Cracking the Conjugal Myths: What Does It Mean for the Attribution Rules?

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INTRODUCTION

The Law Commission of Canada deserves praise for a report[1] that is groundbreaking in both its substantive vision and its methodological approach to tax policy analysis. The report's core argument is that the legal treatment of close adult relationships should depend less on whether they are conjugal in nature and more on their functional relevance to the policy objectives of particular legal regimes. Applying this principle to the Income Tax Act,[2] the report criticizes the tendency in tax law to assume that conjugal partners share all their income, expenses, and property while ignoring or discounting the degree of economic interdependence that exists in many other types of close relationships between adults. The report's recommendations would de-emphasize conjugality to make the income tax more individually focused overall and, where it does take relationships into account, more pluralistic with regard to the form of those relationships. To reach these conclusions, the commission employs a method of analysis that integrates conventional tax policy concepts with the broader public policy questions articulated by the report as a whole, an achievement that is all too rare in tax literature.

In the first part of this brief commentary, I expand on the importance of these contributions and reflect on other changes to the income tax, particularly to the rate structure, that would be needed in order to implement the report's recommendations. In the second part, I turn to a curious silence in the report, namely, its lack of any commentary on the attribution rules. In particular, many of the commission's arguments about the need to promote autonomy and equality in adult relationships could be extended to the spousal attribution rules. Other recent developments, such as the Supreme Court of Canada's decision in *Neuman*[3] and the introduction of the so-called kiddie tax, as well as academic commentary, suggest that we are due for a serious debate on whether to do away with these rules. It is sometimes suggested that abolishing spousal attribution would promote women's equal access

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to income and wealth. However, I argue that this view does not take adequate account of the gap between formal rights and informal power structures within families. Instead of repealing the spousal attribution rules outright, I propose that they should be amended to acknowledge genuine transfers of de facto control over property, without condoning the use of more formalistic transactions that aim principally to reduce the primary wealthholder's tax burden.

UNCOUPLING THE COUPLE IN PERSONAL INCOME TAX POLICY: FROM SPOUSAL STATUS TO THE SOCIOLOGY OF RELATIONSHIPS

The report's most significant contribution lies in its careful unpacking of the assumptions attached to conjugality. Like other legal regimes, tax law has tended to treat membership in a spousal or other conjugal relationship as a unique status to which is automatically attached a host of benefits or burdens, based upon an implicit set of norms about what goes on (or should go on) between spouses. The commission calls for a more rigorous sociological approach that looks beneath the formal status of coupledom to the ways in which individuals actually behave toward each other in a diverse array of adult relationships. This approach illuminates tax inequities both between and within different relationships. It also demonstrates the difficulty of generalizing about modern adult relationships and why it is almost always more rational and equitable to base taxes and benefits on individual circumstance rather than spousal status. One of the main barriers to implementing this type of reform, however, is that it would result in lower revenues and higher benefit costs, likely requiring an increase in tax rates for higher-income individuals.

The pioneering nature of the commission's approach to tax law can be fully appreciated only against the backdrop of history. From its inception in 1917, the income tax gave special treatment to married individuals despite using the individual as the basic tax unit. Interestingly, the federal government was originally hesitant about giving tax recognition to marriage for reasons very similar to those now being cited by the Law Commission. A study by Lahey[4] reveals that the government initially proposed to allow only a basic personal exemption with no dependency exemptions for spouses, children, or anyone else, preferring to remain neutral as among the many different types of supportive relationships people might enter into: "[T]here are many citizens who have not only their own family to take care of, but also the family of a brother or a sister, or perhaps they have to look after an aged father or mother."[5] Opposition MPs objected strongly that it was unfair for married men with dependants to receive no greater exemption than singles, and voiced concern that the bill may even encourage men to remain unmarried.[6] Following these protests, the basic personal exemption was reduced by half for unmarried individuals. Although the definition of "spouse" has been broadened beyond formal marriage in recent years to include common law heterosexual and same-sex partnerships, these reforms stopped short of questioning why conjugality should be the relevant condition for adjusting taxes and benefits in the first place.[7] The Law Commission has now prodded us to take the next logical step, to look at the full array of interdependent relationships between adults.

The report shines a much-needed light inside the conjugal household to examine the validity of ingrained assumptions about what goes on, economically speaking, between members of a couple. These assumptions are so longstanding and pervasive that they are seldom consciously articulated by policy makers. They include the notion that income, expenses, and property are pooled and shared equally by conjugal partners, that support can be delivered to non-income-earning persons via tax concessions given to their spouses, and that having one partner engage in full-time caregiving is a cost rather than an economic benefit to the other partner. The report looks beyond the "black box" of the conjugal couple to empirical evidence that reveals the wide diversity of economic arrangements in adult relationships. It concludes that "conjugality as a proxy for sharing is obviously both over-inclusive and under-inclusive . . . because there is often less than full sharing in conjugal relationships . . . [and] because adults live together in a wide variety of non-conjugal relationships that involve sharing."[8] This finding is key to the commission's recommendation that individuals should be entitled to claim benefits such as the refundable goods and services tax credit and child tax benefit based on their own income without regard to the income of a spouse or common law partner. It also fuels the suggestion that personal tax credits such as the spousal credit and dependent relative credits be replaced with refundable credits or direct grants delivered directly to caregivers and to people with disabilities.[9] This approach is in marked contrast to recent measures such as the caregiver credit, which seeks to value the work of unpaid caregivers by providing tax relief to breadwinners, instead of to caregivers directly.[10]

The commission's recommendations effectively disaggregate the couple to focus instead on the distinct interests and circumstances of individual partners. They aim to promote autonomy and gender equality within relationships and to give non-earning individuals more independence from those who support them financially. This is an extremely valuable contribution to debates over personal income tax policy, which tend to get bogged down in comparing the treatment of different types of couples or families, obscuring the disparate positions and sometimes conflicting interests of individuals within such households.

The report shies away, however, from addressing the revenue implications of its recommendations. While noting that "[a] shift to individual income testing will entail additional program costs unless income cut-offs are lowered or benefit levels reduced,"[11] the authors do not discuss how these costs, or the significant costs of making personal credits refundable, could be financed. A logical solution would be simply to increase the rates of tax on higher-income individuals. Such a reform could be revenue-neutral overall while effectively redistributing tax burdens to higher-income individuals and social benefits to lower-income individuals (as opposed to couples). Thus, one member of a couple may gain while the other loses. This sort of internal redistribution will be desirable in many cases if the objectives of promoting equality and autonomy within relationships are taken seriously. However, it raises an obvious political barrier to implementing the tax section of the report.

The commission is also to be applauded for producing a piece of tax policy literature that is analytically sophisticated yet accessible and engaging to a wide audience. It rigorously applied the standard forms of tax policy evaluation (both technical and tax expenditure criteria) but successfully avoided the tendency of much tax writing to seal itself off hermetically from the language and value judgments that inform public policy analysis in other areas. The methodological and substantive achievements of the report are clearly linked. The commission was able to think past the paradigm of spousal status precisely because it opened the analysis to questions that typically are considered outside the purview of tax policy. The report should make us think more deeply about the conventional distinction between tax policy and social policy. This time-honoured distinction is often appealing as a means of clarifying the objectives and standards against which a provision is being evaluated. Less nobly, however, it can make the analysis of tax policy overly abstract and more easily captured as the exclusive domain of tax "experts." The brilliance of this report lies in the way it interprets the tax policy criterion of "equity" through the richer concepts of "equality" and "autonomy." In doing so, it moves beyond a notion of equity that simply compares numbers on a page to one that is sensitive to the complex dynamics of real interpersonal relationships, including the persistent effects of gender inequality within such relationships.

I now turn to the attribution rules, another part of the Act that badly needs to be reassessed in view of modern norms of gender equality.

SPOUSAL ATTRIBUTION: AN ARGUMENT FOR REFORM VERSUS REPEAL

Although the report evaluates a wide array of tax provisions that give special treatment to conjugal couples, it offers no commentary on the attribution rules as they apply to spouses or common law partners.[12] This is a curious omission given that two background studies prepared for the commission called for a review of the attribution rules,[13] and that the report does address a closely related provision, the rollover that allows property to be transferred between spouses inter vivos or on death without attracting capital gains tax.[14] It is even more curious in light of the importance the report attaches to promoting the autonomy of individuals, encouraging the redistribution of property within relationships, taxing individuals only on income they earn or control, and valuing care work. These are the very values and principles that are often cited by tax policy commentators in favour of abolishing the spousal attribution rules. For example, Neil Brooks has written that attribution "fails to recognise the autonomy of the spouse receiving the property (usually the wife). It also has the effect of discouraging husbands from transferring family property to their wives during marriage and thus achieving a more equitable distribution of wealth."[15] David Duff has advocated repealing the spousal attribution rules on the basis that "adult spouses obtain effective control over the income to which they are legally entitled."[16] He has also suggested permitting some splitting of employment or other income with a partner who provides unpaid care for children, as a means of recognizing the economic value of this work.[17] Kathleen Lahey has criticized "the tendency to view women as being mere puppets" in income-splitting transactions.[18] And Claire Young has recommended that empirical data be collected to determine whether men would transfer more property to female partners in the absence of the attribution rules.[19]

Recent jurisprudential and legislative developments provide further impetus for reconsidering these provisions. In *McClurg*[20] and *Neuman*,[21] the Supreme Court of Canada held that dividends paid on private corporation shares held by the taxpayers' wives could not be attributed to the taxpayers under the indirect transfer rule in subsection 56(2) of the Act, although the corporations were controlled by the husbands. The decisions have been widely interpreted as permitting dividend-sprinkling arrangements as a means of planning around the attribution rules. In reaction to *Neuman*, the government introduced the so-called kiddie tax, a provision that taxes minors at the top marginal rate on private corporation dividends and certain other forms of investment income, thereby removing much of the benefit to parents of splitting passive income with their children.[22] By including only minors in the new legislation, however, the government implicitly condoned this form of income splitting with spouses, raising questions about the strength of its resolve to prevent spousal income splitting more generally.

It appears the time is ripe for a thorough debate on whether the spousal attribution rules have become outmoded in view of changes in the economic status of women and in social norms surrounding gender equality. Although the report does not tackle this question directly, its strong argument in favour of strengthening the individual unit of taxation and reducing the importance of conjugal relationships in the tax system will certainly lend support to the case against spousal attribution. Yet any move to liberalize or abolish the spousal attribution rules must still contend with the objection that doing so would benefit only a select group of the country's wealthiest taxpayers, reducing the progressivity of the rate structure and the equity of the tax system. Some may be prepared to live with this regressive impact if it results in wealth and income being shared more equally by women: "after economic relations between men and women have been equalized, we can take up the issue of equalizing them between women."[23] A persuasive case has not yet been made, however, that giving free rein to income splitting would in fact advance women's equality in a substantive, as opposed to a merely formal, sense. While it would likely result in women holding legal title to more property, this is rather meaningless if it is not understood by the spouses, as well as by third parties, to signify a real change in beneficial ownership and de facto control over the property. For this reason, an outright repeal of the attribution rules as they apply to spouses would be far too blunt an approach. Instead, I will argue, the rules should be revised to distinguish between transfers of effective control over income and property, versus merely formal transfers that aim primarily to reduce the transferor's tax burden.

It is not a simple matter to determine who exercises effective control over income and property within a conjugal partnership or, for that matter, other close adult relationships. As every estate planner and family lawyer understands, informal power dynamics are at least as important as legal rights in determining who really controls a family business or other assets. As an empirical matter, it is simply wrong to assume that a valid transfer of legal title to a spouse always means that he or she is in control of future decisions about the use or disposition of the property, or the expenditure of income from the property. Despite improvements in their status, women still lack equal influence over economic decisions in many families, even where they are formally entitled to it. Brooks hints at this problem when he suggests that "if the transaction has *substantial economic effect*, it should be respected despite the motivation of the transferor,"[24] but he does not elaborate on whether or how "substantial economic effect" differs from the formal control obtained through a transfer of title. Lahey also touches on this problem when she raises the concern that "in adjudicating property claims between spouses, courts may well decide to disregard transfers to spouses as being mere arrangements to avoid tax liability."[25] That is, a legal transfer may be effective for tax purposes but denied and defeated for other purposes. Lahey briefly suggests that there is a need for "tests designed to identify genuine economic autonomy"[26] but does not flesh out what these might look like.

The *McClurg* and *Neuman* cases nicely illustrate how informal power dynamics shape the exercise of legal rights within close personal relationships. In each case, a woman held non-voting shares in a private corporation controlled by her husband. In *McClurg*, the payment of dividends on the non-voting shares was at the discretion of the husband and his co-director (who was not his wife). In *Neuman*, the husband appointed his wife sole director of the corporation but admitted in evidence that he advised her as to what dividends should be declared on each class of shares. In both cases, when dividends were paid on the non-voting shares, it is not clear that the wives were in control of decisions about how the dividend income should be spent or invested.

In the *Neuman* case, the $14,800 dividend paid to Ruby Neuman in 1982 was immediately loaned back to her husband at no interest on the security of a promissory note. The note entitled her to demand repayment at any time and to receive interest thereafter; but at the time of her death six years later, no demand had been made and no interest had been paid on the loan.[27] From Mr. Neuman's perspective, the total effect was that he avoided tax on the amount declared as a dividend to his wife but retained full use of that money for his business or personal purposes at no cost. It is difficult to see this transaction as involving any real redistribution of economic power from husband to wife. In the *McClurg* case, Wilma McClurg reinvested $20,000 of the $30,000 in dividends at issue in another family corporation with a similar capital and management structure, meaning presumably that only her husband, not she, held voting shares and sat on the board of directors.[28] Here again, it is not clear how autonomously she acted in so reinvesting the money, and it appears that in doing so, she relinquished control over the future use of that $20,000 to her husband.

Reform in this area must somehow navigate the dilemma, familiar from many other contexts, of how to encourage the development of more egalitarian relationships while addressing the reality that many heterosexual relationships are not yet equal. To abolish all spousal attribution outright would open the door to transactions that reduce tax liability for the primary wealthholder but do not effect meaningful transfers of control over economic resources. Another approach would be to retain the current rules in subsection 74.1(1) and section 74.2 of the Act but create a new exception, so that attribution would not apply where the transferor relinquished all use of and control over the property and any income therefrom, including de facto as well as de jure control. Such a provision might borrow from the language of subsection 256(5.1) of the Act, dealing with de facto control of a corporation, which refers to "any direct or indirect influence that, if exercised, would result in control in fact." It would be necessary to include de facto control of substituted property or the income from substituted property, to cover situations where gifts of money or property are returned to the transferor's control by way of loans, share purchases, or other superficially commercial transactions. In the case of capital gains attribution, thought should also be given to adding a minimum holding period before the transferee could dispose of the property without attribution of any gain or loss, to reduce the chance of spouses being used as way stations in the sale of property to a pre-identified third party. The provision might also state that the exception would not be available, and attribution would apply retroactive to the time of transfer, in the event that the transferor denies or seeks to rescind the transferee's ownership of the property for any purpose. This restriction addresses the concern that income-splitting transactions may be disregarded when it comes time to determine who owns what for other purposes.

Finally, it is worth underlining Claire Young's point, noted earlier, about the need for reliable empirical data on the distribution of wealth between members of conjugal couples, and between men and women generally. While income statistics are gathered annually for individuals and broken down by gender, data on wealth holdings are far skimpier. Statistics Canada conducted a new survey of household wealth in 1999, 15 years after its previous survey in 1984.[29] As in 1984, however, data were collected on the assets and debts of family units, not for individuals within families. This methodology reflects the stock assumption that all family members benefit equally from property owned by one individual. As the Law Commission so persuasively argues, it is time to move on from such unitary assumptions and to think more clearly about the position of different individuals in families. Without better data on the distribution of wealth, it will be a challenge to design tax policies that can improve women's economic equality, or to evaluate their effects.

NOTES

1 Law Commission of Canada, *Beyond Conjugality: Recognizing and Supporting Close Personal Adult Relationships* (Ottawa: Public Works and Government Services, 2001) (herein referred to as "the report").

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

3 *Neuman v. The Queen*, 98 DTC 6297 (SCC).

4 Kathleen A. Lahey, *The Benefit/Penalty Unit in Income Tax Policy: Diversity and Reform* (Ottawa: Law Commission of Canada, September 2000), 1-2.

5 Remarks of Thomas White, in Canada, House of Commons, *Debates*, August 3, 1917, 4103.

6 Lahey, supra note 4, at 2, note 2.

7 See the definition of "common law partner" in subsection 248(1) of the Act, added by SC 2000, c. 12, section 139(2).

8 Supra note 1, at 85.

9 Ibid., at 72-77.

10 Paragraph 118(1)(c.1) of the Act, added by SC 1999, c. 22, section 31(2). I criticize this and other aspects of the credit in another article: "Tax Law and Social Reproduction: The Gender of Fiscal Policy in an Age of Privatization," in B. Cossman and J. Fudge, eds., *Privatization, Law and the Challenge to Feminism* (Toronto: University of Toronto Press, forthcoming).

11 Supra note 1, at 86.

12 The provisions most directly concerned are subsection 74.1(1) and section 74.2, though other provisions, such as subsection 56(2) (indirect transfers) and section 74.4 (corporate attribution) as they apply to spouses, also should be re-evaluated.

13 See Lahey, supra note 4, at 117-20; and Claire Young, *What's Sex Got To Do with It? Tax and the "Family"* (Ottawa: Law Commission of Canada, May 2000), 40-49.

14 Supra note 1, at 87-89, discussing section 73 and subsection 70(6) of the Act.

15 Neil Brooks, "The Irrelevance of Conjugal Relationships in Assessing Tax Liability," in John G. Head and Richard Krever, eds., *Tax Units and the Tax Rate Scale* (Melbourne: Australian Tax Research Foundation, 1996), 35-80, at 74. For similar views, see Peter W. Hogg, Joanne E. Magee, and Ted Cook, *Principles of Canadian Income Tax Law*, 3d ed. (Scarborough, ON: Carswell, 1999), 117; and Maureen Donnelly, Joanne Magee, and Allister Young, "Income Splitting and the New Kiddie Tax: Major Changes for Minor Children" (2000) vol. 48, no. 4 *Canadian Tax Journal* 979-1018, at 1008.

16 David G. Duff, "Neuman and Beyond: Income Splitting, Tax Avoidance, and Statutory Interpretation in the Supreme Court of Canada" (1999) vol. 32, no. 3 *Canadian Business Law Journal* 345-83, at 379.

17 David Duff, "Tax and the Family" (unpublished draft on file with the author, May 11, 1999), 11. See also a similar proposal by Paul Szabo, MP in his 1994 private member's bill, Bill C-256, An Act To Amend the Income Tax Act (Transfer of Income to Spouse), first reading June 7, 1994 (35th Parl., 1st sess.).

18 Lahey, supra note 4, at 119. See also Lahey's earlier comments in favour of repealing the spousal attribution rules, in Kathleen A. Lahey, "The Tax Unit in Income Tax Theory," in E. Diane Pask, Kathleen E. Mahoney, and Catherine A. Brown, eds., *Women, the Law and the Economy* (Toronto: Butterworths, 1985), 277-310, at 300.

19 Young, supra note 13, at 45 and 48-49.

20 *The Queen v. McClurg*, 91 DTC 5001 (SCC).

21 Supra note 3.

22 Section 120.4 of the Act added by SC 2000, c. 19, section 30. For a thorough discussion of these developments, see Donnelly et al., supra note 15.

23 Lahey, "The Tax Unit in Income Tax Theory," supra note 18, at 300. See also Brooks, supra note 15, at 74.

24 Brooks, supra note 15, at 74 (emphasis added).

25 Lahey, "The Tax Unit in Income Tax Theory," supra note 18, at 300.

26 Lahey, supra note 4, at 119.

27 See the statement of facts in the Federal Court of Appeal decision in *The Queen v. Neuman*, 96 DTC 6464, at 6469.

28 Supra note 20, at 5004.

29 Statistics Canada, *The Assets and Debts of Canadians: An Overview of the Results of the Survey of Financial Security*, catalogue no. 13-595-XIE (Ottawa: Statistics Canada, March 2001).