
Taxing the Family – The Tax Unit: Should New Zealand Adopt a Family-Based Income Tax?

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In April 2008, the New Zealand Government issued a government tax policy discussion document considering whether families should be able to access a form of income splitting through the New Zealand tax system. In Australia and New Zealand, as with most other OECD countries, the individual is the unit of taxation. In applying the principles of equity, families are entitled to certain benefits, currently delivered primarily through the welfare system. This results in a mismatch between the unit taken into account for tax and welfare. In this article, the author explores the concept of the tax unit. The article will review, first, the two main methods of joint taxation, being the accumulation method and the income splitting method, examining the equity and efficiency of each method. The article will then review the New Zealand proposal in the context of this analysis. Finally, some of the alternative methods of providing support for the family will be discussed.

1.0 INTRODUCTION

Determining the appropriate tax unit within a particular jurisdiction, for a particular tax, is a necessary component of that tax system. The tax unit establishes the boundaries of the tax. It determines who is liable, and limits the tax to the resources of that person.

From time to time, there is vigorous debate as to whether the appropriate tax unit for the income tax is the individual, as adopted in most OECD¹ countries (including New Zealand and Australia), couples, as in the United States (US),² or entire families along the lines of the French model.³ Such debates are widely followed by politicians, the media and the general public, who intuitively believe that families are not well catered for within the taxation system. The Liberal Party of Australia, while in opposition in the early 1990s, included income splitting in its platform on the basis that it is fairer to families, although when in government this policy was replaced firstly by the increased tax thresholds for families, then by the Family Tax Benefit.

¹ The Organisation for Economic Co-operation and Development.

² M Brooks, "The Tax Unit and Rate Structure: A Criticism of the Orthodoxy", (1997) Vol 52:1 *Public Finance* 22; M McIntyre, "Marital Income Splitting in the Modern World: Lessons for Australia from the American Experience", in J Head and R Krever (eds), *Tax Units and the Tax Rate Scale*, (Sydney, Australian Tax Research Foundation, 1996), p 1.

³ A-T Dang and J-M Monnier, "The French System of Direct and Indirect Family Transfers and the Principles of Justice", (2004) Vol 38:3 *Journal of Economic Issues* 683.

In New Zealand, the current debate was reignited by the election of members of the United Future Party in the 2005 General Election. As part of the Confidence and Supply Agreement entered into between the Labour Party and United Future Party in the formation of government, the Labour Party agreed to produce a discussion document on income splitting. This discussion document⁴ was published on 27 April 2008.

In this article, the author will explore the concept of the tax unit. The first part of the article – sections 2, 3 and 4 – will review the two main methods of joint taxation, being the accumulation method and the income splitting method, examining the equity and efficiency of each method. The New Zealand proposal will then be reviewed (in sections 5 and 6) in the context of this analysis. Finally, in section 7 some of the alternative methods of providing support for the family will be discussed.

2.0 JOINT TAXATION SYSTEMS

While Australia and New Zealand⁵ have always adopted the individual as the tax unit, there are a number of different models that have been adopted in other jurisdictions. Joint taxation on the income of couples can take one of two models: the aggregation model is a tax on joint income, with both parties jointly liable for the tax, while the income splitting model allows income to be allocated between the parties. Variations to these forms include taxing property income on a joint basis with earnings being taxed on an individual basis; joint taxation may be optional; other family members may be incorporated in the model as in France, and the tax scales may reflect the different status of joint taxation.

Although many countries, such as the United Kingdom (UK), traditionally adopted the married couple as the tax unit, the trend across OECD countries, over the past 30 years, has been to move away from joint taxation systems to individual taxation systems. The UK made the move to individual taxation in the 1970s, although the “married man’s allowance” was retained until 2000. This trend is justified on both equity and efficiency grounds.

3.0 EQUITY ISSUES

While equity is commonly categorised as horizontal and vertical equity, vertical equity can be further described as redistributive equity. While horizontal equity is concerned with ensuring that those who are in the same position should carry the same taxation burden, vertical equity ensures that the tax system recognises that income alone is not always a measure of a person’s circumstances and ability to pay taxes.⁶ In the context of the tax unit debate, the principle of horizontal equity requires that if two

⁴ Inland Revenue, *Income Splitting for Families with Children: A Government Tax Policy Discussion Document*, (Wellington, April 2008), hereafter referred to as “the Income Splitting Discussion Document”.

⁵ Although a form of income aggregation was applied in New Zealand to high income married couples between 1939 and 1962.

⁶ See OECD, *OECD Tax Policy Studies No 13: Fundamental Reform of Personal Income Tax*, (Paris, 2006), p 41:

“*Horizontal equity* from a tax perspective implies that taxpayers in an equal situation should be taxed in an equal manner as they have the same ability to bear the tax burden. Horizontal equity then implies that the tax on a given level of total income should be the same regardless of how this income is composed (e.g. wage and pension income, fringe benefits or any form of capital income including imputed income from owner-occupied housing and capital gains on an accruals basis). However, the notion of “an equal situation” can be ambiguous. Some tax systems consider, for instance, the number of children or the marital status as a relevant difference for tax purposes while other tax systems do not. Moreover, the notion of “an equal situation” can be interpreted not only on the basis of income but also on the basis of taxpayer’s welfare. The notion’s meaning might change over time as well. The tax policy objective of *vertical equity* prescribes that taxpayers with better

persons are earning the same level of income, they should pay the same amount of tax – although one earner may be single, while the other is a sole earner supporting a spouse and children. Clearly, it costs more to support a family than to support a single person, with studies showing that two cannot live as cheaply as one – although they can live more cheaply than two single persons.⁷ A further dimension to equity is the need to ensure gender equity, that is, that the system is not biased in favour of one gender over the other. This is commonly seen in “traditional” family structures where a male breadwinner, as the taxpayer, may be the recipient of any concessions provided through the tax system⁸. Transfer payments are more commonly paid directly to the carer within the family.

Arguments that the individual is the more equitable tax unit are often based on issues of gender politics and property rights. In 1975, in the comprehensive review of the Australian taxation system chaired by the Hon Justice KW Asprey, he noted in the following reservation to the final report:⁹

“In my opinion, in the world of today a married woman should be treated both under the general law and in the taxation system as an individual in her own right and, in relation to the income which is both morally and legally her own, she should pay no more and no less tax than if she were a single person.”

Historically, the UK income tax was developed at a time when women did not have the right to own property in their own right. Accordingly, it was logical for the tax system to be based on joint household income. Among families liable for income tax in the nineteenth century, any income that the wife brought to a marriage was likely to be property income, which is more readily alienated and allocable between family members, rather than income from labour. In contrast, Australia has never had a joint income tax. By the time of Federation, the rights of women to own property and earn income in their own right were well established, although many married women were still financially supported by their husband.

Among the social changes of the twentieth century was a trend for women to be more likely to be engaged in gainful employment. This trend could be observed during both World Wars, as women took the place of men in the workforce; and in a more sustained manner in the second half of the century as women not only remained in the workforce after marriage, but demanded equality in the workplace. Coupled with these changes is a more active involvement in the management, and sharing, of household finances. The extent of pooling of resources within marriage now varies between couples from full sharing of all earnings, to maintaining separate financial accounts.¹⁰

In the face of such social changes and demands for equality, a joint taxation system is an anomaly that may suit some couples but be resented by others, as it demands a full disclosure of information between the couple and imposes obligations without necessarily conferring rights to property and

circumstances should bear a larger part of the tax burden as a proportion of their income. Vertical equity then implies that the distribution of after-tax income should be narrower than the distribution of before-tax income, or that the average tax rate should be increasing in income. This can be achieved by having a basic allowance and/or by having a progressive rate schedule (marginal tax rates that are increasing with income)

⁷ J Hills, R Smithies and A McKnight, “Tracking Income: How Working Families’ Incomes Vary Through the Year”, (CASE Report 32, ESRC Research Center for Analysis of Social Exclusion, London, 2006).

⁸ B Cass and D Brennan, “Taxing Women: The Politics of Gender in the Tax/Transfer System”, (2003) Vol 1:1 *eJournal of Tax Research* 37.

⁹ Taxation Review Committee (KW Asprey (Chair)), *Full Report*, (Canberra, 1975). The Reservation was appended to Chapter 10 of the Report.

¹⁰ See n 7.

income of one member of the couple. While the principle of joint taxation may seem to be a means of applying vertical equity,¹¹ in its original form it is in fact based on horizontal equity, and operates to the detriment of married couples. Joint taxation aggregates the income earned by both members of the couple, and taxes them as if earned by a single tax unit. A limited aggregation model was applied in New Zealand in relation to high income married couples between 1939 and 1962. Where the tax scale is a progressive scale, this has the effect of taxing the second income at the marginal tax rate of the first income earner. To compensate for this, a different tax scale may be adopted with wider bands, as in the US.

The alternative form of “joint” taxation is income splitting, which enables the members of a household to divide the income between the members of that household. In most jurisdictions, this is limited to the members of a “couple”, the definition of which may vary between jurisdictions: it may include married couples only; de facto couples; and/or legal civil partnerships between same-sex couples. However, under the French quotient system the ability to split income among members of a household also extends to children within the household, although each child counts for less than the adults of the household.

The “income splitting” form of joint taxation may be considered to be more equitable as it places single income families in the same position as dual income families. In an income splitting system that also applies progressive tax rates and a tax-free threshold, families effectively obtain access to two tax-free thresholds, and broader income bands for each step in the tax rates scale. Much of the discourse surrounding income splitting in New Zealand and Australia arises from the fact that families in receipt of income from property or business sources may already be able to access a form of income splitting through the implementation of appropriate business structures.¹²

The US is a good case study to examine the differences between the two forms of joint taxation as it has utilised each of these forms at different periods. The introduction of joint taxation in the US was a response to the different legal systems in place in different states, which is a matter of constitutional history. In 1930, the Supreme Court handed down two apparently contradictory rulings: in *Poe v Seaborn*¹³ it ruled that spouses in community property states could return half of the joint income of spouses, while in *Lucas v Earl*¹⁴ it held that income splitting was not valid in common law states. Accordingly, in 1948 a federal law was adopted that would ensure that the residents of all states could split income between spouses.

While this was adopted ostensibly to promote horizontal equity between families residing in community property states and families residing in common law states, commentators also suggest that the move was a response to social conditions post-war, which saw women returning to home duties after working during the war.¹⁵ By the 1960s, it was suggested that single taxpayers were disadvantaged by the availability of income splitting to married taxpayers, as married couples obtained

¹¹ T Dwyer, “The Taxation of Shared Family Income”, in P Saunders (ed), *Taxploitation: The Case for Income Tax Reform*, (New South Wales, Centre for Independent Studies, 2006).

¹² T Cooper, “Taxing the family unit: income splitting for all?”, (1995) Vol 5:1-2 *Revenue Law Journal* 82; C Fisher and K Ritchie, “The Simply Impossible Pursuit of Simplicity in Changing the Tax Unit in New Zealand: Income Splitting”, (Paper presented at the 19th Annual Australasian Tax Teachers Association Conference, Brisbane, Australia, 22-24 January 2007).

¹³ *Poe v Seaborn* (1930) 282 US 101 (SC).

¹⁴ *Lucas v Earl* (1930) 281 US 111 (SC).

¹⁵ N Brooks, “The Irrelevance of Conjugal Relationships in Assessing Tax Liability”, in J Head and R Krever (eds), *Tax Units and the Tax Rate Scale*, (Sydney, Australian Tax Research Foundation, 1996), 35.

the benefit of effectively doubling the band width of the progressive tax rates. It was perceived that this benefit put married couples in an advantageous position relative to single taxpayers as the single person on the same total income as a married couple would pay substantially more tax, while the synergies obtained by pooling resources means that on a measure of the ability to pay, the married couple on the same total income are financially more able to pay the tax.

The response to this perceived inequity resulted in the adoption of a joint taxation schedule in 1969. The income of married couples was aggregated and the tax brackets were increased compared to those applied to single taxpayers. There was also a guarantee that a single person would pay no more than 120 percent of the tax payable by a married person on the same income. However, where the two partners in a marriage were earning similar levels of income, the aggregation could result in them paying more tax than two single persons, as the new brackets were less than double the width of those available for single persons. This discrepancy became known as the “marriage penalty”, and was considered to be a deterrent to marriage. On equity grounds, it was argued that individual taxation was fairer as it eliminated the marriage penalty.¹⁶

Currently, US couples have the option of filing joint returns or separate returns. However, if they choose to file separately they are unable to access a number of deductions and allowances, while paying the same rate of tax, resulting in a higher tax burden. The rate schedules are such that low and middle income earners pay the same rate of tax whether they are single, married filing jointly or married filing separately. When joint income exceeds US\$128,500 married couples face increased rates, through contracting tax brackets, when compared to the tax payable by two single persons each earning half of that amount. The effect of this structure is that where the earnings of the two spouses is not equal, the higher income earner obtains the benefit of paying a lower rate of tax on part of their earnings – the marriage bonus. However, where joint earnings exceed US\$128,500 the second income earner effectively pays tax at the highest marginal tax rate – the marriage penalty.

The point that should be made from the US experience is that the concept of equity is a fluid concept. While it is generally acknowledged that some adjustment needs to be made to tax schedules to reflect the “traditional” family structure, the application of progressive tax scales can result in inequities when compared to the tax payable either by a single person earning the same income as a married couple, or by couples cohabiting in a relationship that is not legally recognised as being married.

The “income splitting” form of joint taxation may be criticised as being overly generous to families and conferring a marriage bonus, while the “aggregation” form of joint taxation may be considered unfair to families as it imposes a marriage penalty with families paying more tax than two individuals, unless the tax bands are adjusted to reflect the joint nature of the earnings.

4.0 EFFICIENCY CONSIDERATIONS

The previous discussion of the equity issues raises the question of the relative efficiency of joint taxation systems. Clearly, where there are non-neutralities, such as marriage bonuses or penalties, it raises the possibility that these will be considered by taxpayers when making decisions, and there will be consequent inefficiencies in the system.

In the case of joint taxation systems, there are three areas where inefficiencies can be observed: marriage decisions; workforce participation and effective marginal tax rates.

¹⁶ N Brooks, “The Irrelevance of Conjugal Relationships in Assessing Tax Liability”, in J Head and R Krever (eds), *Tax Units and the Tax Rate Scale*, (Sydney, Australian Tax Research Foundation, 1996), 35.

4.1 Marriage Decisions

If there is a marriage penalty, which is most likely to arise under an aggregation form of joint taxation, there may be a disincentive to marry, or to stay married. The marriage penalty may arise in a pure aggregation system where the tax brackets are not double those applied to individual taxpayers, so that income earned by the spouse is taxed at the marginal tax rate of the primary income earner. It is more likely to arise where the income of each spouse is approximately equal, as there is not sufficient disparity in relative incomes to transfer the benefit of lower marginal tax rates to the higher income earners.

It would be naïve to suggest that taxation issues are the major motivator for marriage. However, at a time when social attitudes to marriage are changing, and co-habitation is becoming more acceptable, taxation considerations may become a part of the overall consideration. This is also affected by the policy of the particular jurisdiction on the recognition of de facto relationships or civil unions, and the problems in enforcing such recognition.¹⁷ It is more likely that the timing of such decisions will be affected than that the decision itself will be changed.¹⁸ A couple who were motivated by the taxation treatment of the marital unit could adjust their relationship to suit: in the early stages of the relationship they could co-habit while both partners are working full-time, paying single tax rates and avoiding the marriage penalty. If the wife chose to interrupt her career to have children, they could marry at the appropriate time and take advantage of the marriage bonus, then, conceivably, when the wife was able to return to work, and earn an income sufficient to incur the marriage penalty, the couple could divorce and continue to co-habit, although the evidence suggests that this third stage is less likely. In New Zealand, such anomalies are largely eliminated through access to civil unions, and de facto partnerships, which bestow the same rights and obligations as marriage.

This pattern is also likely to reflect the extent of the co-mingling of resources within the family: it is during the period that the wife does not earn an independent income that the husband is likely to be providing financial support for her and the children of the marriage. It is likely that as the wife's income increases on her return to the workforce, her own needs are more likely to be met by her own earnings – although the needs of the children reflect more complex resource sharing issues.¹⁹

The French system is unusual among OECD countries in that income splitting is based on all members of the household rather than just the earning adults. Such a system moves away from the need to define the family based on the relationship between the adults, but it does raise questions as to how the family should be defined.

It has been argued that when defining family relationships for the purposes of tax and welfare law, the spousal relationship should be disregarded in favour of relationships between a parent and child.²⁰ However, if the family was defined on this basis the special circumstances of blended families would need to be considered. Would the children be acknowledged in the family of the birth and step-parents, would it be based on custodial arrangements, or would the relationship be on the basis of some form of

¹⁷ H Hodgson, "More than Just DNA: Tax, Welfare and the Family", (Paper presented at the 19th Annual Australasian Tax Teachers Association Conference, Brisbane, Australia, 23 January 2007).

¹⁸ J Alm, S Dickert-Conlin and LA Whittington, "Policy Watch: The Marriage Penalty", (1999) Vol 13:3 *The Journal of Economic Perspectives* 193.

¹⁹ Taxation Review Committee (KW Asprey (Chair)), *Full Report*, (Canberra, 1975).

²⁰ M Stewart, "Domesticating Tax Reform: The Family in Australian Tax and Transfer Law", (1999) Vol 21 *Sydney Law Review* 453.

shared basis? In the Australian and New Zealand tax transfer systems, the sharing of parental care is acknowledged in the system design.

4.2 Workforce Participation

It is well established that women's workforce participation rates are highly elastic, particularly during the period that mothers are juggling child-rearing duties with paid work.²¹ Decisions as to whether a mother will work, and the extent to which she will work, are affected not only by taxation considerations, but also by the need to purchase services to replace those she would normally provide – particularly childcare and other domestic services. In addition to the marginal rate of tax, other benefits, such as the Australian Family Tax Benefit and New Zealand Working for Families Tax Credit, may also be withdrawn as the spouse income, and correspondingly the family income increases – thus further increasing effective marginal rates of tax.

Two recent studies have examined the impact of joint taxation systems on the workforce participation rate of married women. Dearing²² examined the workforce participation rates in Austria and Germany – two countries with similar economic systems. There are, however, two significant differences in relation to family support: parental leave is more generous in Austria than in Germany, and Austria adopts individual taxation, while Germany applies an income splitting joint taxation system. The study shows that Austrian mothers of infants are more likely to participate in the workforce than German mothers, although when hours of paid employment reaches about 30 the difference tends to disappear. This is attributed to the effect of the different maternity leave arrangements in the two countries. In relation to older children, where maternity leave is not a factor, Austrian women are more likely to undertake part-time or full-time employment than German women, although German women are more likely to work seven hours fewer than Austrian women. In all cases, there is a substantial drop in employment rates at about 20 hours, with fewer women working more than 20 hours each week.

This employment pattern is attributed largely to the tax-transfer system. The study concluded that German women would be more likely to take on additional work if the Austrian conditions were available to them, while a small number of Austrian women would withdraw from the labour force if they were taxed under the German system, and parental leave was limited. Other factors, such as childcare availability in the two jurisdictions, are also relevant in making this decision.

The second study²³ examined the effect of the 1988 tax reforms in Canada, which altered the form of the concession available for married couples. Prior to 1988, the spousal concession was a deduction from taxable income of the taxpaying spouse. The deduction was a maximum of C\$3,700, reducing dollar for dollar if the spouse earned income. This was replaced by a non-refundable tax credit of C\$850, which reduced by 17 percent (the equivalent of the lowest tax rate) for each dollar that the spouse earned over C\$500, to phase out at C\$5,500. These reforms were similar to the tax reforms entered into in Australia in 1975. The effect of the change was that formerly the income of the spouse was taken into account at the marginal tax rate of the taxpayer, similar to a joint taxation system. Following the reforms, the tax credit reduced at the rate of the lowest marginal tax rate, as if the spouse were paying tax as an individual.

²¹ P Apps, "Taxation and Labour Supply", (2007) Vol 22:3 *Australian Tax Forum* 89.

²² H Dearing, H Hofer, C Lietz, R Winter-Ebmer and K Wrohlich, "Why are Mothers Working Longer Hours in Austria than in Germany? A Comparative Microsimulation Analysis", (2007) Vol 28:4 *Fiscal Studies* 463.

²³ TF Crossley and S-H Jeon, "Joint Taxation and the Labour Supply of Married Women: Evidence from the Canadian Tax Reform of 1988", (2007) Vol 28:3 *Fiscal Studies* 343.

The study examined the employment patterns of women who were the secondary income-earners married to both high income and low income-earning husbands, and found an increase in employment among the women married to high income husbands in the order of nine to ten percent, primarily from part-time sources. The authors conclude that joint taxation systems discourage spouses from participating fully in the workforce, as the income earned by the spouse will be taxed at the marginal rates applicable to a higher income-earning spouse. The increased participation rate under an individual taxation system is largely from an increase in women undertaking part-time work.

These case studies support the conclusions of a 1996 Australian study²⁴ in which the authors modelled the effect of income splitting, and concluded that it would increase inefficiency without providing substantial equity gains.

4.3 Effective Marginal Tax Rates

A feature of dependant spouse deductions or credits is that they are generally withdrawn when the spouse is not regarded as being a dependant, which is usually based on independent earnings. This creates a problem similar to that encountered in the accumulation method of joint taxation, as any increases in income earned by the dependant spouse will result in a withdrawal of the credit or deduction. The effective marginal tax rate (EMTR) will incorporate the personal tax paid by the spouse on earnings; the withdrawal of the spouse credit or deduction and will also impact on other transfer payments that may be means tested on family income.

Given that the labour participation rate for married women is very elastic, the effect of the EMTR assists in explaining why married women are more likely to undertake part-time work than full-time work. The effect of the Working for Families package on effective tax rates has been identified as a disincentive in New Zealand under the current system.²⁵

Taking the three effects into consideration, clearly the existence of marriage penalties impacts on a woman's decisions: the timing of marriage; whether to participate in the workforce, and the extent of that participation. This reflects the elasticity of women's participation rates in the workforce. Where a higher marginal tax rate is applied to the earnings of the secondary earner through a joint taxation system, that secondary earner is less likely to take on additional work, as identified in the Discussion Document *Income Splitting for Families with Children*.

5.0 THE CURRENT NEW ZEALAND SYSTEM

Governments may make provision for families through the taxation system, the transfer (welfare) system or a combination of the two. In New Zealand the Working for Families Tax Credit is provided as a transfer payment, whereas in Australia, although over 95 percent of recipients of the Family Tax Benefit take it as a transfer payment, they can choose to take the payment through the tax system.

Family payments are the product of the interaction of a number of government policies. At the most basic level, governments want to prevent children from living in poverty, therefore the policy may be an income supplement to guarantee a base level of income to families. However, recent trends among

²⁴ G Jones and E Savage, "An Evaluation of Income Splitting with Variable Female Labour Supply", (1996) Vol 72:218 *Economic Record* 224.

²⁵ PricewaterhouseCoopers, *Budget 2008 Tax Analysis* (2008), available at <<http://www.pwc.com/nz/eng/ins-sol/publ/tax/Budget2008.pdf>> (as at 4 July 2008); K Rankin, "Comment: An Income Tax Proposal for New Zealand", (2007) Vol 13:1 *New Zealand Journal of Taxation Law and Policy* 10.

OECD countries have been to use such payments to encourage the parents to participate more fully in the workforce. Alternatively, children may be seen as a public benefit to which the community should contribute through the payment of a universal payment, or through financial support to parents who choose to stay at home rather than participating in the workforce. These factors make a rich cocktail of options that are available to policymakers in designing a family tax transfer system.

Currently, the New Zealand Working for Families Tax Credit system incorporates the following policy elements:

- Family Tax Credit is a means-tested benefit available to all parents based on the number and ages of children in the family.
- In-Work Tax Credit is an additional amount available where parents work at least 30 hours during the week (or 20 hours for sole parents).
- Minimum Family Tax Credit is available to very low income families with an income below \$22,245 to ensure they have a weekly income of at least \$355 after tax.
- Parental Tax Credit or Paid Parental Leave is available to the parents of newborn infants. Mothers who have worked for at least 10 hours per week for 6 months prior to the expected birth date are eligible for Paid Parental Leave of up to 14 weeks. Parental Tax Credit is available for eight weeks after birth for parents who are not entitled to Paid Parental Leave.

This combination of payments thus combines elements of community contribution to child welfare, work activation and safety net policies. However, the recognition of parents who choose to stay at home with children is limited to newborns or the period of parental leave available under an employee's conditions of employment.

6.0 THE INCOME SPLITTING DISCUSSION DOCUMENT²⁶

The Income Splitting Discussion Document makes it clear that income splitting is being considered only in the context of families with children. To this extent, the proposal is an implementation of family policy rather than tax policy. This then raises a number of issues that need to be considered.

6.1 Threats to the Revenue through Income Splitting

While Inland Revenue has identified threats to the revenue that arise from income splitting opportunities that currently exist,²⁷ there is no reference to this threat to revenue in the Income Splitting Discussion Document. This also extends the inequity under which employees who do not have families and do not have the opportunity to restructure their income cannot access income splitting. It is likely to increase the number of employees terminating those arrangements in favour of alternative business structures under which income can be allocated to partners and other relatives who may not qualify as "family".

²⁶ Inland Revenue, *Income Splitting for Families with Children: A Government Tax Policy Discussion Document*, (Wellington, April 2008).

²⁷ Inland Revenue, *Briefing for the Incoming Minister of Revenue*, (Wellington, November 2005).

6.2 Integration of Welfare and Taxation Systems

There is an international trend towards the integration of tax and welfare systems. The New Zealand Tax Credit System is named as such, although it is actually paid as a transfer payment outside the tax system. If an income splitting policy were to be implemented, it raises significant administrative problems in relation to determining and implementing tax entitlements in a transfer payment environment.²⁸

As previously discussed, the current Working for Families Tax Credit system incorporates a number of policy design objectives, and the benefits paid for 2008 under the current system are estimated to be about \$2.5 billion.²⁹ The Income Splitting Discussion Document indicates that the fiscal cost of income splitting proposals is about \$370 million, without identifying what concurrent changes would need to be made to Working for Families Tax Credits to offset the new scheme. It may be appropriate to redesign the In-Work Tax Credit component, as that is the group of taxpayers most likely to benefit from the proposal. However, it is much easier to appropriately target transfer payments through means testing than through the structure of the tax system.

6.3 Inequities in Distribution of Benefit within Households

A further problem with delivering family benefits through the taxation system is that the tax concession is distributed unevenly between the spouses, and is not directed to the primary carer. The modelling incorporated in the Income Splitting Discussion Document suggests that in most cases the primary income earner will benefit from the proposal while the secondary income earner will experience higher EMTRs. Transfer regimes are usually designed to ensure that payments are made to the person who will use the benefits most effectively – generally the primary carer for the family. If payments are made to the primary earner through the tax system, the allocation of the funds to the needs of the children becomes a matter for negotiation within the family.

6.4 Disincentives to Participation Rates

The Income Splitting Discussion Document³⁰ acknowledges that the Government is committed to providing real choices to parents and carers in combining their work with their caring roles in accordance with the *Choices for Living, Caring and Working* action plan.³¹ This action plan acknowledges that some mothers would prefer to work fewer hours, or not at all, to help balance the demands of work and family. However, one of the specified goals of the action plan is to “provide financial support for families to ensure that all children have an adequate standard of living while at the same time optimising returns to work as much as possible”.³² The potential impact of this proposal on participation rates is acknowledged in the Income Splitting Discussion Document.³³ It is likely to increase the hours of work of the primary earner (the father) while decreasing the hours of work of the secondary earner (the mother) as the EMTR on additional income earned by the primary earner will decrease, while the EMTR on income of the secondary earner will increase. This impact is the opposite of that proposed in the action plan, which is promoting initiatives to encourage mothers to return to

²⁸ H Hodgson and R Boden, “Not So Distant Cousins”, (2008) Vol 61:3 *International Social Security Review* 29.

²⁹ The Treasury, *Budget Economic and Fiscal Update 2007*, (Wellington, May 2007), Table 6.2, p 185.

³⁰ See n 26, p 2.

³¹ New Zealand Government, *Choices for Living, Caring and Working*, (Wellington, August 2006).

³² See n 31, p 12.

³³ See n 26.

work and to allow all parents to enjoy more flexible arrangements allowing them to better balance their work and family life.

The action plan does acknowledge the special needs of families with a child under one year of age, and commits the Government to work towards appropriate parental leave arrangements. However, this is in the context that workers with appropriate leave arrangements are more likely to return to work, at least on a part-time basis, when the leave entitlement has been taken.

6.5 Determining Qualifying Families

The Income Splitting Discussion Document raises the problem of defining the family. As the policy is clearly intended to support children, the question becomes the age up to which children should be taken into account under this policy. If the Government is concerned about the potential impact of the shift in EMTRs on participation rates, it must be recognised in the design of the system. If the Government intends to encourage women to return to the workforce, the tax concession should only apply to families with young children.

6.6 Joint Taxation Schedules as an Alternative

The Income Splitting Discussion Document does discuss the option of adopting a US-style system of optional accumulation of family income, while applying a different tax scale to families that choose to file joint tax returns. As stated above, the rates currently applying in the US are set at levels that ensure that low and middle income earners access rates similar to an income splitting system, while high income earners pay slightly higher rates. This method does allow more effective targeting of tax benefits and allows for the fact that a family with a non-working spouse may be more able to pay tax as the spouse is able to take care of the children and undertake other home-based duties without needing to outsource these tasks.

7.0 ALTERNATIVES TO JOINT TAXATION SYSTEMS

Given that efficiency arguments show that the individual unit of taxation is more efficient than a pure joint taxation system, an alternative that has been adopted by many jurisdictions that adopt the individual as a tax base, including Australia, is to allow a tax credit or allowance to single income families. These allowances tend to be either a deduction against income, as in the US, or a reduction in the tax payable by way of a credit. The offset may be either refundable or non-refundable (wasteable).

As noted earlier, the New Zealand Working for Families Tax Credit, although means-tested, does not depend to any extent on whether family income is earned by one or both parents. The In-Work Tax Credit requires the family to meet a work test under which the combined hours of work must be at least 30 hours. It is reduced to 20 if the parent is a sole parent.

Each of the deduction and the credit systems in fact has characteristics of one of the two forms of joint taxation. A deduction against the income of the earning spouse, even though it may equate to a second tax-free allowance in a particular jurisdiction, reduces the income of that spouse at the top marginal tax rate, which reflects an income-splitting approach. Such a deduction, as recognised by the Australian Asprey Committee in 1975,³⁴ allows a greater tax concession for the spouse of a high income earner than for the spouse of a lower income earner, while the credit approach allows a similar amount to all eligible taxpayers.

³⁴ Taxation Review Committee (KW Asprey (Chair)), *Full Report*, (Canberra, 1975).

The credit approach effectively increases the tax threshold for such families, but it has the same drawback as the “accumulation” method of joint taxation. Although it will allow single income families an amount that compensates for the additional tax-free allowance available to a two-income family, it does not adjust the income tax rates above the base rate. The credit is allowed at a fixed rate, usually equivalent to the tax rate applicable to incomes around or below the median level. Therefore, a family that pays a tax rate that is more than the rate of the credit allowed will still face a marginal tax payable on additional family earnings. This will have an even more dramatic impact if the credit is also withdrawn due to earnings of the spouse.

If a credit has the effect of increasing the EMTR of single income families, relative to dual income families, then allowing a deduction could be considered more equitable as it reduces the income of the breadwinner, thus reducing the overall tax payable at the higher marginal rate – an effect that is closer to the “income splitting” model of joint taxation. This approach was adopted in Australia prior to the 1975 tax reforms. One of the recommendations of the 1974 interim report of the Asprey Committee was that income tax support for families be changed from a system of deductions to a system of rebates.³⁵ The Australian Commission of Enquiry into Poverty, chaired by Ronald F Henderson, enquiring into poverty concurrently, also recommended that the Child Endowment payment be increased and tax concessions be removed.³⁶ By the time that the final report of the Asprey Committee³⁷ was tabled in the following year, the Australian Government had announced that the system of concessional deductions would become a system of concessional rebates, with effect from the 1974-75 year of income. This was seen as a more equitable system of providing tax relief, as the amount made available to qualifying taxpayers was no longer affected by the marginal tax rate of the taxpayer.³⁸

“One view of the spouse deduction would be that at least a basic minimum which one spouse might be expected to spend on the other who is dependant on him should not be taxed. This points to a deduction approach to the concession. However, in lower income ranges, where the marginal rate of tax is less, the tax saving from a deduction is correspondingly smaller. It is questionable whether the effective assistance should be so unequally distributed, and should be least where it will be of most, if never great, real assistance. The Committee suggests that consideration be given to converting the present deduction to a tax rebate diminishing in relation to the income of the spouse.”

While it is true to suggest that “a poor man’s wife should not be worth less than a rich man’s”,³⁹ the two approaches again illustrate the different outcomes based on the “income splitting” approach and the “accumulation” approach. However, the major problem in implementing a system of tax credits is that they are applied against tax liabilities – leaving a problem in relation to access to the credits by taxpayers who do not have a tax liability sufficient to be absorbed by the credit. There are several approaches to this problem, including:

- Transferable credits;
- Refundable credits;

³⁵ Taxation Review Committee (KW Asprey (Chair)), *Preliminary Report*, (Canberra, 1974).

³⁶ RF Henderson, *Commission of Inquiry into Poverty: Interim Report*, (Canberra, 1974).

³⁷ See n 34.

³⁸ See n 36, para 12.4.

³⁹ See n 36, para 12.3.

- Transfer payments; and
- Negative income tax.

Transferable credits are credits that may be transferred between spouses. The principle is that where one spouse has a surplus credit that is not absorbed by their personal tax liability, then the surplus amount may be transferred to their spouse. It may require both spouses to be paying some tax, which may be the case where the lower earning spouse is in part-time work. In Australia, this approach can be seen in relation to the tax offsets available to seniors: each member of a married couple is available to a certain amount of credit. If one spouse does not lodge a tax return, or the tax liability is less than the available credit, the credit that has not been utilised may be transferred to their spouse who may effectively claim up to double the credit that would be available personally. This approach is used in Denmark in relation to the personal allowance, which is allowed in relation to each taxpayer, and can be transferred between spouses if not fully utilised.

Credits may be refundable, or non-wasteable credits. Such credits are not limited to the tax liability of the claimant, and may result in a tax refund. A non-wasteable credit has a similar economic effect as a transfer payment, under which a payment is made directly to the claimant through the welfare system. While the tax and welfare systems are inevitably interlinked, and modern governments are moving to integrate the systems further, there are differences between the systems that may impact on the claimant, such as annual or periodic payment of entitlements; the requirement to lodge an income tax return; or the application of means tests.⁴⁰ Where a claimant is clearly not taxable, and lodgement of income tax returns is not required, transfer payments are the preferred form of delivery.

The New Zealand Working for Families Tax Credit is paid directly to recipients, either weekly, fortnightly or annually, and reconciled to annual family income at the end of the income year. By contrast, the Australian Family Tax Benefit, which provides a benefit for a low income spouse as well as in relation to children, is available either as a tax offset claimable with lodgement of an income tax return, or as a transfer payment payable fortnightly. Where the recipient is entitled to income support welfare payments, the payment must be claimed on a fortnightly basis and is paid with the income support entitlement. However, over 95 percent of all claimants prefer fortnightly transfer payments.⁴¹ This then raises the question: why is the payment called a “Tax Benefit” when in the vast majority of cases it is delivered as a welfare payment? The answer seems to lie in the public statements of the Australian Treasurer at the time, when he announced that most families would pay no tax unless their income was more than A\$40,000 to A\$45,000.⁴²

A further option that has been canvassed periodically, but not adopted in a pure form, is the option of a negative income tax. Proposals for a negative income tax are based on the concept that transfer payments are a return of taxes that have been paid by the claimant, so the elimination of ‘churn’⁴³ will

⁴⁰ H Hodgson and R Boden, “Not So Distant Cousins”, (2008) Vol 61:3 *International Social Security Review* 29.

⁴¹ H Hodgson, “More than Just DNA: Tax, Welfare and the Family”, (Paper presented at the 19th Annual Australasian Tax Teachers Association Conference, Brisbane, Australia, 23 January 2007).

⁴² P Costello, *Meet the Press 30/04/2006*, (Canberra, 2006), available at <<http://legacy.ten.com.au/promo.aspx?currentpage=2&factSheetYear=2006&factSheetMonth=4&factSheetDate=0&promoID=22&promoSubSectionID=4&searchwords=Costello>> (as at 28 March 2008).

⁴³ “Churn” refers to a tax transfer system under which taxpayers are also eligible for transfer payments, so that part of the tax paid is returned as a cash benefit.

result in a more efficient system overall.⁴⁴ While governments have moved to substantial integration of the welfare and taxation systems, to date the practical issues surrounding full integration have not been overcome.⁴⁵

While not a tax credit or deduction, another alternative that may be considered is the splitting of property income. Currently, certain types of income may be taxed as being received jointly if investments are held in joint names or it may be alienated to a spouse if there is a formal and valid assignment of the income. These principles could be broadened to permit splitting of all property income between spouses. This would acknowledge that income from personal services is appropriately taxed to a particular person who has earned that income, but that income from property relates to assets that are acquired from an accumulation of household wealth. However, such a proposal would clearly only benefit those who had accumulated assets, generally those who are more wealthy. It would also encourage those who had the capacity to establish entities to undertake their business activities. Such a proposal would only be viable if:

- It were hedged with anti-avoidance provisions to ensure that personal services income was not converted to investment income through an interposed entity; or
- A schedular system of taxation was introduced under which appropriate tax rates were applied to acknowledge the inherent differences between income from personal services and income derived from capital sources.

It could also be argued that where the advantage in an income splitting system comes from access to a second tax-free threshold (where the tax system provides a tax free threshold), a restructuring of the tax rates applicable could address the lack of neutrality. If there was no tax-free threshold, and the lower tax brackets were sufficiently broad, there would be no advantage gained by entering into structures that allow some families to access income splitting. However, this could only be achieved through a full review of income tax scales.

8.0 CONCLUSION

While intuitively a joint, income splitting, taxation system may seem to be more equitable to families, the evidence consistently shows that individual taxation systems are more efficient, both in relation to the impact on the labour market and in minimising horizontal distortions between single and married taxpayers. However, the goal of equity does encourage alternative methods of providing concessions to families, to reflect the different vertical equity position of the family unit.

While these concessions do achieve some measure of redistribution, the conundrum that results is that such concessions effectively shift an individual taxation system closer to a joint taxation system, through:

- Means-testing of concessions based on family income;
- EMTRs that impact middle income families more severely;
- Tax credits that mimic an accumulation joint tax system; and/or

⁴⁴ J Humphreys, "Rebuilding Australia's Tax and Welfare Systems", in P Saunders (ed), *Taxploitation: The Case for Income Tax Reform*, (New South Wales, Centre for Independent Studies, 2006).

⁴⁵ RA Moffitt, "The Negative Income Tax and the Evolution of U.S. Welfare Policy", (2003) Vol 17:3 *The Journal of Economic Perspectives* 119.

- Tax deductions that mimic an income splitting joint tax system.

The New Zealand Income Splitting Discussion Document proposes a course of action that is contrary to the OECD trends of the last 30 years. It has been shown that the efficiency costs of joint taxation systems outweigh the benefits that may arise. While the proposal is made on the basis of facilitating choice, an efficient economy requires participation rates to remain adequate to drive the economy and married women are the most mobile sector of the labour force. Accordingly, the current policy trends are to remove disincentives to return to the workforce.

Unlike the Australian Family Tax Credit system, the Working for Families Tax Credit system currently in place in New Zealand does not have an element that relates to whether a family is a single or dual income family. There are problems inherent in such systems, as the necessary means testing on the secondary earner can aggravate the problem of EMTRs increasing as income increases, as both family and spousal entitlements are separately affected by taper rates. However, it would seem that a more viable alternative to a joint taxation system would be to incorporate an additional benefit related to the status of the spouse.

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