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Corporate Tax Centre - In this article, Vern Krishna discusses the fairness of, and criticisms of, the Harper Government's new income splitting proposals and how the Canadian income tax system already contains measures of income splitting for other taxable units.

Income Splitting is Fair (Vern Krishna)

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Vern Krishna—Income Splitting is Fair

The most fundamental question in all tax law is identifying the taxable unit. A half-century ago the Carter Commission recommended that Canada adopt joint taxation for "married" couples as the taxable unit would be fair. Families live as economic units, share their financial resources, and, as such, should also share their tax burdens. Horizontal equity—equal treatment of persons in equal financial circumstances—requires that families with equivalent incomes should pay equal taxes.

Canada rejected the Commission's recommendation and went with taxation of individuals, which is inherently unfair to single income families. For example, a family with a single earner of $100,000 will pay $9,052 more in tax than a family with two earners, where each spouse brings in $50,000. Indeed, the Commission rightly characterized the Canadian system of individually based taxation as leading to "ludicrous results".

The subject has reignited debate with Prime Minister Harper's commitment to permit limited income splitting. Individuals will be able to split up to $50,000 of taxable income with their spouses, but only if they have children under 18 at the end of the year. Spouses without young children get no tax break for the family. Even in these limited circumstances, and out of revenue loss concerns, the government has capped the maximum federal tax credit at $2,000 annually. This is a baby step towards a fairer tax system, but it falls far short of structuring a fair tax system.

For example, the marginal rate of tax in Ontario (2014) increases progressively from 20 to 31, 43, and 48 per cent, as income rises from $25,000 to $50,000, $100,000, and $200,000, respectively. Individuals who earn more must pay not only more in absolute dollars, but also at increasingly progressive rates. Thus, a taxpayer who earns $100,000, and has a stay at home spouse, must pay $9,052 more in tax than a married couple, who each earn $50,000. Hence, the after-tax economic well being of the two families will be quite different.

There are two traditional criticisms of the full income splitting model of taxation. To be sure, income splitting provides greater benefits to higher income individuals than to those with lower marginal rates. A person with $200,000 income will save $19,661, compared with the $2,986 that a person with $50,000 would save if both split their income in half. This result is a mathematical corollary inherent in the progressive system. It applies to every deduction in the tax system—for example, business meals, automobile expenses, business travel, support payments, union dues, and professional fees. It follows the principle, tax more as income rises; deduct more as income falls.

A second criticism from some feminists is that the tax saving from income splitting might induce some women to stay at home. It is difficult to predict the magnitude of behavioural changes, but the tax savings would be a modest inducement for giving up a job. Indeed, as women now comprise 65 per cent of law, and 80 per cent of medical, schools, it is unlikely that they will give up their professional careers to stay at home for the tax savings from income splitting.

The Canadian income tax system already is rife with income splitting, but only for select groups of taxpayers. Thus, we allow higher income retirees to split their pension income with their lower income spouses. For example, a retiree with $100,000 pension income can split her income with her spouse, and reduce her marginal rate from 43 to 31 per cent, thereby maximizing the family's economic well-being.

Similarly, higher income investors can divest a portion of their portfolio to their children to attend university, so that they can pay their own tuition fees and living costs with lower taxed dollars. Higher marginal rate taxpayers can also contribute to the registered retirement savings plans of their lower income spouses, all for an overall net savings in taxes upon retirement or withdrawal from the plan.

The best opportunities for income splitting are for individuals who run their own corporate businesses. For example, a family of four, including two adult children, can sprinkle dividends among the family members. Each member of the family can get up to about $50,000 tax free dividends each year if he or she does not have any other source of income. Even better, with proper planning, each member of the family can ultimately dispose of their shares in the business, or family farm corporation, and extract $800,000 each tax-free.

The new income splitting proposals and the capped credit leave most middle-income employees out in the cold. Middle income individuals are the backbone of the Canadian taxpaying public, and the government is ever mindful of how much revenue they contribute in taxes. To be sure, giving them all a tax break would cost about $4 billion, a number that is actually comparatively small in the long run in the context of the total budget, and impending surpluses, which according to the government will bring additional savings of $9.1 billion over six years. The result of making the family the taxable unit would be fairer than the present system of individual taxation. However, in tax policy, revenue and political considerations often trump structural fairness.

Professor Vern Krishna, University of Ottawa Law School and Of Counsel, TaxChambers LLP.

Vern.Krishna@TaxChambers.ca

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