

TAXING FAMILIES: DOES THE SYSTEM NEED AN OVERHAUL?

CANADA HAS MAINTAINED AN AMBIGUOUS APPROACH TO FAMILY TAXATION FOR DECADES. IT'S TIME TO ADDRESS THE PROBLEM

by Jack Mintz

Springtime is tax time. It is at this time of year that Canadians watch the federal and provincial governments deplete their bank accounts. There has been some progress in the past decade to reduce personal income taxes, yet there is much more that needs to be done to correct for the high taxes raised to fight the deficit during the 1980s and early 1990s.

The issue is not just one of high taxes, however. Canada has an ambiguous approach to family taxation and no clear application of principle has evolved over time. This has resulted in inequitable tax treatment for families with the same earning power. Raised 40 years ago by the famous 1966 Carter Report, which argued for equal treatment for families, still today, a single-earner family pays much more tax than two-earner families. This is an issue that should be corrected, and this can best be achieved by providing opportunities for families to split income more readily.

Income splitting (or family taxation, as it is known), alongside correcting for structural inequality, would help families immensely. It makes a simple point, though the method by which we attain fair family taxation is complex. Problems arise because we have a graduated tax structure – individuals or families with higher incomes pay a greater portion of their income in tax than those with lower income. Under the existing Canadian tax system, two-earner families pay less tax than a single-earner family with the same income.

Consider two Ontario families, each with two children – one with two working parents earning \$35,000 each and the other with one working parent earning \$70,000. Assume the only credits used are for basic personal and child exemptions: The two-earner family pays \$10,364 in 2007 federal and Ontario tax while the one-earner family pays \$14,165 in tax, or 37 per cent more. With rents, mortgage payments, car lease obligations, food, clothing and other demands, the additional \$315 monthly penalty is a burden on the single-earner family.

It makes it much more difficult for one of the parents to stay at home to raise children or spend time doing voluntary work. Ultimately, high taxes imposed on single-earner families drive people to make choices that they may not wish to make. It is an important social issue, too, given Canada's falling birthrate and aging society; recent empirical work, especially by Kevin Milligan at the University of British Columbia, has shown that tax policy has a significant impact on fertility rates. Effectively, all industrialized countries are struggling to achieve equal treatment of families and Canada should be no exception.

In Canada, we have vacillated between using individual and family taxation.

On the positive side, the current system gives some advantages to Canadian families. They can split investment income between spouses under certain circumstances. A spouse can contribute to the other's RRSPs (this is limited by the contribution limits that apply to the single

earner). Canada/Quebec Pension Plan benefits and pension income may be split between spouses. Self-employment income can be split among members of the household to some extent, especially when the business activity is incorporated. The assets of a spouse upon death can be rolled over to another on a tax-free basis to defer deemed realization of capital gains and

retirement savings plans, and spousal testamentary trusts may be created to provide opportunities of splitting income from estates passed onto children. Transfers of unused credits and deductions are permitted in several cases (such as pension income, child, disability and tuition fee and education cost tax credits).

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On the negative side, refundable tax credits to low-income households such as the GST credit and child tax benefits are reduced when family income exceeds a threshold, in contrast to old age security payments that are clawed back on an individual basis. The medical expense credit is limited to three per cent of income earned by the spouse with the lowest income. And of course, income splitting or family taxation is not on the books.

Family taxation offers fairness

The main tax policy argument that is given to support family taxation is based on efficiency and fairness. Taxation should not interfere with decisions to stay at home or work. Further, fairness is achieved by horizontal equity – the equal treatment of equals. Under both objectives, families with similar economic circumstances should be taxed similarly.

Other advantages are achieved with family taxation. Rules for attributing income to different spouses are less complex and costly since income can be aggregated. Tax credits are easily transferable and other provisions such as clawback rates for income-tested benefits and medical expense deductions can be applied on an averaged basis or at reduced rates.

The general lack of clarity on tax policy means the issue has been subject to much debate. In a recent paper, Professor Jonathan Kesselman of Simon Fraser University argued that it would be wrong to split labour income as opposed to investment income because it would create unfairness given that families with a stay-at-home spouse have certain economic advantages. While it is difficult to develop a perfect system, it makes little sense

Overcoming the difficulties

So what makes family taxation difficult? It is the application of efficiency and horizontal-equity principles. Three specific issues arise:

- Overhead costs in running a household are lower per person for larger compared to smaller households.
- A spouse staying at home earns untaxed leisure or production income. In households with two working parents, the working spouses incur costs to earn a living and so are tax-disadvantaged when entering the labour force.
- Under family taxation, a spouse who chooses to work faces a much higher rate of tax compared to individual taxation. It might be more difficult for a spouse to be financially independent.

On the first point, it is correct to claim that people who live together are able to share costs in running a household so that they should pay somewhat more tax per person than an individual taxpayer. While this point makes sense when comparing two- or more member households with a single-member household, the principle is difficult to apply when comparing three types of households – a single person, two living together, both working and two living together with one not working. Like a family with one single earner, two earners living together should also pay more per capita tax than a single individual living on their own. In other words, to achieve equal treatment, some adjustment to the tax base is needed. This is best accommodated by adjusting personal income exemption levels in recognition that some income

person on their own compared to earners in multiple member families. This would apply to all income, including pension, investment or labour income.

As for the second criticism, a spouse who stays home may be engaged in untaxed activities such as voluntary work, raising children or maintaining the household. Couples both working might need to pay contract labour to look after household needs. None of these issues detract from the value of applying the principle that families should be taxed equitably. With regard to untaxed home production – one could adjust the personal exemption downwards for the spouse staying at home when designing the tax base. In the case of voluntary work, it might be viewed that such efforts are socially desirable and hence should not be taxed. As for the need to recognized costs incurred to earn money income, the appropriate approach is to provide some deduction for these costs for both efficiency and fairness reasons. The Canadian tax system already provides for a deduction for child care expenses and an employment income credit. Perhaps these costs need better recognition but we already have the ability to provide tax relief for costs incurred to earn a living. Penalizing families with stay-at-home spouses is not the way to ensure that costs incurred to earn a living are deductible from income.

The final criticism is that a spouse who chooses to work is taxed heavily given the graduated tax structure applied to family income. The additional family income earned is assessed at high marginal tax rates compared to individual income taxation earned by the second earner. Further, a spouse might want to be independent of another, thereby making individual taxation more desirable. Again, alternative approaches under family taxation can ameliorate these effects. For example, families might be given an option to choose between individual and family taxation and exemption levels can be adjusted, as discussed above, so that there is greater incentive for the second spouse to work.

Family taxation around the globe

None of the problems associated with family taxation are insurmountable. The basic aim is to achieve efficiency and fairness under the tax system. It is impossible to see how limiting taxation to individual taxation supports these principles.

TAXATION SHOULD NOT INTERFERE WITH DECISIONS TO STAY AT HOME OR WORK. FURTHER, FAIRNESS IS ACHIEVED BY HORIZONTAL EQUITY – THE EQUAL TREATMENT OF EQUALS. UNDER BOTH OBJECTIVES, FAMILIES WITH SIMILAR ECONOMIC CIRCUMSTANCES SHOULD BE TAXED SIMILARLY

to argue that individual taxation is a superior principle simply because it may be complex to incorporate certain limitations to the family taxation approach.

should not be taxed in order to cover minimum costs of living. To provide for a better treatment of different types of families, a higher exemption should be given to a single

Nine industrial countries apply the family taxation principle. The French and Portuguese systems aggregate family income but explicitly allow for family size to reduce tax payments. The Czech Republic, Germany, Ireland, Luxembourg, Poland, Switzerland and the United States allow family members to file jointly and split income. Other industrialized countries rely primarily on individual taxation but often allow for family tax principles such as the transferability of deductions and credits or joint filing or splitting of income of some sort.

Canadian possibilities

In the Canadian context, three approaches could be used to achieve greater equality among families.

The first approach would be a simple one, similar to the recently-adopted method for pension income splitting, whereby the high-income spouse transfers income to the low-income spouse. While this approach is simplest to apply and amounts could be limited, it would not deal with some of the criticisms related to the equitable treatment of stay-at-home and working spouses, which would require adjustments to exemption levels and tax brackets. Rules would need to be maintained for the transferability of credits, estate planning and attribution of investment income with respect to children. Further, tax planning opportunities may be created in that splitting investment and business income is achieved on a different basis than income splitting for labour income. Nonetheless, income splitting is the simplest approach to apply, because it minimizes disruptions to other parts of the tax system.

The second approach is to follow the German and U.S. models by providing an option for the joint filing of returns. Tax brackets under joint filing would be doubled (or multiplied by a somewhat smaller factor) and exemptions could be adjusted to provide greater relief for those families with two earners. The aggregation of income among family members would greatly reduce compliance and administrative costs. An option could be given to allow families to file jointly or separately, thereby minimizing impacts on existing two-earner families although at the cost of creating more calculations for families.

The third approach would be similar to the French system whereby family income is aggregated and divided by a quotient. The French quotient is based on the number of parents (each given a weight of one) and children (0.5 each for the first two children and a weight of one applied to each additional children; in the case of a single parent, the first child is given a weight of one). Family income is divided by the quotient and the graduated rate structure is applied to the averaged income. The total tax payment is calculated by the averaged individual tax multiplied by the quotient (a limit is imposed on the maximum tax reduction related to the child component). This system provides for all the advantages of pooling although, if mandatory, can lead to high levels of tax on a spouse choosing to work unless ameliorated by the exemption/credit system.

Overall, the federal and provincial governments would face a reduction in tax collections if family taxation principles were broadened today using any of the above approaches. While some experts might call for reductions in marginal tax rates instead, it would be better to address horizontal inequities to give families greater choices in terms of working and voluntary careers and methods by which to raise families. Family taxation, albeit imperfect, makes sense.

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