Policy Forum: Real Versus Notional Income Splitting—What Canada Should Learn from the US “Innocent Spouse” Problem

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INTRODUCTION

Any evaluation of tax policy choices in the area of spousal income splitting must include consideration of its effects on gender equality. Applying the classic tax policy criteria of equity, efficiency, and administrative simplicity in a way that avoids gender is particularly unsatisfying in this context, because income splitting has such obviously gendered dynamics. It is incumbent on income-splitting advocates to consider how the rules can best be designed to enhance rather than detract from women’s economic equality, autonomy, and security. In order to do so, I argue, income splitting must be conditioned on a transfer of legal control over income or property between spouses. I refer to this as “real” income splitting in order to contrast it with the purely notional assignment of income to the tax return of a lower-earning spouse.

Notional income splitting was introduced for the first time in Canada in 2007, through the pension income-splitting rules.1 This comment discusses why notional

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1 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as “the Act”), paragraphs 60(c) and 56(1)(a.2) and section 60.03. Unless otherwise stated, statutory references in this article are to the Act.
income splitting is damaging to gender equality, and why real income splitting is a superior model. It highlights the egregious risk that under notional income splitting some individuals, overwhelmingly women, will be targeted for enforcement actions to collect unpaid taxes on income that they have never received or controlled. This is because the legislation imposes joint and several liability of the spouses for any tax owing on pension income that is shifted between tax returns, regardless of who owns or has influence over the expenditure of that income. Joint and several liability continues indefinitely, and given the time lag from filing to assessment, audit, and enforcement, an individual may be pursued by tax authorities even after a relationship has ended to cover unpaid taxes of a former partner who has since become judgment-proof. Known in the United States as the “innocent spouse” problem, this is the most acute, but by no means the only, way in which women are systematically disadvantaged by such rules. Indeed, it is likely that many more women will be negatively affected by the economic incentives under notional income splitting for second earners to be financial dependants rather than income earners or property holders in their own right. Far from eliminating “second-class taxpayers,” as claimed by Krzepkowski and Mintz, this comment explains why notional income splitting reinforces women’s second-class economic status, by erecting new tax barriers to their financial autonomy.

Statistics on the take-up of pension income splitting confirm that men are the primary beneficiaries by a significant margin. In 2010, 82 percent of the over 1 million individuals claiming the deduction for split pension income were men, and they accounted for 89 percent of the total dollar amount of claims. The revenue cost of these provisions to the federal government is projected to rise to over $1 billion per year in 2012. Thus, pension income splitting has provided a substantial tax reduction for a select, male-dominated group of taxpayers who have had a portion of their income reported on the tax returns of their lower-earning spouses, almost always women. Interestingly, household income data for the same year indicate that men were the sole or higher earners in only about 69 percent of couples with some earnings, yet they captured an even higher proportion of the benefits of pension income splitting. These data drive home the need to consider intra-household economic

2 Subsection 160(1.3).
3 Subsection 160(2).
6 Statistics Canada, CANSIM database, table 202-0105. By way of speculation, the reasons may relate to men’s higher average incomes increasing their potential benefit from income splitting, or to intra-household income distribution among the specific demographic that receives private pension income.
disparities between men and women in any policy analysis of income splitting. Proponents of income splitting tend to gloss over these intra-household effects, preferring instead to focus on comparing the aggregate tax burdens of single- and dual-earner households. It was this logic that framed the Conservative Party’s 2011 election promise to introduce “income sharing” for all couples with dependent children under 18, allowing “spouses the choice to share up to $50,000 of their household income, for federal income-tax purposes,” once the federal budget is balanced. Before moving ahead, the government should undertake a full evaluation of the effects of pension income splitting. In considering different ways to deliver on its election promise, it should pay especially close attention to the distinction between real and notional income splitting.

DISTINGUISHING REAL AND NOTIONAL MODELS OF INCOME SPLITTING

A critical variable in assessing the gender equality effects of income splitting is whether the higher-income spouse must cede legal control over the split income (or the underlying asset that generates the split income) in order to achieve a reduction of tax liability. Until 2007, this was always the case in Canada. That is, a transfer of income or assets in favour of the lower-income spouse was required in order to split income for tax purposes. The pension income-splitting rules departed from this norm. For the first time in the history of Canadian income tax law, a tax reduction can be obtained for individuals through a purely notional transfer of income on paper, from the tax return of the spouse who legally owns the income to the return of the non-owning spouse. In other words, pension income splitting allows for a shifting of tax liability to the lower-earning spouse without any corresponding shift of legal control over economic resources. Rather than “income sharing,” “tax sharing” would be a more accurate term to describe these provisions.

The tax policy arguments against spousal income splitting are linked to the well-known arguments in favour of maintaining an individual, versus joint marital or

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7 See, for example, Krzepkowski and Mintz, supra note 4.
9 See John Lester’s proposal for regular benefit-cost evaluation of all tax expenditures that are close substitutes for program spending, in which he includes the pension income-splitting rules: John Lester, “Managing Tax Expenditures and Government Program Spending: Proposals for Reform” (2012) 5:35 SPP Research Papers 1-42, at 13 (University of Calgary, School of Public Policy).
familial, taxation unit. The case for joint taxation of couples is based on the view that “the income and expenditure of two individuals are not independent when they live together.” However, empirical studies have shown that it is far too simplistic to assume that all income is pooled and shared equally within all households. Rather, couples are highly diverse in the degree to which they share decision making about the use of household income, who manages the finances, and who benefits from consumption. The studies indicate that even where funds are pooled in a joint account, the legal earner or owner still enjoys more control over how money is spent.

From a gender equality perspective, the objections to spousal income splitting (or any other shift toward joint taxation of couples) typically include the following:

- It mainly benefits higher-income married men.
- It privileges couples with a sharply gendered division of labour over all other household forms.
- It discourages wives’ participation in paid work by raising the tax rate on “secondary” earned income.
- It reduces government revenues that could be used to fund transfers or services aimed at reducing labour force barriers and promoting gender equality.


Krzepkowski and Mintz, supra note 4, at 2.


While agreeing with this critique overall, I also suggest that it is insufficiently nuanced in tarring all income splitting with the same brush. I have argued elsewhere that a feminist case can be made for permitting real income splitting, conditioned on shifting legal control of income or property to the lower-income spouse.\footnote{Philipps, supra note 14.}

If properly designed, real-income-splitting rules could provide an incentive for higher-income earners to transfer title over income or assets to their lower-earning spouses, potentially enhancing the latter’s economic autonomy and security both during the marriage and in the event of relationship breakdown. Such transfers would also serve materially to recognize and compensate, at least in part, the unpaid caregiving and other household labour performed by a much lower-earning spouse, usually a woman. These incentive effects have been documented in the United Kingdom, which moved from joint marital taxation to an individual unit in 1990, but allowed outright transfers of property between spouses without attribution of income.\footnote{Melvin Stephens Jr. and Jennifer Ward-Batts found that lower-income spouses reported a larger share of household investment income after the reform than they had before, providing “strong evidence” of tax-motivated property transfers, though most couples did not take full advantage of the potential for reducing taxes in this manner: “The Impact of Taxation on the Intra-Household Allocation of Assets: Evidence from the UK” (2004) 88:9-10 Journal of Public Economics 1989-2007.} Likewise, Schuetze\footnote{Herbert J. Schuetze, “Income Splitting Among the Self-Employed” (2006) 39:4 Canadian Journal of Economics 1195-1220.} found that self-employed men in Canada are more likely to allocate salary, wages, or profits to their wives for tax purposes, compared to their counterparts in the United States, who need only file a joint return with a lower earning spouse to reduce their personal tax rate. Even if the sole motive for such transfers is tax minimization, they must be legally enforceable to have the desired effect.

A possible objection to real income splitting is the difficulty of ensuring that interspousal transfers actually take place and are legally effective rather than sham transactions. One simple way to encourage compliance would be to require a declaration in prescribed form by the transferor spouse that legal ownership of the split income has been gifted or otherwise transferred absolutely to the other spouse. The existing pension income-splitting rules already require a joint election and certification that both spouses agree to the designated amount being deducted on the pensioner’s return and included in the other spouse’s income, and that they understand that they are jointly and severally liable for any resulting tax, interest, and penalties.\footnote{Canada Revenue Agency, Form T1032, “Joint Election To Split Pension Income.”} Undoubtedly the transferor spouse would in many cases retain some informal influence or would benefit from the expenditure of the funds, but this does not take away the value of giving lower-earning spouses legal title to a greater share of the household income. Studies of family economic behaviour indicate that legal
ownership comes with a greater sense of entitlement to participate in decision making.19 As Zelenak suggests, property owners often make consumption decisions cooperatively with a spouse, but ultimately “they still have control over the source of the income (as well as control over whether to remain married).”20 On divorce, family-law rights to claim a share of assets can be difficult and expensive to enforce against an unwilling ex-spouse. Gaining documented title to assets is therefore an important source of future economic security for a low-earning spouse, providing a more meaningful option to exit from a relationship, which should also translate into greater bargaining power within the relationship.21 For all these reasons, tax rules that allow for real income splitting could have some gender-equality-enhancing effects.22

By contrast, notional income splitting of the kind introduced in Canada in 2007 reinforces gender inequalities, because it involves the transfer of tax liability without any legal requirement to share control over the income that gives rise to it. The drafters of this policy presume that income is pooled within the household, and this is precisely the problem. As Lahey has pointed out, “[g]iving people who do not share incomes or property the benefit of presumed sharing eliminates any incentive they might otherwise have to share.”23 If the law is amended to allow notional income splitting of up to $50,000 per annum, many couples who would otherwise engage in real income splitting through existing legal means such as spousal registered retirement savings plans or payment of wages or dividends to a spouse, will likely opt instead simply to shift income on paper. Doing so would often be simpler, and would allow the wealthier spouse to avoid transferring title to any assets or income. Notional income splitting would push couples away from existing tax-planning mechanisms by which a non-earning or low-earning spouse currently can acquire some independent financial resources.

A further challenge is that any income earned independently by the transferee spouse will be stacked on top of the split income, raising fiscal barriers to women’s equal participation in paid labour. This is the primary reason why most tax policy analysts reject joint taxation.24 The proposal by Krzepkowski and Mintz to eliminate the spousal credit for couples who split income, replacing it with an employment income credit for the lower-earning spouse, is an unsatisfying response.25 While alleviating the stacking effect on the first $10,822 (in 2012) of employment income received by a second earner, any dollars above that modest amount would still be

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19 See Burton et al., supra note 13.
20 Zelenak, supra note 14, at 357.
21 For a more detailed elaboration of these arguments in favour of real income splitting, see Philips, supra note 14, at 240-50.
22 For a similar analysis, see Laurin and Kesselman, supra note 14, at 17-18.
23 Lahey, supra note 14, at 26. See also Woolley, supra note 10, at 613.
24 See the articles and reports cited supra at notes 17 and 20.
25 Krzepkowski and Mintz, supra note 4, at 10-11.
exposed to steeper tax rates because the second earner is also reporting a share of the primary breadwinner’s income. Moreover, it is unclear why the second earner should not be able to claim the credit on investment, business, or other independent sources of income. Contrary to its claim, the proposal would create “second-class taxpayers” who would lose access to a comprehensive basic personal credit that is available to every other Canadian resident, and would be exposed to relatively high marginal tax rates on any income beyond $10,822 of wages.

Notional income splitting therefore tends to exacerbate economic inequality between spouses, because it acts as a disincentive to both intra-household transfers and independent earning by the partner who is reporting split income. In theory, wives should be able to bargain for a redistribution of income or property in return for signing a joint election to split income. In practice, many economically dependent wives lack the information, the sense of entitlement, or the bargaining power to demand greater control over household resources. It is common simply to trust that the higher-earning spouse will do the right thing in covering taxes and providing for family expenses. The potential for this to go badly wrong for some people is illustrated vividly in the “innocent spouse” cases that have plagued the US income tax system. I elaborate on the innocent spouse problem below in order to demonstrate the challenges raised by notional income splitting.

THE US INNOCENT SPOUSE PROBLEM

The nature of the problem is best illustrated through a story. One of many well-publicized innocent spouse cases in the United States involved Carol Ross Joynt, whose husband, Howard Joynt, died after evading payroll and business income taxes for years. In her memoir,26 Carol described suffering occasional physical abuse by Howard but also enjoying a privileged lifestyle funded (she believed) through her husband’s inherited wealth and the popular bar and restaurant he owned in Washington, DC. Though a successful journalist who earned a salary of her own, Carol wrote that she knew little of Howard’s business affairs and deferred to his insistence on managing the household finances exclusively. Her occasional questions were met with reassurances that she need not worry, and she signed joint returns trusting that the accountants who prepared them had done so correctly. All seemed well until Howard’s death, when Carol learned that he had been audited by the Internal Revenue Service (IRS), and she was now the defendant in a claim for over $3 million in unpaid taxes, penalties, and interest, an amount that exceeded the value of his entire estate.27 Following a protracted appeal and with the help of legal advice, she eventually reached

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a settlement with the IRS, which accepted at least in part her claim for relief under the “innocent spouse” provisions of the Internal Revenue Code.28

The US legislated joint liability for spouses who file a joint marital return in 1938.29 Importantly, this liability is not limited to the taxes shown as owing on the face of the return, but applies to all taxes subsequently assessed on unreported or misreported income.30 The liability is not limited in time or affected by the terms of a divorce decree or separation agreement.31 Thus, the US system poses an especially grave risk to those who are unaware that their spouses are engaging in aggressive avoidance or evasion of tax. The only defence available to an unwitting spouse under the 1938 legislation was to invoke a common-law doctrine such as duress or fraud to invalidate the signature on the joint return. The harsh effects of the law were revealed in a series of cases involving wives who were made to pay taxes and penalties on the ill-gotten gains of their judgment-proof ex-husbands, even if, for example, the unreported income had been embezzled from the wife’s own business.

Judicial calls for legislative relief were answered with the enactment of the first generation of innocent spouse provisions in 1971. These rules protected spouses from liability in limited circumstances involving an omission of income from the return and only in cases of serious financial hardship.32 Experience showed that the law did not provide relief in all deserving cases, and public and judicial outcries led to successive waves of reform in 1980, 1984, and 1998 to expand the grounds for relief. Not surprisingly, the reforms have also made the rules more complicated. It is now possible to apply for innocent spouse relief under three separate heads, with overlapping but distinct criteria that require the claimant to show, for example, that she (usually) did not know (and in some cases did not have reason to know) of the understatement of tax, and that it would be inequitable to hold her liable for the unpaid tax.33

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28 Internal Revenue Code of 1986, as amended, IRC section 6015, discussed infra.
30 Beck, supra note 29, at 930.
31 United States, Department of the Treasury, supra note 29, at 9, note 8.
32 McMahon, supra note 29, at 638-39.
33 IRC sections 6015(b), (c), and (f).
These ambiguous provisions have generated extensive interpretive debates, and their application must often be based on limited evidence such as the inconsistent testimony of spouses, with the IRS delving into allegations of abuse, mental illness, and other intimate details of a former marriage. The cost to the government of administering these provisions is substantial. The IRS maintains a centralized, dedicated office for processing innocent spouse claims, which were listed by the National Taxpayer Advocate as one of the IRS’s top 10 litigated issues in all but one year in the last decade. From a taxpayer perspective, Drumbl has underlined the access-to-justice and fairness issues created when separated or divorced spouses, often single parents far less privileged than Carol Ross Joynt, must hire professional advisers and prosecute multiple levels of appeal to win the right to innocent spouse relief. While most critiques have focused on the deserving cases that still fall through the cracks, McMahon has also argued that the current rules are at the same time too liberal, opening opportunities for spouses to collude in abusing the provisions in order to evade taxes.

While there is a range of opinions about how best to fix the innocent spouse rules, US commentators seem to agree that they remain costly and unfair despite several rounds of legislative and administrative reform. Moreover, it is overwhelmingly women who bear the brunt of this problem. Tax policy makers ought to consider whether Canada risks importing this problem as they contemplate the implementation of notional income-splitting rules akin to US joint filing.

**Lessons for Canadian Tax Policy Makers**

Notional income splitting carries a real risk that taxes owing on income earned by a wealthier spouse will be unjustly recovered from the other. Admittedly, Canada’s existing pension income-splitting rules do not create the same degree of risk as the US joint-filing system. First, the joint liability of spouses is limited to taxes owing on the split income, unlike the US rules which extend to all unreported income of the other spouse, from any source. In addition, private pension income is subject to withholding at source under subsection 153(1) of the Act, and subsection 153(2) provides that

\[(2) \text{ if a pensioner and a pension transferee (as those terms are defined in section 60.03) make a joint election under section 60.03 in respect of a split-pension amount}\]

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35 McMahon, supra note 34, at 4.

36 Drumbl, supra note 29.

37 McMahon, supra note 34.
(as defined in that section) for a taxation year, the portion of the amount deducted or withheld under subsection (1) that may be reasonably considered to be in respect of the split-pension amount is deemed to have been deducted or withheld on account of the pension transferee's tax for the taxation year under this Part and not on account of the pensioner's tax for the taxation year under this Part.

In most cases, this deeming rule will protect the spouse who reports the income from unexpected tax liabilities after the fact. But it is not a foolproof system. A payer may fail to withhold or remit taxes as required under subsection 153(1), or the amount withheld may turn out to be inadequate to cover tax liability as assessed (particularly if the transferee spouse has other sources of income).

Nor does the law require pension payers or recipients, or the Canada Revenue Agency (CRA), to share information slips so that a spouse can see for herself how much tax has been paid in advance in respect of pension income being reported on her return. The CRA's Q&A Release on pension income splitting states:

2. Is it necessary to contact the payer of the pension?

Splitting eligible pension income does not have any effect on how or to whom the pension income is paid, so it does not involve the payer of the pension. Information slips will be prepared and sent to the recipient of the pension income in the same manner as previous years.

. . .

6. Who will claim the tax withheld at source from the eligible pension income?

The income tax that is withheld at source from the eligible pension income will have to be allocated from the pensioner to the spouse or common-law partner in the same proportion as the pension income is allocated.38

The Q&A responses suggest that spouses have no right to demand copies of information slips provided to pension recipients. The release is silent as to who bears the responsibility for ensuring an appropriate allocation of withheld amounts to the spouse.

These concerns are mitigated to some degree by the CRA’s prescribed form for making the joint election, which does require the parties to provide information about the amount of tax deducted at source in respect of the split income.39 Further, subsection 60.03(4) provides that “[a] joint election is invalid if the Minister establishes that a pensioner or a pension transferee has knowingly or under circumstances amounting to gross negligence made a false declaration in the joint election.” Thus,
an unscrupulous spouse who purposely understates source deductions may remain solely responsible for tax on the pension income, if the form is challenged and the minister can prove the requisite state of mind. However, these measures may not assist in cases where the pension recipient is abusive or domineering, or simply makes an error, and the reporting spouse trusts the information provided, or is not willing or able to challenge or verify information about withholding. As in the United States, not all Canadian marriages are open and cooperative, and both the relationship and the financial circumstances of a taxpayer can change in unpredictable ways between the time when a joint election is signed and the time when tax is finally assessed and must be paid. Realistically, though, the scale of this risk under the current pension income-splitting rules should not be exaggerated. While we should not overlook individual cases of injustice or hardship that may arise, these should be relatively rare instances because source deductions on pension income will usually ensure that the reporting spouse has no additional tax to pay.

A far more significant risk of innocent spouse liability will arise if notional income splitting is opened up to a wider range of income sources and taxpayers, as suggested in the 2011 election campaign. Presumably the income qualified for splitting would include business and investment income that is not subject to withholding of tax at source, and that accordingly creates greater opportunities for aggressive tax avoidance or evasion by the recipient. Cases decided under existing joint-and-several-liability provisions of section 160 of the Act substantiate this concern and offer a glimpse into the potential for an unwitting spouse to be assessed for unpaid taxes, penalties, and interest accruing over multiple years.

In essence, section 160 provides for joint and several liability where an individual transfers property to a spouse for less than fair market value consideration, at a time when the individual owes income tax. As with any tax debt, the normal reassessment period of three years may be indefinite if the primary earner has fraudulently misrepresented his (or her) income. Moreover, the courts have held that the limitation period for assessing the joint debtor starts to run only 90 days after the first spouse is assessed for the unpaid tax, not on the earlier date when the property was transferred. In addition, section 160 has been held to impose absolute liability that does not require any knowledge of the primary debtor’s unpaid tax. The joint debt can be enforced against the spouse even after the primary debtor has gone bankrupt. Further, where the primary debtor owes tax for some years that are subject to joint spousal liability and some that are not (for example, because they postdate the transfer of assets to the spouse), the CRA is under no obligation to apply any amounts that it recovers from the bankruptcy against the joint spousal liability. Rather, the CRA

40 See Madsen v. The Queen, 2004 TCC 511.
41 See Wannan v. Canada, 2003 FCA 423; No. 605 v. MNR, 59 DTC 159 (TAB).
42 See Clause v. The Queen, 2010 TCC 410; Wannan, supra note 41; Bergeron et al. v. The Queen, 2003 TCC 286; and The Queen v. Heavyside, 97 DTC 5026 (FCA).
can apply recoveries to the amounts for which the primary debtor is solely liable, preserving its ability to assess the spouse for joint debts.\(^{43}\)

The risk for spouses inherent in joint liability is nicely captured by Sharlow JA’s comments in the court’s decision against the spouse (the wife) in *Wannan*:

> While not every use of section 160 is unwarranted or unfair, there is always some potential for an unjust result. There is no due diligence defence to the application of section 160. It may apply to a transferee of property who has no intention to assist the primary debtor to avoid the payment of tax. Indeed, it may apply to a transferee who has no knowledge of the tax affairs of the primary debtor. However section 160 has been validly enacted as part of the law of Canada. If the Crown seeks to rely on section 160 in a particular case, it must be permitted to do so if the statutory conditions are met.\(^{44}\)

It should be remembered that in section 160 cases the joint debtor has actually received a transfer of property that may be available to satisfy the tax debt, or that has in some way enriched the joint debtor. The spouse’s situation may be much worse with notional income splitting since joint liability is imposed without any requirement for an actual transfer of income or property.

The US experience shows that it is not a simple matter to design relieving provisions for innocent spouses that will effectively prevent injustice without imposing burdensome costs on taxpayers and tax authorities, and without opening up opportunities for not-so-innocent spouses to collude to defeat the tax authorities. At the very least, this issue needs to be thought through from the standpoint of gender equality, as well as administrative feasibility, before income-splitting rules are broadened. The preferred approach would be to make tax advantages conditional upon a legal transfer of income or assets—that is, to enact real income splitting rather than notional income splitting.

**CONCLUSION**

The so-called innocent spouse problem refers to unjust imposition of joint return liability on a lower-income spouse, where the higher earner has become judgment-proof or is harder to pursue for unpaid taxes. In relatively egalitarian relationships characterized by strong transparency and communication, spouses may well structure their affairs to ensure that taxes are covered by the higher-income spouse and that there is shared benefit from the tax savings on split income, if not from the full amount of the underlying income. However, studies of household economic behaviour suggest that this best-case scenario does not apply in all cases. Rather, some spouses will sign a joint election form without full or accurate information about the implications for their own tax liability, and without gaining control over any additional household resources. The lower-earning spouse (almost always a woman in

\(^{43}\) See supra note 42.

\(^{44}\) *Wannan*, supra note 41, at paragraph 3.
the innocent spouse cases) may then become the target of enforcement actions to collect unpaid tax, perhaps after the relationship has ended, and whether or not she has access to the underlying income. The US experience is that this happens with alarming frequency, and the chosen remedy in that country of granting special relief to spouses deemed “innocent” has created its own set of inequities and administrative burdens.

I highlight the innocent spouse problem in this comment as just the tip of an iceberg. It is one of the more visible, measurable ways in which notional income-splitting regimes undermine gender equality, and one that should dissuade governments from extending notional income splitting any further. But there is a larger and less visible part of the iceberg that should be at least as concerning to policy makers. Notional models of income splitting actually remove incentives for a wealthier spouse to place legal title to assets or income in the hands of a partner who does not have equal earning power, or who forgoes opportunities in the paid labour market in order to focus on parenting or other unpaid care roles. Notional income splitting also raises the marginal effective tax rate on any income earned independently by that partner, raising the fiscal barriers to women’s equal participation in the labour market. These effects may attract less immediate attention but will be far more pervasive than the innocent spouse problem. Wrongheaded from the standpoint of economic efficiency, such a policy also would be a step back in the process of securing Canadian women’s economic and social equality. Real-income-splitting models should be considered as an alternative that could be appropriately designed to have some gender-equality-promoting effects.