. Duff, "Disability and the Income Tax" (2000) 45 McGill L.J. 797, at 883-89; Federal Task Force on Disability Issues, "Costs of Disability" in *Equal Citizenship for Canadians with Disabilities: The Will to Act* (Ottawa: Queen's Printer for Canada, 1996); R. Shillington, *Taxation and Disability: A Report for the Federal Task Force on Disability Issues* (Ottawa: Canadian Council for Social Development, 1996), at 17-19; Standing Committee on Human Rights and the Status of Disabled Persons, *As True as Taxes: Disability and the Income Tax System* (Ottawa: The Committee, 1993) at 13-14; and C.F.L. Young, *Women, Tax and Social Programs: The Gendered Impact of Funding Social Programs through the Tax System* (Ottawa: Status of Women, 2000) at 60,61.

each model coheres with traditional tax policy criteria, especially the principles of equity and simplicity.

Concluding that the third model—creating an entirely new refundable credit—is by far the most attractive, I go on to discuss some of the specific design issues it would raise, particularly the choice between universal *versus* income-tested benefits. Canada's National Child Benefit and Britain's Disabled Person's Tax Credit are reviewed as examples of income tested refundable credits. I argue that a universal refundable credit, available to all people with disabilities, regardless of income, is a far better option. I suggest how such a credit could be designed with some redistributive features that would channel a larger share of resources to those with lower incomes.

II. WHY REFUNDABLE TAX CREDITS? CHOOSING A POLICY INSTRUMENT FOR IMPROVING DISABILITY SUPPORTS

A. Tax Mechanisms: What's so Special about Refundable Credits?

This section compares four distinct mechanisms used by the *ITA* to provide tax relief to individuals with disabilities and to others who support, care for, or employ them: (1) income exclusions; (2) deductions; (3) non-refundable credits; and (4) refundable credits. I provide examples of each mechanism, explaining how it affects the calculation of tax liability, and why it has such different effects on the distribution of the tax burden among people with higher and lower incomes. My analysis demonstrates why refundable credits are the only reliable means of delivering tax relief to those with very little or no taxable income. A more difficult question, however, is whether the tax system is the right vehicle for delivering such benefits at all, as compared to a direct spending program or some other policy instrument. I reserve these larger issues for the next section of the paper.

The most basic distinction among the four tax mechanisms I will discuss is that each operates at a different stage in the calculation of tax liability, as illustrated by Table 1 on the next page.

Taking each of the four mechanisms in turn, I provide examples of how they are used currently to grant tax relief in relation to disability, and compare their distributive impact on taxpayers in different income groups.

1. *Exclusions from Income*

The first way in which the *ITA* provides tax relief to people with disabilities is to exclude certain payments or amounts from the definition of taxable income. It is important, however, that these exclusions are based not on the status of the taxpayer as disabled or poor, but on the type of income received. As a consequence, income exclusions are, distributively speaking, a rather arbitrary form of assistance. If a low-income person does not receive income from the "right" sources, all of her income will be subject to tax.

Table 1: Steps in the Calculation of Federal Income Tax Liability⁶

gross income	
⇓	mechanism 1: exclusions
minus deductions	
⇓	mechanism 2: deductions
= "income" ⁷	
⇓	
minus further deductions	mechanism 2: more deductions
⇓	
= "taxable income"	
⇓	
taxable income x progressive marginal tax rates ⁸	
⇓	
= preliminary tax payable (before credits)	
⇓	
minus non-refundable credits ⁹	mechanism 3: non-refundable credits
⇓	
= federal tax payable	
⇓	
minus refundable credits	mechanism 4: refundable credits
⇓	
= federal tax owing <u>or</u> refund owing to taxpayer	
(a negative balance or 'overpayment' due to refundable credits is paid to taxpayer)	

6. Note that after computing federal income tax, provincial income-tax liability is computed, and the two are added together to reach the taxpayer's final tax bill. Each province maintains its own separate income tax legislation, but all provinces except for Quebec have largely incorporated the federal system under a set of administrative arrangements known as the Tax Collection Agreements. The interaction of federal and provincial tax mechanisms is discussed further in Part II.B., *infra*.
7. The term *income* refers to a taxpayer's net income after deducting certain expenses and other amounts allowed under Division B, Part I of the *ITA*: s. 3. *Income* is then adjusted to reach *taxable income* under Division C, which allows a second layer of deductions: s. 2(2). Thus a taxpayer may be entitled to claim deductions at two different stages in the calculation of tax liability.
8. For the 2001 taxation year, the marginal rates are 16% on the first \$30,754 of taxable income; 22% on taxable income over \$30,754, up to \$61,509; 26% on taxable income over \$61,509, up to \$100,000; 29% on any taxable income over \$100,000: see *Legislative Proposals*, *supra* note 2, cl. 58(2), amending s. 117(2).
9. The most important non-refundable tax credit is the basic personal credit in 2001, which effectively exempts from tax the first \$7,412 earned by all taxpayers: s. 118(1)(c). This "basic personal amount" is scheduled to rise to at least \$8,000 by 2004: see *Legislative Proposals*, *id.*, cl. 59(3.1).

People with disabilities receive income from a wide range of sources.¹⁰ Though it is useful to categorize them loosely as public or private, it should be remembered that many "private" income plans are in fact publicly subsidized through tax incentives or otherwise, while "public" support is sometimes conditioned upon prior participation in the labour force and payment of contributions or premiums. Private sources of income would include, for example, employment or self-employment, investments in corporate shares, bonds, or other income-producing properties, pensions and other retirement savings, private disability-insurance plans, and court-awarded damages or settlements in personal injury actions. Public sources of income for people with disabilities include provincial automobile accident insurance, worker's compensation and social assistance schemes, and federally the Old Age Security (OAS), Canada Pension Plan (CPP), Quebec Pension Plan (QPP), and Employment Insurance (EI) programs.

Payments from some of these sources are excluded from the *ITA*'s definition of *income*, either by legislative exemption or by judicial or administrative interpretation, while others must be included in income and fully or partially subjected to tax.¹¹ Thus the tax status of income received by people with disabilities depends very heavily on its source, and sometimes upon fine distinctions about the exact circumstances in which it was received. This is well illustrated, for example, by the tax treatment of payments under a disability insurance plan arranged through an employer. When an employee becomes disabled and makes a claim under such a plan, the insurance payments may be taxable or non-taxable, depending on who paid the premiums under the plan. If the premiums were paid exclusively by the employee, the insurance benefits are tax free. If an employer or other person (such as a union) paid all or any portion of the premiums, however, the employee must report payments under the plan as income. Where the cost of premiums was shared, the employee may deduct her portion and report only the net benefit for income tax purposes.¹² Further complications can arise if the insurance company disputes an employee's eligibility for benefits, and eventually settles the claim with a lump-sum payment. In two recent cases, the Tax Court of Canada held that such lump-sum payments are not caught by the *ITA* and can be received tax free, regardless of who paid the premiums under the plan.¹³ However, the same Court held in another case that the lump sum settlement was taxable because, *inter alia*, the employer had paid the premiums under the plan.¹⁴ Finally, if an employee has no disability insurance benefits but instead receives sick pay or

10. See Fawcett, *supra* note 4 at 140-46.

11. See Duff, *supra* note 5, at 874-81; David Schulze, "Obstacles to Equity: An Analysis of the Taxation of Disability Income in Canada and Proposals for Reform" 14 *Windsor Y.B. Access Just.* 135; and David M. Sherman, *Taxes, Health & Disabilities* (Scarborough: Carswell Thomson Professional Publishing, 1995) at 139-53.

12. See s. 6(1)(f), and Interpretation Bulletin IT 428, *Wage Loss Replacement Plans* (April 30, 1979).

13. *Whitehouse v. R.*, 2000 D.T.C. 1616 (T.C.C.) (informal procedure); *Landry v. R.*, 98 D.T.C. 1416 (T.C.C.) (informal procedure).

14. *Dumas v. R.*, 2000 D.T.C. 2603 (T.C.C.) (general procedure).

compassionate payments directly from an employer, these amounts are fully taxable in the same manner as regular wages.¹⁵

The tax treatment of public income support also varies, depending on the program. Sickness or disability benefits received under the CPP, QPP, EI, or OAS must all be included in income.¹⁶ By contrast, social assistance and worker's compensation are not subject to income tax, though they are included in determining eligibility for certain income tested tax credits.¹⁷ Thus receipt of welfare or worker's compensation may result in the loss of other tax-based benefits such as the age credit for those over 65,¹⁸ the goods and services tax credit,¹⁹ the Canada child tax benefit,²⁰ and the refundable medical expense supplement.²¹ Payments under a provincial auto accident insurance plan are not required to be included in income at all.²²

Income exclusions may be helpful to some low-income people with disabilities who happen to receive their incomes from non-taxable sources. But overall they are highly inefficient and unfair as a mechanism for tackling poverty among people with disabilities. First, the income exclusions are of no value to those earning less than the basic personal amount, which is received tax free in any event by all individuals (\$7,412 in 2001, scheduled to rise to \$8,000 by 2004).²³ Nor do they assist those who live on poverty-level incomes from fully taxable sources, such as wages, CPP, EI, OAS, or employer-paid disability insurance. The system could be made more horizontally equitable by treating all forms of disability income the same, instead of exempting some and taxing others.²⁴ But exempting all disability income from tax would be vertically inequitable as between lower and higher income individuals. This is because the value of an income exclusion in terms of tax dollars saved rises directly in proportion to income. A single person with a disability, living modestly on \$10,000 of

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15. S. 5(1), 6(1)(a). There is a narrow exception that allows employees with disabilities to receive certain cash or in-kind benefits from their employers tax-free. If an employee meets the stringent definition of disability needed to qualify for the disability tax credit (discussed *infra* at note 40 and related text), two types of fringe benefits are expressly excluded from income: the cost of hiring an attendant to assist the employee in the performance of her duties, or, where the employee has a mobility impairment, the cost of transportation to and from work and parking near the workplace: s. 6(16).
 16. Ss. 56(1)(a)(i)(A),(B),(iv).
 17. This is accomplished by including such benefits in the definition of income (s. 56(1)(u),(v)), but then deducting them from "taxable income" (s. 110(1)(f) preamble, (ii)). Note 7 explained the difference between income and taxable income.
 18. S. 118(2).
 19. S. 122.5.
 20. S. 122.61.
 21. S. 122.51.
 22. Duff, *supra* note 5, citing a private opinion letter from Revenue Canada.
 23. *Supra* note 9.
 24. For an argument in favour of full taxation of all disability income, with full deductibility of all contributions to income-replacement plans, see Duff, *supra* note 5, at 879-81. Schulze makes the opposite case, calling for a comprehensive exemption for all forms of disability income and full taxation of amounts contributed to income-replacement programs (*supra* note 11, at 150-60).

