Policy Forum: Tax Consequences of Income Splitting for Canadian Households

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**Contents**

Introduction 681
The Canadian Tax System and Income Splitting 683
Other Equity Issues 690
Conclusion 693

**Introduction**

Personal income tax systems have become an increasingly complex tool for adjusting the distributional impact of taxes of a widely diverse set of individuals. A recurring topic for policy debate has been the extent to which the income of a spouse should be included in determining an individual’s tax burden. While the tax system is focused primarily on the welfare of individuals, structuring the tax system solely around the individual as the tax unit would ignore the fact that the welfare of an individual depends on whether he or she lives alone, with a spouse, or with children. An individual may be able to pool income with a spouse in order to save on necessary household expenses and allow for increased consumption spending, while raising children incurs substantial additional costs. These issues have led tax commissions in Canada¹ and the United Kingdom² to recommend that the family, rather than the individual, be considered the appropriate unit of taxation.

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Including household income to some degree when determining tax burdens has become the norm across most developed countries, though the extent varies considerably. The United States maintains a full joint-filing system, with tax-bracket thresholds that are simply doubled for couples. France has a more elaborate measure to determine the size of the household for tax purposes, which includes the number of children. Some other countries allow for limited splitting of income between spouses. A more common approach, and the one currently employed in Canada, is to continue to maintain the individual as the tax base for the progressive income tax scale, while having a transfer system that is means-tested on total household income. Currently, only seven countries in the Organisation for Economic Co-operation and Development (OECD) require joint filing by couples, with six additional countries offering couples the option to file jointly.

There are a number of arguments against moving toward taxing the income of the household instead of the individual. Comparing families solely on the basis of their joint household income may ignore key differences in family structure that may favour some households over others. In the case of couples, if a single-earner couple has the same total income as a dual-earner couple, the two couples will have an equivalent tax burden. However, the single-earner family is able to provide additional unpaid household production as compared with the dual-earner family. Individuals living alone and single parents also have different expenses than households with two adults. The second argument against taxation based on the combined income of both spouses is that this raises the marginal tax rate of the secondary (lower) earner to the rate of the higher-earning spouse, distorting and discouraging his or her labour force participation.

These concerns have led to a shift away from joint tax systems back to a system in which the individual is the primary tax unit. Over the last 40 years, seven OECD countries have switched from joint taxation to individual taxation, namely, Austria, Denmark, Finland, Italy, the Netherlands, Sweden, and the United Kingdom (despite the issuance of the Meade report3 promoting joint taxation). The prevalence of tax brackets based on the individual but with transfer systems based on the household reflects an attempt to alleviate problems in individual incentives faced by joint tax schemes while acknowledging the importance of household income in individual welfare.

Recent exceptions to this trend include France and Canada. France has one of the most complex personal income tax structures aimed at ensuring equality between families. The French tax code weights the number of adults and children within a household as part of the measurement of the household’s tax burden. In 2012, the French government attempted to impose a 75 percent marginal tax rate on individuals making more than €1 million per year. This proposal was eventually struck down by France’s Constitutional Council because it “violated the principle of equality,” in that two households with identical income may or may not have been

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3 Ibid.
subject to the tax “depending upon the division of income between the taxpayers comprising the household.”4 Though France’s ruling simply maintained the status quo, Canada is potentially moving toward the introduction of measures that move the tax structure closer to joint taxation. During the 2011 federal election, the Conservative Party of Canada proposed a variation of joint taxation in the form of income splitting, allowing couples with a child under the age of 18 to shift up to $50,000 of income between spouses for tax purposes, and thereby potentially lower the family’s total tax burden.5

The purpose of this article is to consider how income splitting would affect different subsets of the Canadian population. The next section shows how the tax burden of couples most affected by income splitting would change under different proposals, and why these changes may be preferable to an increased reliance on means-tested transfers. The discussion then continues with a look at how these proposals may affect tax equity between households of different sizes. The article concludes with a short comment on issues of implementation and intra-family inequality.

THE CANADIAN TAX SYSTEM AND INCOME SPLITTING

The current Canadian personal income tax system is similar to the systems in many OECD countries. Individuals file separate tax returns with tax brackets based on their own income, while the size of transfers and credits is largely based on the total income of the household. For example, the value of the goods and services tax/harmonized sales tax refundable credit depends on total family income, and specific tax credits for families with children can only be claimed by one spouse. Any unused portion of the basic personal exemption can also be transferred to a spouse.

With this type of tax system, the tax burden of an individual who is married or in a common-law relationship depends not only on the individual’s income but also, to a lesser degree, on the income of his or her spouse. When one member of the couple is in a higher income tax bracket than the other, the two individuals will have a greater joint tax burden than will be the case for couples where both spouses are in the same tax bracket. This difference in the tax burden hinges on the progressive nature of tax brackets. Low-income couples will have similar tax burdens whether or not there is an income disparity between the spouses, since the higher income earner will still be in a low income-tax bracket. High-income couples with a large income disparity will pay more taxes than high-income couples with evenly split earnings, since in the former case one earner will be in a higher marginal tax bracket, whereas in the latter case both individuals will be in a lower tax bracket.

4 Le Conseil Constitutionnel Decision no. 2012-662 DC, at paragraph 73, 29 December 2012.
Consider the tax burden of two hypothetical families, each consisting of a couple with no children: one family has a single wage earner who provides all of family’s employment income; the other has two earners, each of whom earns half of the family’s total employment income. The joint taxes paid by these two couples as their income increases are illustrated in figure 1.\(^6\) These calculations include not just the progressive income tax scale but all other credits and deductions available to the couple, and exclude payroll taxes. Both payroll taxes—employment insurance (EI) and Canada Pension Plan (CPP)—are premiums paid by working individuals that have specified maximum contributions. The contribution is capped to limit the amount of insured earnings (under EI) and the amount of forced retirement savings (CPP). The effect of these caps is that a single earner who earns more than the cap pays less into these programs than is the case for dual-earner families. However, both of these programs have expected benefits that would also need to be factored into any analysis. Dual-earner families would receive higher benefits from EI if both spouses became simultaneously unemployed, and would receive a higher public pension owing to employer contribution matching. Rather than attempting to account for the benefits for each family type throughout the income distribution, these taxes have been omitted from the calculations.

At low incomes, the total tax burden between the two couples is almost identical. Much of their tax burden is reduced by tax credits based on total income, and neither family has an earner in a high income-tax bracket. As soon as the single-earner couple reaches a higher tax bracket, the tax burdens diverge. At a total household income of $75,000, a family with a single earner will pay almost $2,500 more in taxes, or 31 percent more, than the dual-earner family. The absolute difference in tax burden grows with income, though the percentage gap begins to narrow when both dual earners enter the highest tax bracket.

However, the joint income of these couples may not be an appropriate measure of their total welfare. The most obvious difference in the two hypothetical families in this simple example is the time allocation of one of the spouses. The family with a single earner has a stay-at-home spouse who is able to provide additional unpaid, and untaxed, production at home that adds to the total implicit household income of the family. This household income is important and should be accounted for in the tax system. Currently, the only mechanism for taxing this additional household production is through the progressive nature of the tax system. Since lower-income couples already have similar tax burdens, it is only when a single earner moves into a higher

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\(^6\) All calculations of tax burdens are done using Kevin Milligan’s Canadian Tax and Credit Simulator (CTaCS) for the 2012 tax year: Kevin Milligan, “Canadian Tax and Credit Simulator,” database, software, and documentation, version 2012-1 (2012) (faculty.arts.ubc.ca/kmilligan/ctacs/). The Conservative Party’s most recent proposal for income splitting restricted its use to families with children under the age of 18. For a comparison of the tax burdens for families with children, see Matt Krzepkowski and Jack Mintz, “No More Second-Class Taxpayers: How Income Splitting Can Bring Fairness to Canada’s Single-Income Families” (2013) 6:15 SPP Research Papers 1-17 (University of Calgary, School of Public Policy).
income bracket that the tax system implicitly accounts for differences in home production. This would be justified if the additional home production were correlated in some manner to the income of the wage earner, but this does not seem to be the case. In a survey of household time use, Frazis and Stewart from the US Bureau of Labor Statistics\(^7\) show that the value of household production is relatively flat across the income distribution and acts similarly to a lump-sum transfer of income.

A Statistics Canada study\(^8\) attempted to quantify the value of household work provided by an individual on the basis of gender and whether the individual was married, employed, or had children. The calculation was done using a replacement-cost approach, taking the hours spent on each household tasks and matching these

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with the hourly wage of employees in a corresponding service industry. Updating these values for inflation, a single-earner household provides approximately $35,400 in unpaid household income, compared to $24,300 for a dual-earner family. These values are comparable to those calculated for the United States by Frazis and Stewart.

By ignoring differences in household production, the current tax system imposes a lower tax burden on single-earner couples at the low end of the income scale and on dual earners at higher incomes. Income splitting equalizes the tax burden between the types of couples on the basis of total market income, not the total implicit household income. In this sense, income splitting on its own may shift the tax burden for high-income single-earner couples below that for dual-earner couples by not accounting for their additional household production.

The tax burden of the two hypothetical families under an income-splitting proposal is shown in figure 2 as a function of their total implicit household income. Since the tax burden of the two families is almost equal but the single-earner family is able to provide more household production from the at-home spouse, the tax system provides a tax benefit to single-earner households. Since the additional household production is likely constant throughout the income distribution, the difference in tax burdens between the two families is relatively stable at just under $1,500 for couples making less than $85,000 and increases to $2,250 for couples making over $100,000 as earners shift between tax brackets. Instead of being used to provide a tax break to some families, income splitting may be used to allow for alternative mechanisms to adjust for differences in the earning structure of couples. One potential change is to adjust the use of the basic personal tax exemption alongside an income-splitting proposal to account for differences in time allocation.

Currently (in 2012), the basic personal exemption is $10,822, which is multiplied by the tax rate for the lowest tax bracket (15 percent) to yield a tax credit of $1,623.30.

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9 The other approach used by Statistics Canada and others is the opportunity-cost approach, which attempts to predict the employment possibilities of individuals. This method is considered to be less accurate than the replacement-cost approach.

10 This includes the estimated value of an employed husband and wife for the dual-earner couple and an employed husband and unemployed wife for the single-earner couple. The secondary earner is usually classified in the literature simply as the lower income earner or the stay-at-home spouse. The primary earner is usually characterized as male and the secondary earner as female (though, as Milligan notes in the introduction to this Policy Forum, more recent data suggest that this characterization is no longer appropriate). Changes in gender roles and composition in couples will affect the amount of household work done. This analysis also assumes the same amount of work done by the male whether the spouse works or not. It is likely that an individual with an unemployed spouse may do less household work than one with an employed spouse, so this underestimates the differences in total household production.

11 With income splitting, the only difference between a single-earner couple and a dual-earner couple would be the value of the employment income tax credit on the first $1,095 of income.
Each spouse is eligible to claim this exemption, but any unused amount can be transferred to the other spouse. The rationale for the transferability of this deduction is to allow households a higher threshold of tax-free income in order to fund additional necessary expenses of a low-income spouse. With income splitting, the tax structure could be changed so that, rather than allowing transferability and income splitting jointly, individuals choosing to split income would be permitted to use the basic personal exemption only against their own employment income. This would prevent single-earner couples from receiving two tax benefits (the transferred amount and the savings from income splitting), and the value of the credit would be approximately equal to the additional tax burden faced by a dual-earner couple if income splitting were in place after including household production. Dual-earner couples with a large amount of income disparity would therefore be the primary recipients of a tax break, instead of single-earner couples. These dual-earner couples would

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12 A similar adjustment was first proposed in Douglas Hartle, *Taxation and Married Women in Canada*, report prepared for the Royal Commission on the Status of Women (Ottawa: Information Canada, 1971).
not benefit from additional household production, as a single-earner couple would, yet they would face a similar tax burden since the higher-income spouse would still be in a higher marginal tax bracket.

Sacrificing transferability would also limit the effect of some disadvantages of income splitting. A key argument against income splitting is that it would negatively affect the secondary earner’s labour force participation. Increasing the impact that an individual’s income has on the tax burden of his or her spouse results in their labour decisions becoming more interdependent. As the benefit of income splitting is simply to shift income from a high income tax bracket onto a lower one, this shift increases the marginal tax rate of a secondary earner. Rather than being subject to the same progressive income scale, the secondary earner is immediately subject to the high marginal tax rate of his or her spouse. Recent literature has argued that the marginal tax rate for the secondary earner should be decreasing in relation to the earnings of the primary earner, not increasing as in the case of joint taxation. Kleven, Kreiner, and Saez13 develop a model wherein the secondary earner makes a discrete choice to enter the labour force. They then look at how the tax rate of the secondary earner should be correlated with the earnings of the primary earner. When the secondary earner makes a discrete choice to work, it is the average, not the marginal, tax rate that influences the labour decision. The decision to enter the labour market signals that an individual has low costs of work; therefore, a positive tax rate for dual-earner couples would lead to optimal redistribution. However, the secondary earner’s relative contribution to the total welfare of the household decreases as the primary earner’s income increases, and this lowers the value of the redistribution. Accordingly, the optimal tax system should exhibit “negative jointness,” such that the average tax rate applicable to the secondary earner as a result of entering the labour force should decrease as the income of his or her spouse increases.

Income splitting would result in a move toward “positive jointness,” since the marginal tax rate of the secondary earner would be equal to the tax rate of the primary earner, and that rate would rise as their income increased and they moved into higher tax brackets. Immervoll, Kleven, Kreiner, and Verdelin14 find that moving toward negative jointness rather than positive jointness may result in significant efficiency gains. They show that a revenue-neutral decrease in the tax rate applicable to secondary earners in 15 European countries could increase the welfare of a dual-earner couple by $1, by taking away less than $0.50 from single-earner households. Several studies of European tax changes have shown that moving toward a system of joint taxation has negative effects on the female labour supply (since secondary

earners are predominantly women), though these effects are relatively small compared to other factors of female labour force participation over the last few decades. Restricting the transfer of the basic personal exemption would counteract this effect of positive jointness and would lower the tax rate of many secondary earners. Currently, because the basic exemption is transferable, it is used whether the secondary earner enters the labour force or not, provided that the primary earner’s net income is greater than twice the amount of the exemption, or $21,644. This means that a secondary earner effectively begins to pays tax on any employment income above the existing $1,095 employment tax credit, even though this would fall into the lowest tax bracket. Under the modified income-splitting proposal above, secondary earners would claim the exemption on their own income, lowering their tax burden, even though they will face a higher marginal tax rate once they become tax-paying. If $50,000 of income (the maximum under the Conservative Party proposal) is shifted to the lower-income spouse, the average tax rate for a secondary earner making less than $32,000 under the adjusted system proposed here would be lower than under the current tax system. Past that threshold, since the secondary earner would then be in a higher income tax bracket, the tax burden on that individual would increase, though the total tax burden of the family would clearly still be lower. Nevertheless, this is a relatively high threshold since it approximates the median individual Canadian income, and is higher than the estimates of the value of household production. Crossley and Jeon show that labour force participation of lower-income individuals may be quite sensitive to these types of tax changes. They use a 1988 tax reform that modified the basic exemption from a tax deduction to a tax credit, and thereby lowered the marginal tax rate for secondary earners with high-income husbands by up to 17 percent. Crossley and Jeon argue that this reform translated to a 10 percent increase in the labour force participation of lower-educated women married to high-income husbands.

This continues to be the case in Canada. Of all married, opposite-sex couples in 2010, 42.6 percent were dual-earner couples where the husband earned more than the wife, and an additional 15.6 percent were single-earner couples with the husband being the sole earner. See Statistics Canada, CANSIM database, table 202-0105. However, as noted by Milligan (citing data from the same source), in recent years the proportion of higher-earning women among couples with at least one working spouse is increasing: see the Editor’s Introduction to this Policy Forum and table 1 therein.


The adjustment to the basic exemption described above would also introduce some negative jointness further into the income distribution than would be the case for most other tax systems. The negative jointness feature of European tax systems is primarily attributable to the clawback of means-tested transfers as household income increases. As the primary earner’s income increases, the secondary earner’s income will have a smaller effect on reducing the value of the transfers, thus lowering the effective tax rate that results from entry into the labour force. This effect holds only where the primary earner has low income and the tax rate applicable to the secondary earner is quite flat or increasing through the remainder of the primary earner’s income distribution. Limiting transferability of the basic amount with income splitting would add a further reduction in the average tax rate past the point where means-tested transfers would otherwise be clawed back for low-income secondary earners.

OTHER EQUITY ISSUES

The previous section showed how adjustments to the personal tax system could equalize the joint tax burden of couples regardless of how the income is earned between spouses. Reforming the tax system with this focus would also cause distortions in the relative tax burden between different subsets of the population. Adding income splitting into the Canadian tax system, either in its standard form or alongside changes as proposed in the previous section, effectively results in a tax break for relatively high-income couples that have a disparity in their earnings, and will not affect the taxes paid by others. This will result in high-income couples contributing a smaller proportion of total personal tax revenue to the federal government, altering the proportion of taxes paid across the income distribution and between family types. Laurin and Kesselman analyzed the original income-splitting proposal put forward by the Conservative Party, without the additional changes proposed here. They estimate that the proposal, which was restricted to couples with children under the age of 18, would cost $2.7 billion per year, and would swell to $5.6 billion if extended to all couples. There would also be an additional cost of $3.5 billion for the provinces if they followed along with the proposal. Laurin and Kesselman show that 41 percent of these benefits would go to couples with market income greater than $125,000. Single individuals would receive no benefit, and many of the other beneficiaries would receive less than $1,000 in tax relief, resulting in a decrease in the overall progressivity of the tax system.

Comparing the appropriate tax burden between couples and single individuals requires some weighting of the individuals within a household to control for differences in costs of living. While a couple requires more resources to achieve the same
standard of living as an individual, this is partially offset by returns of scale in household costs; consequently, a couple requires less than twice the income to have the same standard of living as an individual making the same amount of money. Attempting to compare welfare across family types has led to equivalence scales to allow for determination of the amount of income that a family of a given size should have to be comparable to the income of an individual. The OECD, and recently Statistics Canada, have taken to using the so-called square-root rule to calculate household equivalence scales. This is a simple approach that takes the square root of the number of individuals within a household to determine its individual-income equivalent. This means that a couple’s income can be divided by approximately 1.414 in order to be directly comparable to the income of a single person. This scaling can then be used to compare the respective tax burdens of single- and dual-earner couples against that of an individual taxpayer. Both before-tax and after-tax incomes of these households should correspond to the same equivalent-income scale, so that a couple should have the same average tax rate as an individual with an equivalent-adjusted income.

This equivalency in tax burden holds under a flat income tax, since the average tax rate and the marginal tax rate will always be equal. Means-tested transfers based on household income lower the average tax burden for equivalent individuals, and fixed deductions and a progressive income tax structure lower the average tax burden for dual-earner couples (though this depends on the spacing of tax brackets). The average tax rates for the two hypothetical couples introduced earlier, and for an individual with an equivalent-adjusted income, are shown in figure 3 for varying levels of market income, where all three have positive tax burdens. Under the current tax system, dual-earner couples making more than $20,000 in joint income will have a lower average tax burden than an individual throughout the remainder of the income distribution. This percentage point difference varies between 1.5 percent and 3 percent. The disparity results from a combination of the couple’s ability to claim two basic personal exemptions, in addition to gaps in the income tax brackets where the single-earner will move to a higher income tax bracket before the dual-earner couple. A single-earner couple has a lower average tax burden than the equivalent-income individual until an income of around $55,000, at which point the couple will reach higher tax brackets sooner (since they need a larger income to be comparable). Because this equivalence scale is based on total market income, the income-splitting proposal here puts the single-earner couple above the dual-earner couple and below the individual throughout most of the income distribution. Thus, an income-splitting proposal will result in a shift in the proportion of tax payments from couples onto single individuals, although the tax share will be similar regardless of how the couple’s income is earned. Without including an equivalence weighting in the calculation of the tax burden, this will be a by-product of any income-splitting proposal, and one that should be carefully considered.

Increasing the average tax rate for couples would lead to an increase in the cohabitation or marriage penalty described previously.
Still other important differences exist between couples. The preceding analysis assumed that the welfare of a couple could be determined simply by aggregating their total market incomes and any household production. A dollar earned by one spouse provided the same effect as a dollar earned by the other. There is evidence that this may not be the case. Many couples do share incomes, particularly in paying for household expenses, but their expenditures may differ depending on who earns income within the family.21 The key issue for policy makers is the extent to which the tax system should take these differences into account. The less the government’s perception that individuals share income with each other, the less preferable any policies toward joint taxation will be.

This does lead to a final point on implementation of any income-splitting proposal. Since couples may not fully share their earnings, any income-splitting proposal should recognize its potential effect on intra-family equity. From a tax-filing perspective, an income-splitting proposal would notionally shift income to give a higher-income spouse some tax relief while leaving the lower-income spouse with

a tax bill for income over which he or she may not have physical control. If couples paid taxes out of their own earnings, this would result in a decrease in intra-family equity. The lower-income spouse would incur a larger tax bill and see his or her personal disposable income decline, while the higher-income spouse would receive the windfall. Instead, provisions in the tax legislation could adjust for the tax difference from income splitting by providing for a transfer to the lower-income spouse. This would result in the higher-income spouse having an identical tax burden as he or she would bear without income splitting, but would lower the total tax burden on the family by providing a transfer to the lower-earning spouse as a tax benefit. This solution would increase the complexity of tax filing to a certain degree, but it would not be overly difficult to implement as a way of ensuring that the tax system does not have adverse effects on intra-family equity.

CONCLUSION
Introducing income splitting in its simplest form would likely have a number of undesirable consequences for the economy. That said, there may be potential gains if this increased connection between the taxes of spouses included a partial substitution of the transferability of the basic personal exemption. The reduction in transferability would effectively adjust the tax system to recognize the tax benefit of work done by stay-at-home spouses, while simultaneously providing an additional tax credit to encourage them to enter the labour force, at least partially offsetting negative effects of income splitting on a secondary earner’s labour force participation. This adjustment would nonetheless require some tradeoffs in other equity comparisons. It would lower the average tax rate for higher-income couples with a high earning disparity to a tax rate closer to the rate of couples with similar spousal incomes, but provide no benefits to single individuals or single-parent households if income splitting were not extended to them.