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INCOME SPLITTING IN AUSTRALIA: TIME FOR A PRINCIPLED APPROACH?

Abstract

Income splitting occurs where a taxpayer diverts some of the income that they might have derived personally to a taxpayer who is on a lower tax rate. This is permitted under current tax laws; however, the Australian Taxation Office ('ATO') has recently asserted limits to some known methods of income splitting. This article examines the current law in relation to income splitting in Australia, including the ATO's recent formal policies. Broadly speaking, the law allows the splitting of income from property and business income, unless that business income is generated from the taxpayer's personal services. This means that salary- or wage-earning taxpayers are at a relative disadvantage. One way of levelling the playing field could be to permit joint returns, allowing spouses to split their entire incomes — as is done in the United States of America. Alternatively, income splitting could be curtailed substantially beyond what the ATO currently permits, through legislative change. This article examines both approaches and concludes that either approach would be preferable to the current law.

I Introduction

An income tax system characterised by progressive tax rates will invariably tempt those on relatively high tax rates to split income with others on lower rates.[1] Income splitting is the process by which a portion of a person's assessable income is diverted to another party who is on a lower tax rate, resulting in a lower aggregate tax liability.[2] Recently, the Australian Taxation Office ('ATO') has targeted certain forms of income splitting. It has done so by releasing guidelines restricting the use of trusts to split property income[3] and limiting professionals'

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1 See, eg, Samuel D Brunson, 'Grown-Up Income Shifting: Yesterday's Kiddie Tax Is Not Enough' (2011) 59(3) *University of Kansas Law Review* 457, 468.

2 Graeme S Cooper et al, *Income Taxation: Commentary and Materials* (Lawbook, 9th ed, 2020) 440 [7.10].

3 Australian Taxation Office, *Income Tax: Section 100A Reimbursement Agreements* (TR 2022/4, 8 December 2022) ('TR 2022/4'); Australian Taxation Office, *Section 100A Reimbursement Agreements — ATO Compliance Approach* (PCG 2022/2, 8 December 2022) ('PCG 2022/2').

ability to split their firm's profits.[4] Given that the ATO is not a legislative body, its approach has been seeking to apply the existing law more strictly.[5]

To what extent and in which situations income splitting should be allowed are perplexing questions that affect the income tax liability of many taxpayers. It can be seen, from the multiplicity of policy approaches taken by different jurisdictions, that there is no one obvious or perfect answer. However, given the importance and impact of income-splitting laws, there is substantial utility in understanding the current law, its trade-offs, and potential policy alternatives.

Part II of this article discusses the current law on income splitting, including an explanation of the main methods used to achieve it under Australian law. Part III of the article turns to anti-avoidance provisions and how they curtail income splitting. The discussion here includes a description of recent ATO guidelines on the application of the law as it relates to income splitting in professional services firms, such as accounting and legal partnerships. Part IV then examines the broad question of whether couples should be able to make joint returns, as is the case in some jurisdictions such as the United States of America ('USA'). In essence, joint returns result in full income splitting between a spousal couple. Part V of the article approaches the issue on the assumption that the current system of individual returns is maintained. It examines the broad approach of the current law, and suggests that the ability to split income under the current law should be curtailed. Part VI then concludes that either of the approaches in Parts IV or V — despite entailing diametrically opposed policies — would be preferable to the status quo.

II Income Splitting in Australia

Australia treats individuals as taxpayers and assesses them on their income.[6] This is in contrast to some other jurisdictions, such as the USA, that allow or mandate couples to lodge joint tax returns based on their aggregate income.[7] However, Australia does take a 'joint income' approach when assessing the entitlement of individuals to certain government benefits, such as the age pension[8] or when assessing other tax liabilities such as the Medicare levy surcharge.[9]

By way of background, the income-splitting techniques described below involve arranging the ownership of income-producing assets so as to modify the taxpayers assessable on the income of such assets. Such assets may include business interests

4 Australian Taxation Office, *Allocation of Professional Firm Profits — ATO Compliance Approach* (PCG 2021/4, 16 December 2021) ('PCG 2021/4').

5 Ibid; TR 2022/4 (n 3).

6 *Income Tax Assessment Act 1997* (Cth) s 4-1 ('*ITAA 1997*').

7 IRC § 6013 (2006).

8 *Social Security Act 1991* (Cth) s 1064.

9 *Medicare Levy Act 1986* (Cth) s 8D.

as well as more passive investments. Often ownership arrangements involve use of a trust that alters the ownership of beneficial interests in such assets.

In contrast, case law has established that personal exertion income cannot be shifted to another person in a tax-effective manner.[10] This position arises from an important distinction between existing and future proprietary interests. An actual proprietary interest, including a right to income, is considered a chose in action, and is thus transferable (alienable),[11] unlike a 'mere expectancy' of future income, which cannot be effectively immediately alienated.[12] Although a purported transfer of a mere expectancy for consideration will give the assignee a right to the income, this will only come into effect once the assignor has derived the income.[13] Consequently, in the case of personal exertion income that is not based on an underlying proprietary interest, an attempted alienation only takes effect after the income is earned and the tax liability has accrued — making income splitting in such a scenario ineffective.[14] In contrast, anti-avoidance provisions aside, courts have allowed the effective alienation of business interests, notwithstanding that the business income was in substance predominantly due to the personal services of the owner.[15]

Techniques for income splitting have evolved over time and can be placed in one of the three categories discussed below.

A *Utilising an Entity for Businesses*

The carrying on of a business through various entities is a popular way of income splitting. At the simplest level, this can involve carrying on a small business in

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10 *Liedig v Federal Commissioner of Taxation* (1994) 50 FCR 461, 472 ('*Liedig*'). While the term 'income from personal exertion' is given a technical definition in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) ('*ITAA 1936*'), the definition does not provide a substantive definition of what types of income fall under it. Judicial decisions have also been reluctant to give a precise definition of the term. In contrast, the Personal Services Income ('PSI') provisions, which as discussed below in Part III(B) impose some legislative limits on income splitting, describe 'personal services income' as income that is 'mainly a reward for your personal efforts or skills (or would mainly be such a reward if it was your income)': *ITAA 1997* (n 6) s 84-5.

11 *Shepherd v Federal Commissioner of Taxation* (1965) 113 CLR 385, 390–1 (Barwick CJ).

12 *Norman v Federal Commissioner of Taxation* (1963) 109 CLR 9, 26 (Windeyer J).

13 *Tailby v Official Receiver* (1888) 13 App Cas 523, 546 (Lord Macnaghten); *Palette Shoes Pty Ltd (in liq) v Krohn* (1937) 58 CLR 1, 26–7 (Dixon J).

14 *Liedig* (n 10) 471–2.

15 Ibid 474, discussing *Tupicoff v Federal Commissioner of Taxation* (1984) 56 ALR 151. But see *Hollyock v Federal Commissioner of Taxation* (1971) 125 CLR 647, 653 ('*Hollyock*'), where Gibbs J in obiter dictum did question whether business income that was in essence due to the personal exertion of the taxpayer could, anti-avoidance provisions aside, be legally assigned. In New Zealand, there is a stronger judicial basis for being unable to alienate such amounts: Ian Tregoning, 'Liedig and the Limits of Section 96' (1998) 8(1) *Revenue Law Journal* 122, 127–9.

the form of a company where the taxpayer and their spouse both own its shares and so receive dividend income. Similar arrangements involve utilising a unit or discretionary trust instead of a company. More sophisticated arrangements involve utilising multiple entities. For instance, a business partnership may have discretionary family trusts (in lieu of individuals) as partners,[16] or the business might be in the form of a company with shareholders that are discretionary trusts.[17]

One arrangement that differs from the direct use of an entity to split income is the use of a 'service trust'. Here, a professional practice (such as a law or accounting firm) pays a service trust for its administrative services.[18] Specifically, the service trust pays for administrative services directly, including leasing of office and office furniture, purchasing stationery and equipment, and paying administrative staff.[19] The service trust then marks up these costs and charges the professional practice for their supply.[20] The service trust, which is typically in the form of a unit trust, then distributes its profit to the unit holders, which are typically the relatives and related entities of the partners.[21]

B *Partnership Income Assignments*

A different form of income splitting available to partners is a partnership income assignment. This is sometimes referred to as an *Everett* assignment, after the High Court case that held such arrangements to be tax-effective.[22] Here, in essence, the partner transfers part of their right to income in the partnership to a third party, which may be a person (often their spouse) or an entity such as a discretionary trust.[23] While such an assignment, legally speaking, involves the partner holding part of their interest on trust for the assignee,[24] the unique nature of such an arrangement means that it is in substance fundamentally different from utilising an entity to split income.

Since the introduction of Capital Gains Tax ('CGT'), income assignments are less tax-effective, as they will typically lead to the transferor incurring a substantial CGT

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16 PCG 2021/4 (n 4) [147].

17 Ibid [173].

18 Australian Taxation Office, *Your Service Entity Arrangements* (Guide No NAT 13086–04.2006, April 2006) 5.

19 Ibid.

20 Ibid.

21 See, eg, the facts in the income-splitting case of *Phillips v Federal Commissioner of Taxation* (1977) 13 ALR 417, 420.

22 *Federal Commissioner of Taxation v Everett* (1980) 143 CLR 440 ('*Everett*').

23 'Everett Assignments', *Australian Taxation Office* (Web Page, 4 July 2022) <https://www.ato.gov.au/Business/Income-and-deductions-for-business/In-detail/Professional-firms/Everett-assignments/#MeaningofanEverettassignment>.

24 Ibid.

liability.[25] However, situations such as the transferor having substantial current or carried-forward capital losses can still potentially lead to the assignment markedly reducing their tax liability.[26]

C *Passive Income-Producing Property Ownership*

Whereas the previous categories applied to income splitting by business owners, the simplest form of income splitting is shared ownership of passive income-producing property. Here, the lower-tax-rate spouse owns income-producing assets such as shares or a cashflow-positive investment property. A variant of this approach uses an entity, such as a trust or company, as a vehicle to own such assets for income-splitting purposes. As with income assignments, transfer of part or full ownership from one taxpayer to another can potentially trigger a CGT liability.[27]

III Limits on Income Splitting

The tax legislation includes various anti-avoidance measures, some of which are specifically aimed at preventing or strongly discouraging income splitting. Further, the general anti-avoidance provisions, located in pt IVA of the *Income Tax Assessment Act 1936* (Cth) ('*ITAA 1936*'), can also prevent income splitting in certain situations. It is worthwhile to consider the most important anti-avoidance provisions.

A *Division 6AA — Income of Minor*

Division 6AA of pt III of the *ITAA 1936* was introduced in 1979 and is aimed at parents attempting to split income with their children who are under the age of 18.[28] These provisions apply to income earned directly by a minor[29] as well as to a minor's present entitlement to trust income.[30] Where div 6AA applies to the income of a minor, this income is in substance subject to the top tax rate for amounts above a modest tax-free threshold of $416.[31] Minors who are financially independent or under certain specified circumstances are deemed to be 'excepted persons', and are not subject to these provisions.[32] Specifically, 'excepted persons'

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[25] Section 104-10 of the *ITAA 1997* (n 6) makes a gain from transfers of assets potentially assessable and s 116-30 deems gifts and non-arm's-length transfers to have been sold at market value.

[26] Under *ITAA 1997* (n 6) s 102-5 any carried-forward and current capital losses are offset against capital gains.

[27] Ibid ss 104-10, 116-30.

[28] Explanatory Memorandum, Income Tax Assessment Amendment Bill (No 6) 1979 and Income Tax (Rates) Amendment Bill (No 2) 1979 (Cth) 2–3.

[29] *ITAA 1936* (n 10) ss 102AD, 102AE.

[30] Ibid s 102AG.

[31] *Income Tax Rates Act 1986* (Cth) sch 11 ('*ITRA 1986*').

[32] *ITAA 1936* (n 10) s 102AC.

are minors engaged in full-time work, certain minors considered disabled under the legislation, and minors with carer responsibilities.[33]

Importantly, minors who are not 'excepted persons' (referred to as 'prescribed persons')[34] are only subject to the higher minor rates on certain types of income. Broadly speaking, higher tax rates apply to income that is 'unearned', such as shares or real estate whose purchase has been funded by their parents.[35] Conversely, income such as employment income, as well as income from investments acquired with funds originating from the services income of the minor, are not subject to minor tax rates.[36]

B *Personal Services Income Provisions*

In the late 1990s, the federal government was concerned about the increasing number of taxpayers who were utilising an interposed entity to earn and split income from what was essentially employee-like personal services income.[37] In order to neutralise the tax effectiveness of these 'employee on Friday, contractor on Monday' arrangements, the government introduced the Personal Services Income ('PSI') provisions.[38]

PSI is defined by these provisions as income mainly attributable to the taxpayer's personal effort and skills — as opposed to income generated mostly by business capital, employees or trading stock.[39] The provisions apply to situations where the taxpayer has either directly,[40] or through an entity, arranged to be paid for their services.[41] Where the PSI provisions apply, they limit the deductions available to what could be described as deductions only available to employees.[42] They also prevent income splitting by deeming the income to have been earned by the taxpayer providing the services.[43]

Importantly, the adverse consequences of these provisions do not apply to PSI earned by taxpayers carrying on a Personal Services Business ('PSB').[44] Broadly speaking,

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33 Ibid s 102AC(2).

34 Ibid s 102AC(1).

35 Ibid ss 102AE(1)–(2).

36 Ibid s 102AE(2).

37 John Ralph, *A Tax System Redesigned* (Final Report, 1999) 288–94.

38 Explanatory Memorandum, New Business Tax System (Alienation of Personal Services Income) Bill 2000 (Cth) 5–6 [1.5]–[1.10] ('PSI Explanatory Memorandum').

39 *ITAA 1997* (n 6) s 84-5.

40 Ibid div 85.

41 Ibid div 86. Where an interposed entity is used, the legislation refers to this as a 'personal services entity': at s 86-15.

42 Ibid div 85 (where the individual has contracted directly with the employer), sub-div 86-B (where an entity has been interposed to be paid for the services).

43 Ibid sub-div 86-A.

44 Ibid ss 85-30, 86-15, 86-60.

this exception is aimed at distinguishing between PSI earned through a 'genuine business' and PSI earned from what is in substance an employment-like relationship.[45] For instance, a sole practitioner accountant or medical practitioner, who is mostly earning income from providing personal services to various clients, would be considered a PSB and will not be affected by the PSI provisions.[46] However, the Explanatory Memorandum to the PSI provisions, as well as other ATO documents,[47] make it clear that income splitting through a PSB is still potentially subject to the general anti-avoidance provision in pt IVA of the *ITAA 1936*.[48]

C *Section 100A — Trust Income*

Section 100A of the *ITAA 1936* is an anti-avoidance provision aimed at trust income subject to a 'reimbursement agreement'.[49] This provision, broadly speaking, applies to persons who are legally entitled to trust income, but in reality are unable to control a portion of such funds.[50] Section 100A was originally enacted to prevent tax minimisation arrangements involving distributions to a tax-advantaged beneficiary, where in reality most of the funds were channelled to another person.[51] Where s 100A applies, the tax liability falls on the trustee at the top tax rate.[52] The ATO has recently turned its interest to s 100A and has introduced Taxation Ruling 2022/4 ('TR 2022/4') detailing the application of that provision.

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45 Ibid div 87. Broadly speaking, to be a PSB under this division, the taxpayer must either have been paid to produce a result rather than paid for their time (s 87-18), or in the alternative, not have 80% or more of their PSI derived from one client (s 87-15) and pass at least one of three other tests, being: the *unrelated clients test* (s 87-20) (the PSI must have been sourced from at least two unrelated clients through work obtained by the taxpayer offering services to the public or sections of the public); the *employment test* (s 87-25) (employee or employees must have been engaged to undertake at least 20% of the principal work that generated the PSI); and the *business premises test* (s 87-30) (premises were used by the taxpayer to generate PSI, and those premises were separate from the taxpayer's home or the business premises of clients).

46 The requirements for a PSB would be fulfilled in such a situation as a result of no single client or patient generating 80% or more of the PSI, and both the unrelated clients test and business premises test being likely to have been fulfilled.

47 See, eg, Australian Taxation Office, *Income Tax: Personal Services Income and Personal Services Businesses* (TR 2022/3, 23 November 2022) [160] ('TR 2022/3').

48 PSI Explanatory Memorandum (n 38) 11.

49 *ITAA 1936* (n 10) s 100A.

50 Ibid ss 100A(1), (7).

51 Explanatory Memorandum, Income Tax Assessment Amendment Bill (No 5) 1978 (Cth) 31–2.

52 Section 100A deems such income to not be presently entitled in the hands of the relevant beneficiary, meaning that it will be subject to s 99A of the *ITAA 1936* (n 10), which assesses such income in the hands of the trustee at the top tax rate as specified by *ITRA 1986* (n 31) s 12(9). In contrast, under normal circumstances, under s 97 of the *ITAA 1936* (n 10), beneficiaries presently entitled to income are assessable on the income at their applicable tax rate.

Section 100A is limited in its application due to its requirement that the relevant agreement was entered into for the purpose of obtaining a tax benefit,[53] as well as an exemption for ordinary family or commercial dealings.[54] The ATO has recently issued TR 2022/4 which reads down the ordinary family dealings exemption by stating that arrangements are less likely to be covered by it if they involve a purpose of minimising tax.[55] However, some have disagreed with the ATO interpretation, and argued that as a matter of statutory interpretation, the ordinary family dealing exception can in many instances comfortably apply, notwithstanding the presence of a tax minimisation purpose.[56]

According to the ATO, where parents presently entitled to trust income use such funds to make a one-off gift to an adult child, s 100A would typically not apply, as this arrangement would be covered by the ordinary family dealing exception.[57] In contrast, the ATO's view is that if such gifts were continuous, then potentially s 100A would apply to them (especially if some other features were present, such as the parents being on a lower tax rate than the child), due to the repeated splitting between the parties entitled to the trust income and the party who regularly receives its benefit.[58]

D *Section 26-35 — Excessive Payments to Related Entities*

Section 26-35 of the *Income Tax Assessment Act 1997* (Cth) ('*ITAA 1997*') states that the deductibility of payments to related entities can be restricted to the amount that the Commissioner of Taxation considers reasonable.[59] 'Related entity' includes both a relative and a partnership in which a relative is a partner.[60] This prevents a rudimentary form of income splitting involving a taxpayer who is on a comparatively high tax rate employing and excessively remunerating their family member, such as their spouse, for which a deduction is claimed. To prevent double taxation, any amount denied a deduction is also not regarded as income in the hands of the recipient of the payment.[61]

Although s 26-35 does not apply to situations such as the sole shareholder of a corporate entity arranging for the company to excessively remunerate an employee

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53 *ITAA 1936* (n 10) ss 100A(8)–(9).

54 Ibid s 100A(13) (definition of 'agreement').

55 TR 2022/4 (n 3) [105], [195].

56 Mark West, 'Section 100A and Tax Purpose' (2022) 56(11) *Taxation in Australia* 701, 712. See also Michael Butler, 'The Increasing Use and Threat of Section 100A' (2020) 24(2) *Tax Specialist* 45, 59, where the author argues that the 'ordinary family dealing' exception should be interpreted widely.

57 TR 2022/4 (n 3) [143].

58 Ibid [144].

59 *ITAA 1997* (n 6) s 26-35(1).

60 Ibid s 26-35(2).

61 Ibid s 26-35(4).

family member, case law disallows such deductions to the extent that such expenditures are not motivated primarily by a genuine income-producing purpose.[62]

E *Other Specific Provisions*

Certain other provisions in the tax legislation are aimed at restricting income splitting in situations where the legal recipient of the income lacks control of the funds. For instance, s 94 of the *ITAA 1936* is aimed at 'uncontrolled' partnership income, which applies where a partner, in substance, lacks control over their share of partnership income. Similarly, s 102 of the *ITAA 1936* is aimed at situations where the settlor of a trust has the power to revoke the trust, resulting in their being able to access its income and capital.

At times, rather than relying on an anti-avoidance provision, the ATO has succeeded in denying income-splitting attempts by successfully claiming that the relevant expenses do not satisfy the tax legislation's general deduction provision. For instance, this is the approach that the ATO has taken in relation to service trusts.[63] Specifically, whether the ATO regards the professional firm's payment to a service trust as fully deductible depends on the degree to which the service trust is being used as an income-splitting device.[64]

F *Part IVA — the General Anti-Avoidance Provision*

Part IVA of the *ITAA 1936* is the tax legislation's general anti-avoidance provision. It potentially applies to a broad variety of situations, including some income-splitting scenarios. The Commissioner of Taxation can use pt IVA to 'undo' an income-splitting arrangement where its general requirements are fulfilled. Specifically, pt IVA applies where there is a scheme that grants a tax benefit to the taxpayer which has been entered into for the dominant purpose of obtaining a tax benefit.[65]

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62 See *Ure v Federal Commissioner of Taxation* (1981) 34 ALR 237, where the Full Court of the Federal Court held that an attempt by a taxpayer to split his income with his wife by lending money to her at a lower interest rate than he was paying on the borrowed funds was ineffective, as only part of the interest was deductible under the general deduction provision. The Court's reason for this disallowance was due to the taxpayer's borrowing of the money not being accompanied by a genuine income-producing purpose: at 241–2 (Brennan J), 250 (Deane and Sheppard JJ).

63 Australian Taxation Office, *Income Tax: Deductibility of Service Fees Paid to Associated Service Entities: Phillips Arrangements* (TR 2006/2, 20 April 2006) [18]–[30].

64 Australian Taxation Office, *Your Service Entity Arrangements* (n 18) 11–17. According to the ATO, service trust arrangements can also in some circumstances contribute to the application of pt IVA of the *ITAA 1936*, the general anti-avoidance provision: PCG 2021/4 (n 4) [130]–[134].

65 *ITAA 1936* (n 10) ss 177A(5), 177D.

As discussed, the ATO has specifically singled out pt IVA as potentially applying to PSI that is generated through a PSB.[66]

The ATO has had previous successes in using pt IVA's predecessor provision to prevent income-splitting arrangements. Specifically, the Full Court of the Federal Court in *Tupicoff v Federal Commissioner of Taxation* was successful in applying it to an insurance company employee who resigned and then, so as to facilitate income splitting with his family, provided services to his ex-employer through a trust.[67] In another landmark decision, the High Court in *Federal Commissioner of Taxation v Gulland* ('*Gulland*') decided that this predecessor provision applied to three unrelated medical specialists who used trust arrangements for income-splitting purposes.[68] Subsequent to pt IVA replacing its legislative predecessor, case law,[69] as well as the ATO itself,[70] indicated that pt IVA would have been successful in preventing income splitting for cases decided under its predecessor. However, pt IVA does not apply to all cases of income splitting. This is illustrated by the Full Court of the Federal Court deciding that pt IVA did not apply to a taxpayer who used an entity to carry on his share broking business, as it was held that the dominant purpose of structuring the business in such a manner included asset protection but did not include the purpose of obtaining a tax benefit.[71]

Recently, the ATO has published Practical Compliance Guideline PCG 2021/4 ('PCG 2021/4'), which discusses when the ATO will seriously consider using pt IVA to prevent income-splitting arrangements relating to professional firm profits.[72] This document is broadly aimed at taxpayers who own an equity stake in businesses that involve the taxpayer selling their professional services, such as law, accounting or medical partnerships.[73] The document discusses techniques such as taxpayers utilising service trusts,[74] undertaking *Everett* income assignments,[75] partnerships where the partners are discretionary trusts rather than individuals,[76] running a

[66] TR 2022/3 (n 47) [267]–[269].

[67] (1984) 56 ALR 151, 152–4 (Fisher J, Jenkinson J agreeing at 154), 164–6 (Beaumont J, Jenkinson J agreeing at 154).

[68] (1985) 160 CLR 55, 71, 76 (Gibbs CJ, Wilson J agreeing at 77), 81–4 (Brennan J), 113, 117–18, 126–7 (Dawson J, Wilson J agreeing at 77) ('*Gulland*').

[69] See *Liedig* (n 10) 472, where Hill J indicated that *Gulland* (n 68) would have had the same result if decided under pt IVA.

[70] See Australian Taxation Office, *Income Tax: Income Splitting* (IT 2330, 30 June 1986) [41] ('IT 2330').

[71] *Federal Commissioner of Taxation v Mochkin* (2003) 127 FCR 185, 205–9 [81]–[98] (Sackville J, Merkel J agreeing at 216 [136], Kenny J agreeing at 216 [137]).

[72] PCG 2021/4 (n 4) [30]–[37].

[73] Ibid.

[74] Ibid [130]–[134].

[75] Ibid [135]–[139].

[76] Ibid [147]–[151].

business as a company with discretionary trust shareholders,[77] and carrying on a business as a unit trust with discretionary trusts as the unit holders.[78]

According to PCG 2021/4, if the arrangement resulting in the income splitting of the professional services firm income has a sound commercial rationale,[79] and does not exhibit certain high-risk features,[80] the ATO uses a 'traffic light' system to evaluate the likelihood of giving serious consideration to applying pt IVA.[81] This traffic light system in essence evaluates the degree of income splitting by examining how much of the professional services income of the business owners is assessable to them, as opposed to being split with others. It does this by calculating the degree to which the profit entitlement is returned to the owner,[82] the average effective tax rate paid by the taxpayer owner and their associates due to the income-splitting arrangement,[83] and the remuneration returned to the taxpayer 'as a percentage of the commercial benchmark for the services provided'.[84] In other words, the ATO's view appears to be that as long as the taxpayer is a genuine business owner, and there is some commercial explanation for the income-splitting arrangement, then some income splitting — though not an excessive degree — is acceptable.

In contrast, the ATO has stated that when it comes to income splitting of property, or businesses in which the owner is not selling their personal services, income splitting is typically tolerated and will not be subject to the general anti-avoidance provision.[85] That policy can be historically linked to the case of *Deputy Federal Commissioner of Taxation v Purcell*,[86] where the general anti-avoidance provision in effect at the time was found to be inapplicable to an owner of primary producing property who had declared the relevant income-producing assets to be held on trust for himself and his relatives.[87] The ATO has stated, however, that the general anti-avoidance provision could apply to such non-personal exertion business income-splitting

77 Ibid [167]–[172].

78 Ibid [177]–[181].

79 Ibid [10]. PCG 2021/4 indicates that justifying a business structure arrangement on the basis of asset protection is only valid if in substance the arrangement results in asset protection: at [41].

80 Ibid [10]. An example of a high-risk feature is a salaried non-equity partner attempting to make an *Everett* income assignment: at [57].

81 Ibid [9]–[11], [65]–[81].

82 Ibid [82]–[83].

83 Ibid [84]–[86].

84 Ibid [100]–[105].

85 IT 2330 (n 70) [15]–[17].

86 (1921) 29 CLR 464.

87 Ibid 473 (Gavan Duffy and Starke JJ), 476 (Rich J). See also Australian Taxation Office, *Income Tax: Family Companies and Trusts in Relation to Income from Personal Exertion* (IT 2121, 12 December 1984) [20], where the ATO expresses the view that the current general anti-avoidance provision, pt IVA, would also be inapplicable to such a factual scenario.

arrangements where the arrangements were 'beyond the range of transactions ordinarily explicable as normal commercial or family dealing'.[88] As an example of this, the ATO pointed to two High Court decisions (each before a single judge), where income-splitting arrangements were struck down under the previous general anti-avoidance provision.[89] The first of these was *Millard v Federal Commissioner of Taxation*,[90] where a bookmaker who had previously operated as an individual commenced operation through a company for income-splitting purposes;[91] the second was *Hollyock v Federal Commissioner of Taxation* ('*Hollyock*'),[92] where a pharmaceutical chemist declared his pharmaceutical business that he ran individually to be operated as a trust.[93] However, it could be argued that both of these cases did involve the owner of the business selling, in substance, their personal services, and thus fall within the scope of scenarios in which, traditionally, income splitting has been restricted.[94] This perspective leads to the conclusion that there is very wide scope for income splitting through ownership of property, or business assets that do not involve the owner making money from their personal services, without invoking the general anti-avoidance provision.

IV Should Income Splitting Be Widely Available through Joint Returns?

As discussed above, in Australia income splitting is only available to any meaningful extent to some taxpayers, being those who derive income from property and, to varying degrees, to those deriving business income.[95] In contrast, in some

88 IT 2330 (n 70) [15].

89 Ibid [21]–[25]. See also at [41], where the ATO expresses its view that where the income-splitting arrangement was found to have been disallowed due to pt IVA's immediate predecessor, it would also be disallowed under the current pt IVA.

90 (1962) 108 CLR 336.

91 See IT 2330 (n 70) [22], where the reason was explained as being

> that the bookmaking business was conducted precisely as it had been conducted before the agreement was entered into, that no advice of the agency agreement had been given to relevant authorities, eg racing clubs, that the bookmaking business had not been assigned and was never intended to be assigned to the company and that it was not possible for the company to obtain registration as a bookmaker. All of these factors led to the conclusion that the whole purpose and effect of the agreement was to split the taxpayer's income into a number of parts in order to minimise the amount of tax which would become payable.

92 *Hollyock* (n 15).

93 See IT 2330 (n 70) [25], where the ATO states that the Court in *Hollyock* was influenced by the fact that the wife did not in substance receive her entitlement of her share of the profit.

94 See Tregoning (n 15) 129–30, where the author describes *Hollyock* as a case involving a business owner selling their personal services.

95 See above Parts II, III(B), III(F).

jurisdictions,[96] such as the USA, married couples can file joint returns and are assessed on their aggregate income.[97] This differs from the Australian position, where the unit for tax purposes is primarily the individual, and joint returns are unavailable.[98]

Widespread spousal income splitting could be implemented in two ways. The first would be to allow or mandate joint returns for couples, which would aggregate their incomes, but apply more generous income tax brackets.[99] An alternative is to continue with individual returns, but impute the average income of a couple into each of their individual tax returns.[100] For the sake of clarity, this article will refer to income splitting between couples as a system of *joint returns*, given that this is the mechanism widely adopted by jurisdictions that allow that form of income splitting.[101]

Some limited jurisdictions include children in the process of automatically allowing income splitting.[102] However, given that families are given various government benefits for the upkeep of children, including direct payments and indirect transfers such as government contribution to their schooling,[103] the argument for a joint return to be affected by children (by allowing more generous tax brackets) is not particularly strong.

The joint return approach, where available, in essence means that such couples automatically split all their income. It could be argued that making income splitting

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96 David G Duff et al, *Canadian Income Tax Law* (LexisNexis, 4th ed, 2015) 22.

97 IRC (n 7) § 6013. Under the USA law, domestic unmarried partners, even if registered, cannot utilise the federal joint tax return system: 'Answers to Frequently Asked Questions for Registered Domestic Partners and Individuals in Civil Unions', *Internal Revenue Service* (Web Page) <https://www.irs.gov/newsroom/answers-to-frequently-asked-questions-for-registered-domestic-partners-and-individuals-in-civil-unions>.

98 *ITAA 1997* (n 6) ss 4-5, 4-10; *ITRA 1986* (n 31) s 12(1), sch 7.

99 Jonathan R Kesselman, 'Income Splitting and Joint Taxation of Couples: What's Fair?' (2008) 14(1) *Institute for Research on Public Policy Choices* 1, 10 <https://irpp.org/wp-content/uploads/assets/research/new-research-category/income-splitting-and-joint-taxation-of-couples/vol14no1.pdf>.

100 Ibid 9.

101 M Christl, S De Poli and V Ivaškaitė-Tamošiūnė, 'Does It Pay To Say "I Do"? Marriage Bonuses and Penalties across the EU' (JRC Working Papers on Taxation and Structural Reforms No 07/2021, Joint Research Centre, European Commission, 2021) 5.

102 See, eg, 'France: Individual: Taxes on Personal Income', *PWC Worldwide Tax Summaries* (Web Page, 14 February 2022) <https://taxsummaries.pwc.com/france/individual/taxes-on-personal-income>.

103 See, eg, Patricia Apps and Ray Rees, 'Household Saving and Full Consumption over the Life Cycle' (Discussion Paper No 280, IZA Institute of Labor Economics, April 2001) 6–7.

universally available to couples would level the playing field as compared with the current law. It would also save significant resources currently devoted to tax planning with the aim of legal income splitting.[104] Such reasons were among the justifications for introducing income splitting in the USA through joint tax returns.[105]

It has long been said that policy decisions on the introduction of joint income tax returns for couples involve an unresolvable trilemma in which it is possible to attain at most two out of three desired goals.[106] Those goals are progressive taxation, marriage neutrality, and couples neutrality.[107]

Specifically, 'marriage neutrality' refers to the individual's tax burden being the same irrespective of whether they are single or part of a couple. As far as marriage neutrality is concerned, joint taxation can potentially result in marriage bonuses and penalties.[108] If the joint return regime has tax brackets double the size of those applicable to individuals, it can result in marriage bonuses but not penalties.[109] If, on the other extreme, it has tax brackets equal to those applicable to single returns, it will cause only marriage penalties, not bonuses.[110] Tax brackets falling somewhere between these extremes will generate both.[111] Specifically, in such a scenario, couples with greater differentials in incomes are more likely to be subject to a marriage bonus, whereas those with similar incomes are more likely to face a marriage penalty.[112] Where joint returns have a rate schedule that at times imposes marriage penalties, policymakers need to be careful to ensure that such penalties do not harshly apply to lower income earners.[113]

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104 Julie Smith, 'Income Splitting' (Research Paper No 10 1994, Parliamentary Research Service, Department of the Parliamentary Library, Parliament of the Commonwealth of Australia, 20 July 1994) 17.

105 See Boris I Bittker, 'Federal Income Taxation and the Family' (1975) 27(6) *Stanford Law Review* 1389, 1441. See also Terry Dwyer, 'The Taxation of Shared Family Incomes' (Policy Monograph No 61, The Centre for Independent Studies, 2004) 10, where this argument is made in the context of the Australian tax system.

106 Yair Listokin, 'Taxation and Marriage: A Reappraisal' (2014) 67(2) *Tax Law Review* 185, 185.

107 Ibid.

108 Lawrence Zelenak, 'Marriage and the Income Tax' (1994) 67(2) *Southern California Law Review* 339, 339.

109 Ibid 340.

110 Ibid.

111 Ibid.

112 Ibid 340–1. See also Michael J McIntyre and Oliver Oldman, 'Taxation of the Family in a Comprehensive and Simplified Income Tax' (1977) 90(8) *Harvard Law Review* 1573, 1587–8, where the authors note that as women's income becomes over time gradually more equal to men's, under such a system, there is an increased incidence of marriage penalties.

113 James M Puckett, 'Facing the Sunset: An Egalitarian Approach against Taxing Couples as a Unit' (2022) 55(2) *Loyola of Los Angeles Law Review* 477, 498–9.

The term 'couples neutrality' is a reference to equal taxation treatment between couples who have the same aggregate incomes, regardless of the way such incomes are split between them.[114] In isolation, universal income splitting results in couples neutrality.

A joint return regime invariably generates numerous advantages and disadvantages. It is noteworthy that elements of income splitting are potentially also available, to a limited degree, in single-return tax systems through the use of earned income tax offsets, dependent spouse deductions and government benefits.[115]

The following discussion examines the main issues regarding the feasibility of a joint tax return system.

A *Attribution of Income*

One of the main arguments for income splitting through joint returns is that the benefit of the aggregate income of couples, irrespective of how it is earned between them, is predominantly shared by both spouses.[116] Specifically, whether there is one main income earner, or two equal ones, most of the resources consumed and utilised, such as housing, food, holidays and transport, benefit both of the spouses.[117] This is due to the pragmatic and legal reality that in general, a primary-earning spouse is going to support the secondary- or non-earning one.[118] As such, and as discussed later in this article,[119] it can be argued that couples inequality through an individual return regime breaches concepts of horizontal equity, being the principle that those in a similar economic position should pay the same amount of tax.[120] An extension to this argument is that given that the central basis of a progressive tax system is

114 Daniel Hemel, 'Beyond the Marriage Tax Trilemma' (2019) 54(3) *Wake Forest Law Review* 661, 663.

115 Smith (n 104) 3–4.

116 McIntyre and Oldman (n 112) 1592–7.

117 Ibid.

118 Bittker (n 105) 1420.

119 See below Part IV(E).

120 James Alm, Leslie A Whittington and Jason Fletcher, 'Is There a "Singles Tax"? The Relative Income Tax Treatment of Single Households' (2002) 22(2) *Public Budgeting and Finance* 69, 85. But see Note, 'The Case for Mandatory Separate Filing by Married Persons' (1981) 91(2) *Yale Law Journal* 363, 363, where Lynn A Stout asserts that the claim for increased horizontal equity under a joint return system is premised on the assumption that couples 'pool their incomes and share them equally'. However, as discussed in this section of the article, perfect income sharing is not required to justify income splitting on the basis of horizontal equity.

that the tax burden follows the ability to pay,[121] the full household income[122] should be the focus of applicable tax rates.[123]

Some have argued against this justification by asserting that supporting a secondary-earning or non-earning spouse should be viewed as a form of consumption.[124] In response, this argument has been said to be of limited importance, as deciding whether to categorise supporting a spouse as a consumption good is ultimately a value judgement based on societal norms.[125] Although there is no moral obligation on people to be part of a spousal couple, such relationships and the rights and obligations that flow from them are strongly recognised by our society.[126]

It has also been argued that this 'shared benefit' justification for joint returns, while substantially accurate for low- and middle-income couples, is not necessarily true for couples with higher incomes.[127] Specifically, such couples are more likely than others to have substantial savings and investment assets which are not co-owned.[128] However, amounts saved and invested rather than consumed typically also benefit both parties. This is true for continuing marriages, given that both parties are likely to benefit from the future consumption of returns of invested funds. Further, even if the relationship breaks down, investments made during the marriage are likely, to a significant extent, to benefit both parties, given that divorce laws in Australia, particularly in longer-term marriages, divide assets in a manner that also takes

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[121] See Stephen Utz, 'Ability To Pay' (2002) 23(4) *Whittier Law Review* 867, 867–9 nn 1–9 for an excellent reference to literature on the justification of the 'ability to pay' as a vital benchmark for ascertaining the relevant tax burden. But see Walter J Blum and Harry Kalven Jr, 'The Uneasy Case for Progressive Taxation' (1952) 19(3) *University of Chicago Law Review* 417, 430–44, where the authors discuss the disadvantages of a progressive tax regime.

[122] See Hemel (n 114) 661, 691–2, where the author states that marriage is strongly, though not perfectly, correlated with cohabitation.

[123] Stephanie Hunter McMahon, 'To Have and To Hold: What Does Love (of Money) Have To Do with Joint Tax Filing?' (2011) 11(3) *Nevada Law Journal* 718, 746–8 ('To Have and To Hold'). But see Lily Kahng, 'One Is the Loneliest Number: The Single Taxpayer in a Joint Return World' (2009) 61(3) *Hastings Law Journal* 651, 680, where the author claims that singles earn less for similar work and face higher living costs, and thus should not be regarded as having a stronger ability to pay despite only supporting themselves. However, the author's evidence supporting these claims appears to fall far short of being conclusive proof.

[124] Kahng (n 123) 679.

[125] See Anne L Alstott, 'Comments on Samansky, "Tax Policy and the Obligation To Support Children"' (1996) 57(2) *Ohio State Law Journal* 381, 386–7.

[126] Jeannette Anderson Winn and Marshall Winn, 'Till Death Do We Split: Married Couples and Single Persons under the Individual Income Tax' (1983) 34(4) *South Carolina Law Review* 829, 842.

[127] See ibid 845.

[128] Ibid.

into account the non-financial contributions of the parties.[129] However, one could envision a situation where a single income earner couple invests most of the funds in the income earner's name, and upon the relationship breakdown, the investments remain predominantly in the name of the income earner. In such a scenario, seeing the income earner's funds as applied in an approximately 50:50 manner is arguably misguided. In response, first, it could be argued that the shared benefits justification for joint returns is not based on some notionally perfect 50:50 sharing of benefits, but rather on approximations that are close enough to reality to warrant being translated into law. Further, if there is sufficient evidence that the benefit of aggregate incomes in higher-income couples deviates sufficiently regularly from an effective 50:50 split, the tax brackets could reflect this so as to reduce the effect of income splitting for such couples.[130] Such an outcome is preferable to the current approach, which allows income splitting through the manipulation of income-producing business and passive property assets, which is an approach more readily used by wealthier individuals.[131]

Others have argued from a different, control perspective, pointing to research indicating that for a substantial percentage of couples, the party with the primary income source is the one who has substantial control of financial decision making.[132] This appears to be the case sometimes even where joint accounts are used to pool income.[133] One commentator has argued that logically, those with control of the money should be the ones assessed to pay tax, and so an individual taxation regime is justified.[134] As an extension of this argument, the 'ability to pay tax' criterion has at times been used by such commentators to propose that as those who earn the income have control of it, it is their individual ability to pay the tax that should determine the liability.[135] It has been speculated that the previously discussed 'benefits' approach is popular among economists, whereas the 'control' approach is more popular among legal scholars.[136]

While both of the above perspectives might have some merit, the benefits approach, as a practical matter, better reflects reality. First, even within relationships where there is a primary income earner, a substantial percentage of couples do not restrict

[129] Eithne Mills and Marlene Rita Ebejer, *Family Law* (LexisNexis Butterworths, 8th ed, 2021) 500–2.

[130] Specifically, the higher tax brackets could apply to the aggregate couples' income at amounts which are substantially less than double the income that they apply to for singles: Kesselman (n 99) 19.

[131] See ibid.

[132] Marjorie E Kornhauser, 'Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return' (1993) 45(1) *Hastings Law Journal* 63, 80–91.

[133] Jan Pahl, 'Household Spending, Personal Spending and the Control of Money in Marriage' (1990) 24(1) *Sociology* 119, 124.

[134] Kornhauser (n 132) 109.

[135] Ibid 110.

[136] Duff et al (n 96) 22–3.

financial decision-making control to one person.[137] Further, joint finances have been found to be more common the longer a couple has been together, or where one has given up working for reasons such as looking after children or education.[138] Most importantly, the reality is that one person having control of the money cannot be conflated with whether the funds are spent on that earner or on the family.[139] Ultimately, a large proportion of household spending is on items which, by their nature, are used by the family, such as accommodation, food, and other household-related expenditure.[140] Given the importance of 'ability to pay' in our tax system,[141] the amount of resources the household has is vital in determining the appropriate tax burden. Interestingly, some who have argued against joint returns have conceded that the benefits approach and the control approach merely reflect different perspectives, each having value.[142]

None of this is to deny that couples' financial decision-making equality is an important consideration that should be strongly encouraged. A feeling of control,

137 Martin Klesment and Jan Van Bavel, 'Women's Relative Resources and Couples' Gender Balance in Financial Decision-Making' (2022) 38(5) *European Sociological Review* 739, 746.

138 Kornhauser (n 132) 87–8.

139 See Michael J McIntyre, 'What Should Be Redistributed in a Redistributive Income Tax?: Retrospective Comments on the Carter Commission Report' in W Neil Brooks (ed), *The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later* (Carswell, 1988) 189, 194, where the author makes the interesting argument that if we are to tax the entity that had control and 'could have' benefitted from the funds, it follows that we are taxing potential, which according to the author leads to the unappealing conclusion that we should tax an early retiree, or someone who has consciously chosen a lesser-earning career, on their potentially higher income.

140 Michael J McIntyre, 'Individual Filing in the Personal Income Tax: Prolegomena to Future Discussion' (1979) 58(3) *North Carolina Law Review* 469, 469–70. See also: Zelenak (n 108) 353, where the author states that realistically, most couples have no choice but to share their income; Australian Bureau of Statistics, *Household Expenditure Survey, Australia: Summary of Results* (Catalogue No 6530.0, 13 September 2017) Graph 2 — Proportion of Weekly Household Spending on Goods and Services 1984, 2009–10, 2015–16, which indicates what percentage of Australian household expenditure is spent on different categories; Roger Wilkins et al, *The Household, Income and Labour Dynamics in Australia Survey: Selected Findings from Waves 1 to 20* (Report, Melbourne Institute: Applied Economic & Social Research, University of Melbourne, 2022) 62, which also confirms that a substantial dollar amount of household expenditure is spent on items such as accommodation (and associated maintenance and repairs), education, utilities and insurance. Cf Pamela B Gann, 'Abandoning Marital Status as a Factor in Allocating Income Tax Burdens' (1980) 59(1) *Texas Law Review* 1, 67, where it is argued that the amount of income sharing between couples being unknown supports a system of individual returns. However, in response to this, the argument for joint returns is based on resources being broadly spent on both; it does not require a perfect 50:50 income sharing between the individuals in a couple.

141 Utz (n 121) 867–9.

142 See, eg: Zelenak (n 108) 358; Kesselman (n 99) 8.

including financial control, is an important aspect of wellbeing.[143] However, there is no evidence that imposing a higher tax burden on couples who have a primary income earner than on couples who earn similar amounts would encourage more equitable financial decision making.

B *Economies of Scale*

It has been argued that if income splitting is to be implemented through joint returns, some recognition of the economies of scale that couples enjoy is required.[144] This is because it takes less than double the funds to support a couple than it takes to support a single.[145] Specifically, items such as accommodation, utilities, and many discretionary expenses such as holidays cost less than double for a couple as compared to a single.[146]

Here, an appropriate policy response is to subject joint returns to a rate schedule that establishes income brackets which, while more generous than those applying to singles, are less than twice the rate for singles.[147] For instance, it has been suggested that increasing the income tax bracket thresholds applicable to singles by 50 per cent would give policy acknowledgment to the economies of scale that couples enjoy.[148] The USA acknowledges these economies of scale through the tax bracket thresholds that apply to joint returns.[149]

Disregarding economies of scale in joint returns by way of tax bracket thresholds of twice the size of single ones would mean, as discussed above, no marriage penalties, whereas most couples with dissimilar incomes would be subject to marriage bonuses.[150] This would result in singles who earn the equivalent income as a couple, comparatively speaking, suffering from a disproportional singles penalty.[151]

Conversely, recognising economies of scale by setting those tax scales at somewhere between one and two times that of the single rate would lead to both marriage

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143 See Reed Larson, 'Is Feeling "in Control" Related to Happiness in Daily Life?' (1989) 64(3) *Psychological Reports* 775, 782, where the author finds that for many individuals, a chronic lack of control compromises wellbeing. See also Linda Skogrand et al, 'Financial Management Practices of Couples with Great Marriages' (2011) 32(1) *Journal of Family and Economic Issues* 27, 31, where the authors find that even if one partner primarily manages finances, this can be consistent with a high level of wellbeing if there is mutual trust and understanding about financial decision making.

144 Duff et al (n 96) 23.

145 Kesselman (n 99) 6.

146 See ibid.

147 Ibid 5–6.

148 See ibid 6.

149 IRC (n 7) § 1.

150 Kesselman (n 99) 8–10.

151 See also Kahng (n 123) 660.

penalties and bonuses, depending on the size of the disparity between the incomes of each spouse.[152] This will also lessen the tendency of singles who comparatively speaking earn the equivalent income as a couple suffering from a singles penalty.[153]

A contrary argument — one that opposes recognition of potential economies of scale — poses a rhetorical question framed in terms of relationship categories: if one is to take into account the economies of scale of spousal relationships, why not also take them into account in respect of other cohabitation arrangements, such as housemates or young adults still living with parents?[154] However, such arrangements are inherently different from spousal relationships, given that they are typically entered into to save costs, with the trade-off being less comfort and freedom than would be experienced by a person living independently. In other words, such non-spousal arrangements could be seen in many cases as a choice to reduce consumption on accommodation and related expenses.[155] In contrast, the cost savings from spousal cohabitation arrangements could, notwithstanding their disadvantages,[156] be argued to constitute a 'windfall gain', as people voluntarily enter into such arrangements primarily motivated by love and affection rather than a desire to save funds.[157]

A further argument made against recognising economies of scale in joint returns is that while it is relatively easy to quantify such economies from data at lower income levels, where most funds are spent on non-discretionary items, such estimates become much more difficult as incomes rise.[158] Such an argument does not deny that there are economies of scale, but claims that given the wide variability in taxpayers' choices and preferences, implementing a 'one size fits all' formula

[152] See above nn 109–111 and accompanying text. See Alan J Auerbach and Kevin A Hassett, 'A New Measure of Horizontal Equity' (2002) 92(4) *American Economic Review* 1116, 1124–5, where the authors describe the difficulty of finding an equivalence scale that is fair across the income spectrum.

[153] See Nancy J Knauer, 'Heteronormativity and Federal Tax Policy' (1998) 101(1) *West Virginia Law Review* 129, 151–2, discussing an instance in the USA where the size of the singles penalty was reduced after Second World War widows lobbied for such a reduction due to the involuntariness of their single status.

[154] Bittker (n 105) 1423. See also Puckett (n 113) 485, 510, where the author points out that the tax system ignores many instances of taxpayers with the same taxable income having different purchasing power (an example being the different costs of living in different cities).

[155] William A Klein, 'Familial Relationships and Economic Well-Being: Family Unit Rules for a Negative Income Tax' (1971) 8(3) *Harvard Journal on Legislation* 361, 386.

[156] See McIntyre (n 139) 198, where the author cites loss of privacy and independence as examples of disadvantages of spousal cohabitation.

[157] D'Vera Cohn, 'Love and Marriage', *Pew Research Centre* (Web Page, 13 February 2013) <https://www.pewresearch.org/social-trends/2013/02/13/love-and-marriage/>. See Penelope M Huang et al, 'He Says, She Says: Gender and Cohabitation' (2011) 32(7) *Journal of Family Issues* 876, 886.

[158] Bittker (n 105) 1424.

would be likely to cause injustice by over-recognising such economies. In response, it can be argued that it is not possible to perfectly align the taxpayer's ability to pay with their tax burden; rather, policy should attempt to make any such evaluation as accurate as possible while taking into account other policy considerations.[159] The reality is that in spousal cohabitation, nearly all couples do in fact benefit from economies of scale.

In summary, given that the aim of joint returns is to accurately reflect the 'ability to pay' for couples, there are convincing arguments for recognising some level of economies of scale in joint returns. Notwithstanding the difficulties of doing so, such recognition should, to the extent possible, be based on evidence of the cost savings that benefit couples at different income levels. Importantly, at lower income levels, care should be taken to ensure that rates do not affect lower income earners in a way that may increase the risk of such couples living in poverty.[160]

C *Imputed Income and Cost Saving*

Some have argued against a joint return regime by arguing that couples with a single income earner have a greater ability to pay tax than a dual-income-earning couple with the same aggregate income.[161] Thus, it has been argued that in couples where one person works no, or few, hours in paid employment, there is a substantial amount of imputed income in the form of housework, cooking, and other activities.[162] Further, it has also been argued that non-deductible working costs, such as transport to and from work and work clothes, are substantially reduced in the case of a couple with only one primary worker.[163] Thus, it is argued, a joint return regime is not justified, given that it should be recognised that a single-earner couple should pay more tax because of their superior ability to pay.[164]

To the extent such arguments are accepted as the main reason against a joint return regime, the logical corollary is that they are inapplicable to couples with two full-time workers.[165] Some of those opposing a joint return system have conceded

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159 See below Part IV(E).

160 See also Puckett (n 113) 498–9.

161 Kesselman (n 99) 26–7.

162 See, eg: Tony Cooper, 'Taxing the Family Unit: Income Splitting for All?' (1995) 5(1–2) *Revenue Law Journal* 82, 88; ibid; Listokin (n 106) 188–9.

163 See: Cooper (n 162) 88; Kesselman (n 99) 26–7.

164 Kesselman (n 99) 27. See also Patricia Apps, 'Family Taxation: An Unfair and Inefficient System' (Discussion Paper No 524, Centre for Economic Policy Research, The Australian National University, May 2006) 8–9, where the author argues that another aspect of the unfairness in allowing joint returns for couples lies in the fact that when comparing one-earner as against two-earner couples with the same aggregate incomes, the hours worked to pay tax for a joint-income couple far exceeds the hours worked to pay the tax for an equivalent single-income couple. However, given that our income tax system is based on incomes rather than incomes per hour, such an argument appears to have limited merit.

165 Kesselman (n 99) 27.

that while this reasoning is theoretically valid, in reality, it would be hard to verify whether both members of the couple are in full-time work.[166]

The following discussion examines in more detail the extent to which these arguments militate against a joint return regime.

1 *Reasons Joint Returns Can Be Justified Despite Issues of Imputed Income and Work Expense*

It would be an unlikely coincidence if, when comparing the tax burden of a single-primary-earner couple in an individual return regime and a joint return regime, the extra tax burden from the former accurately reflected the economic benefits of a non-working spouse's imputed labour and expenditure savings. In other words, if we are to impose extra tax on the basis of the economic benefits from there being a non-full-time working spouse, then this should be accurately reflected in direct adjustments to the tax burden of such couples, rather than through the arbitrary result of a tax system focused on individual incomes.[167]

Further, there are persuasive arguments for not taking the impact of imputed income into account when determining the tax liability of couples. At its core, our tax system does not in general take into account imputed income. There are respectable reasons for this, including that, first, many of the tasks that we perform every day, regardless of marriage status, can be considered a form of imputed income. This includes tasks such as shaving (which saves barber fees) and pruning roses (saving gardening fees).[168] It is difficult to argue that there is even an approximate point at which such activities are to be taken into account by the tax system.[169] This is especially so given that often, self-performed services such as cooking are qualitatively different from their commercial equivalents, such as eating restaurant food or even take-away.[170] Further, although the data does support the supposition that more domestic services are provided where a couple includes a non-working spouse,[171] there is substantial variance as to the extent to which this is the case for

166 Kesselman (n 99) 28 argues that one of the problems with restricting joint returns to such a system would be gathering accurate information on hours worked. See also Gann (n 140) 39, where it is argued that a system of individual rather than joint returns eliminates the problem of differentiating between single- and dual-income-earning couples.

167 See Matt Krzepkowski and Jack Mintz, 'No More Second-Class Taxpayers: How Income Splitting Can Bring Fairness to Canada's Single-Income Families' (Research Paper No 6(15), The School of Public Policy, University of Calgary, April 2013) 4, 8–9, where it is demonstrated that the contrast in tax burden between single- and dual-earner couples in an individual progressive system is markedly different from the contrast between such couples in a joint return system that takes into account imputed income for single-earner couples.

168 McIntyre and Oldman (n 112) 1611–12.

169 Ibid.

170 See Bittker (n 105) 1434.

171 Patricia Apps and Ray Rees, 'The Household, Time Use and Tax Policy' (2004) 50(3) *CESifo Economic Studies* 479, 487–8.

such couples, as well as for other household types.[172] This is partly because different households have different circumstances and needs — for instance, living in an older house on a larger block of land as compared to a smaller apartment without a garden would result in substantially different domestic requirements.[173] Ultimately, while a tax system should strive to tax people in accordance with their ability to pay, this has to be balanced with how accurately this can be accomplished, pragmatism, and minimising complexity.[174]

A further important reason as to why imputed income not being expressly recognised does not negate the implementation of a joint return regime is that the issue of potential recognition of imputed income is factually applicable to other scenarios, and not restricted to couples with one main income earner. For instance, it could be argued that the imputed income from singles who do not work because they earn their income primarily from investments, as compared with full-time working singles, should also be taken into account by the tax system, if it is going to take account of the imputed income of couples with only one main worker.[175]

Some might argue, however, that the current non-recognition of imputed income from self-provided services in most contexts is an argument to recognise it in a greater number of scenarios, including, though not necessarily restricted to, the situation of single-income couples. In reality, for pragmatic purposes, it would not be realistically possible to ask people to record their self-performed services and subsequently to tax them on them.[176] Consequently, as taxing the actual amount of self-performed services is near impossible, a surrogate measure of self-performed services is necessary so as to tax such imputed income in a de facto manner. Individual taxation in such a context can be seen as utilising a surrogate for the purposes of taxing some types of self-performed services.[177] However, while the use of a surrogate can never be 100% accurate, in this instance it is suggested that the inaccuracy is too pronounced to justify its use. Specifically, for the reasons

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172 Ibid 480.

173 McIntyre and Oldman (n 112) 1615–16.

174 Louis Kaplow, 'Accuracy, Complexity, and the Income Tax' (1998) 14(1) *Journal of Law, Economics, and Organization* 61, 62, 77–8. See also below Part IV(E) for a discussion regarding the criteria for evaluating joint returns.

175 See also Bittker (n 105) 1435–7. See also McIntyre and Oldman (n 112) 1622, where the authors point out that a single-earner couple has less leisure time than couples or singles who purely live off property income.

176 Tsilly Dagan, 'Taxing the Non-Market Economy' (Bar-Ilan University Public Law and Legal Theory Working Paper No 09-09, Bar-Ilan University Law School, July 2008) 26.

177 See Thomas Chancellor, 'Imputed Income and the Ideal Income Tax' (1988) 67(3) *Oregon Law Review* 561, 563. See also Victor Thuronyi, 'The Concept of Income' (1990) 46(1) *Tax Law Review* 45, 82, where the author, while arguing for the taxation of imputed income for self-performed services, states that for the sake of fairness, this should be confined to the taxpayer self-providing their market activities, such as a farmer providing their family with their farm's products.

mentioned above, including the fact that many couples adversely impacted by individual taxation have dual incomes, as well as the heterogeneity of the extent of self-performed services even amongst single-earner couples, such a surrogate will all too frequently be a very inaccurate proxy for the actual amount of self-performed services.[178]

Further, realistically, even if it were possible to directly measure and tax self-provided services at a broad level, many would at an instinctual level oppose it.[179] Consequently, use of an individual taxation regime of a surrogate for imputed income from self-performed services should raise the same concerns.[180] Specifically, it has been argued that the whole principle behind taxing self-provided services is misguided, due, at the base level, to being motivated by a principle to tax 'satisfaction',[181] which is too wide a criterion to have a tax base on.[182]

It should also be noted that notwithstanding that some commentators desire to tax imputed income on the basis that it should be included in what some regard as an ideal tax base,[183] realistically, for practical and pragmatic reasons, there are many instances of tax laws deviating from such a theoretical base. These include the non-taxation of most unrealised capital gains,[184] main residences,[185] and personal gifts.[186] The related claim that dual-income couples should pay less tax than single-income couples on similar total incomes, due to the former having

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178 Use of a surrogate for self-performed services in other contexts would also have severe limitations in its accuracy. For instance, taxing unearned income at a higher tax rate than personal exertion income, for those of working age who depend on their unearned income as a form of subsistence, would be based on broad, often incorrect individual assumptions regarding the extent of self-performed services that such taxpayers undertake.

179 Chancellor (n 177) 566–7.

180 Ibid 565.

181 See, eg, Mark A Haskell and Joel Kauffman, 'Taxation of Imputed Income: The Bargain–Purchase Problem' (1964) 17(3) *National Tax Journal* 232, 233, where the authors justify taxing imputed income on the basis that non-market activities grant satisfaction.

182 See Chancellor (n 177) 578–83, where the author discusses the disconnect between satisfaction and market outcomes, the latter being what the tax system's base is primarily based on. For instance, the author argues, those paying a market price for an item might pay substantially less than they are prepared to, showing a disconnect between market forces and satisfaction. Further, the author argues, even for those paying as much as they are prepared to for an item, the satisfaction attained usually only very vaguely resembles the amount paid.

183 See SL Hurley, 'The Unit of Taxation under an Ideal Progressive Income Tax' (1984) 4(2) *Oxford Journal of Legal Studies* 157, 165.

184 See James Alm, 'Is the Haig–Simons Standard Dead? The Uneasy Case for a Comprehensive Income Tax' (2018) 71(2) *National Tax Journal* 379, 389.

185 *ITAA 1997* (n 6) sub-div 118-B.

186 *Scott v Federal Commissioner of Taxation* (1966) 117 CLR 514, 526.

higher non-deductible work-related expenses such as travel and clothing, is also, upon examination, of limited force. Given that the tax system has labelled such expenses (which are often necessary to undertake work, but not incurred directly in the process of working) as non-deductible,[187] it appears arbitrary to take them into account for dual-working couples as compared to single-income couples.[188] Further, as is the case with imputed income, if such expenses are to be taken into account, then this should affect the tax burden of nearly all income earners who have to work for their money, not just dual-income couples.[189]

Notwithstanding these issues, if the tax system were to take into account the loss of imputed income (to the extent the worker undertakes full-time hours), as well as work-related expenses that are currently regarded as personal, there are direct ways of doing so. This appears preferable to relying on the individual return regime, which as discussed, does not attempt to accurately reflect these concepts in its calculation of the taxpayer's burden.[190] Such methods include allowing additional deductions above what is currently the case, or through an earned income offset.[191]

However, as discussed, the issues of imputed income and work-related expenses apply to most taxpayers with substantial employee obligations. Subsequently, realistically, if the tax system took account, for all such workers, of lost imputed income from working, as well as work expenses currently considered non-deductible, this would cause a substantial loss of revenue.[192] This would be likely to cause those benefits to be clawed back through compensatory current or future higher taxes. Consequently, unless those higher taxes fell predominantly on unearned income — which

187 See, eg: *Lunney v Federal Commissioner of Taxation* (1958) 100 CLR 478, 486 (Dixon CJ), 501 (Williams, Kitto and Taylor JJ) (where the High Court disallowed the deductibility of travel expenses between home and work); *Mansfield v Federal Commissioner of Taxation* (1995) 31 ATR 367, 375 (where Hill J of the Federal Court said that generally, expenditure on ordinary clothing is not deductible).

188 But see Tsilly Dagan, 'Commuting' (2006) 26(1) *Virginia Tax Review* 185, 201–7, where the author discusses the problem with courts categorising certain work-related expenses, such as commuting, as non-deductible.

189 Bittker (n 105) 1443–4.

190 Krzepkowski and Mintz (n 167) 4, 8–9.

191 McIntyre and Oldman (n 112) 1622–3 make the point that since the amount of leisure given up by workers corresponds to the number of hours worked, this raises administrative complexities in ascertaining the number of hours worked by a taxpayer. See also Nancy C Staudt, 'Taxing Housework' (1996) 84(5) *Georgetown Law Journal* 1571, 1620–7, 1636–8, where the author argues that the importance of housework be recognised through making it assessable, though the author also suggests that this be accompanied by a tax offset so as to minimise the taxation burden that such policy might have on lower-income taxpayers. See also Lisa M Colone, 'Taxing Housework… with a Deeper Purpose' (2002) 21(3) *Virginia Tax Review* 417, 425, where it is argued that the taxation of housework recommendation in Nancy C Staudt's 'Taxing Housework' is not an attempt either to incentivise or disincentivise the decision of women to undertake paid work.

192 Bittker (n 105) 1435.

is unlikely, given their limited tax base — the compensating increase in taxes would to a large extent fall on those who received the breaks (workers), meaning that the exercise would largely be a zero-sum game.[193] While applying such concessions only to couples that have both persons working would not have the same fiscal consequences, it would be inherently inequitable to other taxpayers suffering from loss of imputed income and work-related expenses.

Overall, the preceding discussion indicates that the issues of imputed income and work-related expenses should in general not prevent the introduction of a joint return regime.

2 *Is There a Stronger Case for Opposing Income Splitting for Couples with Young Children?*

It has been argued that the non-recognition of imputed income in the context of couples with younger children presents a stronger case for disallowing automatic income splitting and instead having a genuine individual return regime.[194] Specifically, it is argued that in such cases, having one person working relatively little or no paid hours results in substantial childcare expenditure savings, and so presents a stronger argument against a joint return regime.[195]

By way of background, it has been argued that for those with children, Australia's current income tax and benefit system already in some cases results in a de facto income splitting regime.[196] This is because although the equivalent amount earned by one person is taxed more highly than if it were split between two, the net effect, after taking into account Family Tax Benefit, in many cases, broadly equalises this.[197] The reason being that, as Family Tax Benefit is partially means tested against both combined incomes and the secondary income earner, couples with a single earner are entitled to greater benefits.[198] However, under the means testing laws, this applies only under a certain aggregate income level.[199]

It has been argued that this de facto income splitting regime is especially unfair for those couples with younger children, given that, unlike the imputed income earned by a stay-at-home child carer, the market income earned by the secondary earner and used to pay child care is taxed.[200] Consequently, it has been claimed that it is

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193 Ibid 1435–7.

194 Apps (n 164) 7–9.

195 Ibid.

196 Ibid 8.

197 Ibid 7–8.

198 *A New Tax System (Family Assistance) Act 1999* (Cth) sch 1 pt 4.

199 Ibid sch 1 cls 28B, 29, 30, 32–3.

200 Apps (n 164) 10. See also Patricia Apps et al, 'Labor Supply Heterogeneity and Demand for Child Care of Mothers with Young Children' (2016) 51(4) *Empirical Economics* 1641, 1653, 1671, for a more recent discussion concerning how government benefits

inequitable that a couple with a single primary earner should only pay the same net tax (after taking into account government benefits) as a dual-earning couple with the same aggregate income, given that the need to pay child care out of after-tax income in the latter case makes them economically worse off.[201] In essence, this is a specific application of the 'imputed income argument' against joint returns. Although that argument is generally aimed at the current law, if its logic is accepted in such a context, it holds equally against an explicit joint return regime.

Is child care for parents of young children an area where there are stronger arguments for recognising distortions caused by the differing tax treatment of imputed and market income? This could be argued, given the relative importance and positive long-term externalities as well as the labour-intensity of raising children. However, it does not follow that it is a good argument against universal joint returns. Rather, there are other ways to address the specific situation relating to couples with young children, such as properly formulated childcare subsidies. Specifically, the Australian Labor Party's proposed changes to the childcare subsidy system feature substantially less tapering for larger household incomes than under the current system.[202] Though the policy gives a markedly larger subsidy to higher-income families,[203] it does to some extent further reduce the difference in net cost between purchased and stay-at-home child care.[204] Some have also argued that rather than providing childcare subsidies,[205] the government should dramatically increase the provision of public child care.[206]

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continue to make the Australian tax system to some degree emulate a joint return system, leading to potentially unfavourable outcomes for mothers with pre-school children.

201 Apps and Rees, 'The Household, Time Use and Tax Policy' (n 171) 481, 494, 498.

202 'Labor's Plan for Cheaper Child Care', *Australian Labor Party* (Web Page) <https://www.alp.org.au/policies/cheaper-child-care>.

203 Ben Phillips, 'Research Note: Modelling of the 2022 Coalition and Labor Child Care Policies' (Research Note, Centre for Social Research & Methods, The Australian National University, May 2022) 5–7.

204 Owain Emslie, 'Explainer: Everything You Need To Know about the Major Parties' New Childcare Policies', *Grattan Institute* (Web Page, 10 May 2022) <https://grattan.edu.au/news/explainer-everything-you-need-to-know-about-the-major-parties-new-childcare-policies/>.

205 See OECD, 'Is Childcare Affordable?' (Policy Brief on Employment, Labour and Social Affairs, June 2020) <https://www.oecd.org/els/family/OECD-Is-Childcare-Affordable.pdf> 2–3, where it is discussed how such subsidies have contributed to Australia having among the most expensive (predominantly private-sector) childcare in the world.

206 Matt Grudnoff, *The Economic Benefits of High-Quality Universal Early Child Education* (Report, Centre for Future Work, The Australia Institute, March 2022) 39–40 <https://australiainstitute.org.au/wp-content/uploads/2022/04/Economic_Aspects_of_ECEC_in_Australia-WEB.pdf>.

While there are relatively stronger arguments for recognising the role of imputed income as between dual-income and single-income couples with younger children, such recognition can be directly dealt with by adequate policy responses, such that these arguments do not negate the net benefits of introducing a joint return regime.

3 *Conclusion on the Imputed Income Argument against Joint Returns*

The imputed income and lack of work-related expenses that benefit couples with only one main earner do not, from an equity perspective, negate the benefits of a system of joint returns — irrespective of whether the couple has children. That aside, as discussed below, some have argued against joint returns on the basis of economic efficiency, in that joint returns can lead to the secondary earner facing higher marginal tax rates, which leads to reduced labour supply. These arguments are discussed in Part IV(D) below.

D *Labour Market Efficiency*

It has been argued that joint returns reduce labour market efficiency through reduced workforce participation by secondary earners (predominantly women) because they face higher marginal tax rates than would be the case under a single return system.[207] The direct benefits of increased female labour supply include contributing to increased societal wealth,[208] and there are also indirect benefits, such as improved workplace leadership through greater diversity.[209]

However, it is important to put this in context. The main disincentive effect against secondary income earner workforce participation is due to the lack of taxation of imputed work income and the non-deductibility of many work expenses.[210] Higher marginal tax rates on secondary earners due to joint returns do however exacerbate the effect of these by creating a further secondary earner disincentive.[211]

This issue has become less important than previously, given the long-term decline in the sensitivity (elasticity) of married women's labour market participation to tax rates.[212] While opinions vary on the extent to which joint returns create a disincentive

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[207] Listokin (n 106) 188–9.

[208] See Edward J McCaffery, 'Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code' (1993) 40(4) *UCLA Law Review* 983, 1036–43, where the author explains that minimising 'deadweight losses' involves the tax system not dissuading married women from entering the workplace.

[209] Hemel (n 114) 689.

[210] Zelenak (n 108) 372–3.

[211] McCaffery (n 208) 988, 993–4.

[212] Bradley T Heim, 'The Incredible Shrinking Elasticities: Married Female Labor Supply, 1978–2002' (2007) 42(4) *Journal of Human Resources* 881, 915; Anil Kumar and Che-Yuan Liang, 'Declining Female Labor Supply Elasticities in the United States and Implications for Tax Policy: Evidence from Panel Data' (2016) 69(3) *National Tax Journal* 481, 511–12.

to secondary earner labour supply, with some arguing it is relatively weak,[213] there is evidence that to a material degree such a disincentive exists.[214]

Importantly, there is a high degree of variability amongst countries that utilise joint returns regarding the degree of such a disincentive effect, which is partially due to the different features of each one's tax system.[215] The degree of the disincentive effect on participation is also highly variable between individual couples, and is relatively weaker for those couples that have a primary earner on a relatively good income.[216]

However, while joint returns can have some, albeit highly variable, negative effect on economic efficiency, this needs to be put in context. Ultimately in many cases the most efficient tax policies can be highly inequitable. For instance, a head tax (which is a tax that requires each taxpayer to pay an identical dollar amount)[217] is more economically efficient than income taxes,[218] but few would condone making a head tax the primary source of government revenue. Another similar example is that from an efficiency perspective, sales taxes on luxury goods should be set at a comparatively low rate, and conversely, sales tax rates on inelastic staples should be comparatively high,[219] and yet this would not be regarded as fair policy. In other words, any negative impact on economic efficiency needs to be balanced against the

213 See, eg: Stephanie Hunter McMahon, 'Gendering the Marriage Penalty' in Anthony C Infanti (ed), *Controversies in Tax Law: A Matter of Perspective* (Ashgate, 2015) 27, 42–3; Staudt (n 191) 1613.

214 See, eg: Apps (n 164) 8, 18; Kesselman (n 99) 30–2; Margherita Borella, Mariacristina De Nardi and Fang Yang, 'Are Marriage-Related Taxes and Social Security Benefits Holding Back Female Labour Supply?' (2023) 90(1) *Review of Economic Studies* 102, 124.

215 Alexander Bick and Nicola Fuchs-Schündeln, 'Quantifying the Disincentive Effects of Joint Taxation on Married Women's Labor Supply' (2017) 107(5) *American Economic Review* 100, 103–4. See also Alexander Bick et al, 'Long-Term Changes in Married Couples' Labor Supply and Taxes: Evidence from the US and Europe since the 1980s' (2019) 118(1) *Journal of International Economics* 44, 50, where the authors explain how the United Kingdom's now-superseded joint return regime had tax brackets that in many cases did not disincentivise women from participating in the labour market.

216 Henrik Jacobsen Kleven, Claus Thustrup Kreiner and Emmanuel Saez, 'The Optimal Income Taxation of Couples' (2009) 77(2) *Econometrica* 537, 544–5.

217 Peter Varela, 'What Are Progressive and Regressive Taxes?' (Policy Brief No 3/2016, Tax and Transfer Policy Institute, The Australian National University, February 2016) 1.

218 Joshua Cutler, 'The Parallel Head Taxes of Margaret Thatcher and Barack Obama: Economics as Morality and Its Populist Rejection' (2020) 29(2) *Southern California Interdisciplinary Law Journal* 251, 258, 278.

219 Harvey S Rosen, 'Is It Time To Abandon Joint Filing?' (1977) 30(4) *National Tax Journal* 423, 427. The author explains that efficiency demands that goods that have the most elastic demand (such as luxuries) have comparatively lower sales tax rates than goods with comparatively inelastic demand (such as many necessities).

advantages of a joint return regime, which include increased horizontal equity, and improvements to other aspects of efficiency, as well as simplicity.[220]

If, however, this potential labour supply issue is a concern, alternative effective policies can be implemented in the context of a joint return regime. One method is to make income splitting by couples optional.[221] However, in many cases couples would be unlikely to take up this option to lower the second earner's marginal tax rate given that it would defeat the whole point of income splitting (lowering the average aggregate tax rate of the couple). A more preferable alternative would be to allow a secondary earner an offset that would in effect lower their marginal tax rate.[222] Such a targeted offset, while not, as discussed earlier, necessarily justifiable on equity grounds,[223] could arguably be justified on the basis of increasing labour supply. Some would correctly point out that this would in effect reduce couples neutrality, and so would in substance emulate some of the features of a single return system (in that dual-income couples were taxed more lightly than single-income ones with the same aggregate incomes).[224] However, such an offset could potentially be targeted so as to control its impact on couples neutrality. Further, there are other potential policy responses that governments can use to increase labour participation rates, such as those affecting the affordability of child care.[225]

[220] See below Part IV(E).

[221] Jason J Fichtner and Jacob Feldman, 'Taxing Marriage: Microeconomic Behavioral Responses to the Marriage Penalty and Reforms for the 21st Century' (Working Paper No 12-24, Mercatus Center, George Mason University, September 2012) 16.

[222] McCaffery (n 208) 1058; Grace Blumberg, 'Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers' (1971) 21(1) *Buffalo Law Review* 49, 62. See also Commonwealth of Australia, *Personal Income Tax: The Tax Unit* (Treasury Taxation Paper No 6, October 1974) 8, discussing the presence at the time of 'wife's earned income allowances'. Clearly, modern equivalents would be gender neutral.

[223] See above Part IV(C)(1). See also below Part IV(E) for a discussion on evaluating tax policy.

[224] Hemel (n 114) 688.

[225] Florence Jaumotte, 'Female Labour Force Participation: Past Trends and Main Determinants in OECD Countries' (Economics Department Working Paper No 376, OECD, 12 December 2003) 6; Nisar Ahmad, Amjad Naveed and Rayhaneh Esmaeilzadeh, 'Female Labor Force Participation in the United States: Impact of Income Taxes During 1990–2000' (2016) 10(3) *South East Asia Journal of Contemporary Business, Economics and Law* 32, 42.

E *Policy Evaluation of Joint Returns*

It is worthwhile to evaluate a joint return regime against the benchmark criteria generally applied to tax laws: equity, efficiency and simplicity.[226] *Equity* consists of both horizontal and vertical equity; whereas horizontal equity is the principle of those of equal financial position paying the same amount of tax,[227] vertical equity concerns those of greater means paying relatively more tax.[228] Unlike horizontal equity, which at the base theoretical level is relatively uncontroversial, vertical equity raises the issue of how much extra tax the better off should pay, which is ultimately based on various assumptions and underlying justice theory.[229] Ultimately, both horizontal and vertical equity are interlinked with the concept of 'ability to pay' of taxpayers.[230]

The criterion of *efficiency* calls for the tax laws to minimise the degree to which they distort market-based decision making.[231] The criterion of *simplicity* is directed at ensuring that tax laws can be easily understood and applied.[232]

These criteria will be applied to two broad scenarios. The first of these involves a couple whose only income is in the form of personal exertion income, which as discussed, cannot be split under current laws. The second scenario involves situations where a couple has income from business or property that can be subject to income splitting under current laws.

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[226] Taxation Review Committee, *Full Report: 31 January 1975* (Report, Australian Government Publishing Service, 31 January 1975) 11–17 [3.1]–[3.28] ('*Asprey Report*'); Commonwealth of Australia, 'Reform of the Australian Tax System' (Draft White Paper, June 1985) 14–15 [1.1]–[1.10]; 'A Strong Foundation: Establishing Objectives, Principles and Processes' (Discussion Paper, Review of Business Taxation, November 1998) 62–4 [6.7]–[6.19]; Commonwealth of Australia, 'Re:Think' (Tax Discussion Paper, March 2015) 14.

[227] Richard A Musgrave, 'ET, OT and SBT' (1976) 6(1–2) *Journal of Public Economics* 3, 4.

[228] Richard A Musgrave and Peggy B Musgrave, *Public Finance in Theory and Practice* (McGraw-Hill, 5th ed, 1989) 223.

[229] Paul R McDaniel and James R Repetti, 'Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange' (1993) 1(10) *Florida Tax Review* 607, 610.

[230] See James R Repetti, 'The Appropriate Roles for Equity and Efficiency in a Progressive Individual Income Tax' (2020) 23(2) *Florida Tax Review* 522, 567–8, 570–1, where the author argues that the 'ability to pay' is one of the major forms of distributive justice and approaches taken to designing a tax base, and that utilising the 'ability to pay' concept impacts on how horizontal and vertical equity are applied.

[231] James Alm, 'What Is an "Optimal" Tax System?' (1996) 49(1) *National Tax Journal* 117, 117.

[232] Binh Tran-Nam, 'Tax Reform and Tax Simplicity: A New and "Simpler" Tax System?' (2000) 23(2) *University of New South Wales Law Journal* 241, 242.

1 *Couple Earning Only Personal Exertion Income*

As discussed earlier, the ‘impossible trilemma’ means that a tax system cannot achieve all three goals of progressive taxation, couples neutrality and marriage neutrality. This article argues that a joint return regime accompanied by a rates schedule that realistically reflects the economies of scale enjoyed by many couples would link the tax burden on the personal exertion income of such couples more strongly to their joint ability to pay tax. Specifically, given that a couple’s ability to pay tax on their personal exertion income is reflected in their joint income, such a regime, by implementing couples neutrality, will support horizontal equity.

While a joint return regime is incompatible with marriage neutrality, it can still support principles of equity by recognising that the ability to pay is different for a given amount of personal exertion income when it is earned by a single taxpayer as opposed to being earned in aggregate by a couple. To what extent a joint regime is compatible with principles of equity ultimately depends on whether the rate schedule accurately assesses the economies of scale enjoyed by couples.

Some have, however, argued that a joint return regime resulting in a lack of marriage neutrality would reduce vertical equity.[233] Specifically, it has been argued that couples with one high income earner would get a tax break from such arrangements.[234]

However, as discussed, for a number of reasons, imputed income from self-performed services is generally not taken into account in our tax system. Such reasons include the substantial difficulty in valuing the imputed income and the substantial heterogeneity regarding the degree to which people utilise imputed income, as well as wider arguments against such income being included at the tax base in the first place.[235]

Even accepting that there is a case for the recognition of imputed income, arguments based on the vertical inequity of joint returns are inapplicable where there are two full-time earners in a marriage (who often benefit from a joint return system where they have dissimilar incomes).[236] Also, it is important to recognise that no tax system is perfect, and there are inevitable trade-offs in the vast majority of tax policy decisions.[237] In other words, even if it is accepted that due to the imputed income of self-performed services, a joint return system can subsequently in some instances increase vertical inequity, such a system can still have sufficient net advantages.

233 Kesselman (n 99) 38.

234 Martha T McCluskey, ‘Taxing the Family Work: Aid for Affluent Husband Care’ (2011) 21(1) *Columbia Journal of Gender and the Law* 109, 123–4.

235 See above Part IV(C)(1).

236 See Joseph E Stiglitz and Jay K Rosengard, *Economics of the Public Sector* (WW Norton, 4th ed, 2015) 682–3, where the authors point out that one wage-earner families have greater imputed income than two wage-earner ones.

237 William G Gale, ‘What Can America Learn from the British Tax System?’ (1997) 50(4) *National Tax Journal* 753, 754.

The evidence has indicated that the degree of inequity in a properly formulated joint return regime is potentially limited,[238] and can result in net advantages over an individual return system.[239]

Importantly, while a joint return system might not recognise the relatively higher imputed income of a single-earner couple, the counter to this is that single-earner couples will have a strong tendency to have, in the aggregate, a decreased opportunity to increase their tax-free human capital.[240] In other words, since they collectively work fewer hours, they have less collective opportunity to increase their human capital through work experience.

Overall, while it is all too easy to describe the introduction of a regime that in some instances lowers the tax burden for higher income earners as breaching vertical equity, ultimately such policies need to be evaluated in a balanced, fair manner. The fairness of a joint return system can be illustrated by a further examination of the above example of a single high income earner who marries a stay-at-home partner and is consequently subject to a lower tax burden. It is unrealistic to imagine that in most instances the extra costs of the living expenses of financially supporting the spouse would be recouped by the value of the domestic housework undertaken by them. The reality is that a system of joint returns, as discussed earlier, recognises the differences in ability to pay due to the different living expenses of a couple as compared to a single person.

A further issue that a joint return system resolves is the inequity under current laws, where income splitting is disallowed for personal exertion income and instead confined to those who earn money from property and certain types of business income — often taxpayers of higher wealth.[241] However, as discussed later in this article, another approach to dealing with this particular equity issue is through the introduction of laws restricting income splitting.[242]

As far as efficiency is concerned, as discussed, while there are some concerns about this criterion for joint returns, they can be moderated by appropriate policy.[243] Further, as far as simplicity is concerned for couples earning income from personal

238 Jeffrey Liebman and Daniel Ramsey, 'Independent Taxation, Horizontal Equity, and Return-Free Filing' (2019) 33(1) *Tax Policy and the Economy* 109, 126.

239 See Nuria Badenes Plá et al, 'Joint Taxation in Spain and Its Effects on Social Welfare: A Microsimulation Analysis' (EUROMOD Working Paper No EM 23/20, Institute for Social and Economic Research, University of Essex, December 2020) 12, where the authors discuss the welfare enhancement of joint taxation in Spain.

240 McIntyre and Oldman (n 112) 1618. For a discussion of the difficulties in taxing human capital, see generally Louis Kaplow, 'Human Capital under an Ideal Income Tax' (1994) 80(7) *Virginia Law Review* 1477.

241 See Kesselman (n 99) 19.

242 See below Part V.

243 See above Part IV(D).

exertion, it is likely to be slightly improved, given that only one tax return per couple would need to be lodged.

2 *Couple Earning Income from Property or Business That Currently Can Be Subject to Income Splitting*

It is also worthwhile evaluating the impact of joint returns on property and types of business income that under current laws can be split within couples.

It is noteworthy that with an individual return system, to the degree such income is legally able to be split, it can be shifted onto the lower-earning spouse to take advantage of their lower tax rates. This is fundamentally different from the result from a joint return system, where such income, rather than being predominantly shifted to the lower-earning spouse, is in substance compulsorily split in an even manner.[244] For instance, in the USA, joint returns aggregate all the income of the couple, including investment income.[245] This, as discussed, increases horizontal equity, because it results in such income being subject to the same treatment as personal services income under such a regime.

Further, a joint return system also improves equity in the sense that under current arrangements, those who choose to utilise tax planning arrangements to split such income end up arbitrarily paying less tax than those who for various reasons have not done so.

Efficiency would also be much improved for such income under such a joint return system, given that it would minimise resources put into entering into income-splitting arrangements.[246] Similarly, simplicity would also be much improved given that a joint return system reduces the need to understand and apply laws relating to income splitting.

F *Summary of Evaluation of Joint Returns Approach*

It has been suggested that, given the complexity of the issues and the trade-offs that would be necessitated by joint returns, the default — individual taxation — is the appropriate policy.[247] Another commentator has stated that since there are arguments for both joint and individual returns, a 'compromise' approach would work best: one with less-progressive tax rates accompanied by a system where

[244] Rosen (n 219) 424. This is assuming that either joint returns are mandatory for spouses, or in the alternative, joint returns give sufficient advantages that very few taxpaying couples, when presented with a choice, would opt to file individual tax returns.

[245] IRC (n 7) §§ 1, 61.

[246] See McMahon, 'To Have and To Hold' (n 123) 736–7, where the author discusses how the introduction of joint returns in the USA was motivated by the desire to eliminate income-shifting devices.

[247] Joel S Newman, 'Taxation of Households: A Comparative Study' (2010) 55(1) *Saint Louis University Law Journal* 129, 152.

the rates for joint returns and for couples filing separately are set at a level that minimises the degree of marriage bonuses and penalties.[248] Notwithstanding the reality of the conundrums involved, there is a solid case for the introduction of a joint return regime.

A policy of a joint return system has many advantages, most notably levelling the playing field as far as income splitting is concerned. In other words, appropriately formulating the rate thresholds so as to maximise the accuracy of the relative ability of couples to pay tax would aid equity and simplicity. Further, despite the arguments that economic efficiency might to some extent be compromised, compensatory policies are available.[249]

However, to be politically viable, the introduction of such a regime would need generally to avoid increasing the tax burden of existing couples. Consequently, the introduction of a joint return approach might need to be accompanied by a rate schedule that leads to substantially more marriage bonuses than marriage penalties. This presents two potential problems. First, such a policy could be overly generous to couples as compared with singles. In other words, by not adequately recognising the economies of scale from which couples benefit, the policy could breach notions of equity by assessing couples as having a lower ability to pay than is actually the case.

Second, such an approach might lead to a substantial loss of government revenue.[250] Such a loss might then be clawed back in the future through higher taxes, which could lead to an increase in the net real tax burden on singles, as compared with its level prior to the introduction of the regime.[251] However, notwithstanding such genuine concerns, a properly timed and implemented joint return regime could be politically and fiscally viable[252] and bring net advantages to the tax system.

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248 Listokin (n 106) 199–201, 202–5.

249 See above Part IV(D) regarding how the use of tools such as a targeted offset can help abate the loss of economic efficiency in such a scenario.

250 See *Asprey Report* (n 226) 140–3, where such implementation issues were used by the Chairman as a major justification for recommending that an individual tax regime be maintained.

251 Cooper (n 162) 92. Smith (n 104) 8, using older figures, discusses estimates which indicated that the revenue loss was approximately 5–6% of income tax revenue, though this was based on full income splitting with no allowance for economies of scale enjoyed by couples.

252 If the implementation of such a regime widened tax brackets for singles, and took into account economies of scale in a fair manner by having joint return tax brackets less than double the single ones, the result could be that hardly anyone suffered from an increase in taxes. Although this would be at a fiscal cost, if implemented at the right time, this could be fiscally viable.

V What Types of Income Splitting Should Be Allowed?

As discussed in this article, the underlying current principle is that the greater the degree that the income is generated from property, the more income splitting is permitted. In the case of business income, this principle manifests itself through the allowance of income splitting generally to the extent that what is split is in substance property rather than personal exertion income. Assuming that Australia continues with an individual returns regime, it is worth examining the broader question of whether the current law on income splitting should be subject to policy reform.

Importantly, the current state of property income-splitting laws should not be seen as an optional, limited version of a joint return regime that is restricted to property income. Rather, it broadly allows property income to be shifted to a substantial degree to the lower-income spouse. This is in the context of property income already being subject to concessional tax treatment in some situations.[253] Further, as discussed earlier in this article, there are economies of scale that couples enjoy,[254] yet voluntary income splitting of property income can be undertaken without any matching penalty that takes into account such economies.

The main legal impediment to splitting property income is the cost of transferring pre-existing property, which can typically result in a substantial CGT bill.[255] However, careful tax planning, such as acquiring an asset before it has appreciated in value through a trust, or in the lower-income-earning spouse's name, can avoid this.[256]

The current law, which in effect allows such splitting, is based on attributing the income to the taxpayer who owns the property. One main argument for allowing income splitting in such situations is based on respecting property ownership.[257] Further, pragmatically speaking, as income from property is a relatively minor

253 For example, CGT is subject to a 50% discount in many situations: *ITAA 1997* (n 6) div 115.

254 See above Part IV(B).

255 *ITAA 1997* (n 6) ss 104-10 (which would apply when property is transferred), 104-55 (which applies when a trust is created), 104-60 (which applies to assets transferred to a trust).

256 This would generally not trigger a CGT event under the CGT provisions in *ITAA 1997* (n 6).

257 See Lisa Philipps, 'Income Splitting and Gender Equality: The Case for Incentivizing Intra-Household Wealth Transfers' (Research Paper No 04/2010, Comparative Research in Law and Political Economy, Osgoode Hall Law School of York University, 2010) 8–9, where the author discusses this principle in the context of women's agency of their property ownership, including situations where such ownership results from inter-spouse transfers.

proportion of the tax base,[258] the amount of revenue at stake, while material, is limited.

That the law should allow, in effect, discretionary income splitting of property income is not incontestably desirable — indeed, some jurisdictions have laws that limit or largely prevent this.[259] Some of the various policies of other jurisdictions include attributing unearned income to the top income earner, taxing it at an unearned income rate, or automatically attributing the unearned income on a 50:50 basis within the couple.[260]

In support of the status quo, it has been argued that a law that allows income attribution for tax purposes to follow asset ownership helps aid gender financial equality.[261] This is because it will in some cases encourage asset transfers to married women who are on lower tax rates, which will result in increasing their economic power.[262] Proponents of such reasoning emphasise that such discretionary income splitting from property transfers should only be allowed where there has been a truly valid transfer of ownership.[263]

It may be argued that such a justification is superfluous, given that upon marriage breakup, especially for longer marriages, courts do not necessarily give undue attention to legal and equitable title in property division matters.[264] However, it has also been pointed out that such an approach gives women more control of the property and its income during marriage, and if there is a relationship breakdown, it gives those without access to adequate legal representation greater access to assets.[265] Notwithstanding the validity of this point, and that generally encouraging women to have a more equal portion of marital property is a highly worthwhile aim, it does not follow that the quest for greater sharing of marital property should be the overriding principle regarding how property income is taxed.[266]

Importantly, to the extent that splitting of property income is justified on the basis of respecting ownership, there is a sound argument for distinguishing between property income splitting through the outright ownership of property and splitting

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258 Australian Bureau of Statistics, *Survey of Income and Housing, User Guide, Australia, 2019–20* (Catalogue No 6553.0, 28 April 2022) Table 1.

259 Kesselman (n 99) 23.

260 Ibid.

261 Philipps (n 257) 7.

262 See ibid.

263 See also 'The Case for Mandatory Separate Filing by Married Persons' (n 120) 379–80, where the author argues that although joint returns are objectionable partially due to the lack of control of funds by the non-primary earner, no such objection applies to income splitting resulting from property transfers.

264 Mills and Ebejer (n 129) 425.

265 Philipps (n 257) 10.

266 See Zelenak (n 108) 385.

by the use of an entity such as a trust.[267] This is especially the case where the income-splitting instrument in question is a discretionary trust, which does not typically give the beneficiaries any solid proprietary interest in the underlying property.[268] While there are provisions, as discussed earlier in this article, that seek to allow the taxation of the individual only where they have the control of the income,[269] in general, the law does not require that they have ownership or control of the underlying income-generating property. In accordance with such an argument, ahead of the 2019 federal election, the Australian Labor Party proposed a policy to tax discretionary trust income more aggressively than is currently the case,[270] but the policy was abandoned after the party's electoral defeat.[271]

Another commentator has argued for a more extreme approach, saying that Australia should take a much broader, harder line on income splitting than is currently the case.[272] Suggestions for accomplishing this include a tightening of the general anti-avoidance provision.[273] Specifically, it has been suggested that as an example, pt IVA be modified by limiting the current requirement that it is to apply only to arrangements entered into with the dominant purpose of obtaining a tax benefit.[274] Although it is beyond the scope of this article to discuss the details regarding the specifics of such hypothetically modified provisions, careful drafting could dramatically reduce the amount of legal income-splitting arrangements. Such a broad approach has the advantage of improving equity, given that it would curtail the amount of income splitting available to only a subset of taxpayers. Further, it could improve efficiency, given that it would, in some cases, lead to the non-primary earner having less property income; consequently, they would be subject to lower marginal tax rates on their labour income — though, as discussed earlier, the importance of this in improving labour market participation is debatable.[275] Also, depending on how such modified legislative provisions are defined, simplicity could be improved

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267 Ibid 387.

268 Harold Ford et al, Thompson Reuters, *Ford and Lee: The Law of Trusts* (at Release 174) [5.9930].

269 See above Part III(C).

270 Australian Labor Party, 'A Fairer Tax System: Discretionary Trusts Reform' (Document No 5445589, Parliamentary Library, Parliament of Australia, 30 July 2017) <https://parlinfo.aph.gov.au/parlInfo/download/library/partypol/5445589/upload_binary/5445589.pdf;fileType=application%2Fpdf#search=%22library/partypol/5445589%22>.

271 Rachel Clun, 'Labor Abandons Trust Fund Tax Reform, Shadow Treasurer Confirms', *The Age* (online, 3 April 2022) <https://www.theage.com.au/politics/federal/labor-abandons-trust-fund-tax-reform-shadow-treasurer-confirms-20220403-p5aaf3.html>.

272 Cooper (n 162) 98.

273 Ibid 93.

274 Ibid.

275 See above Part IV(D).

to the extent that the law left less scope for ambiguity as to where income splitting is disallowed.[276]

An even more extreme suggestion is to establish a system, as in some other jurisdictions, where property and other unearned income are subject to the tax rate of the higher income earner in the couple.[277] This approach has the advantage of lowering the marginal tax rate faced by the secondary income earner, and thus might in some instances encourage their labour market participation, potentially improving efficiency.[278] It would also aid simplicity by making attempts at income splitting redundant. But it could also be argued that this might be harsh and lead to such income being overtaxed. Specifically, it would be in some instances inequitable as it would subject unearned income from property genuinely acquired by the secondary-earning spouse to a potentially higher tax rate than money they earn from personal services. Although an attempt could be made to draft laws exempting from such provisions any property genuinely acquired by the lower-earning spouse, such as assets brought into the marriage, or bought with funds that they earned, overseas experience has indicated that such laws are relatively easy to exploit.[279] Other approaches, such as subjecting unearned income to a standard unearned income tax rate,[280] would improve simplicity, though ultimately would negatively affect equity by not taxing such income at a progressive rate that takes into account the taxpayer's other income.

In summary, if Australia is to continue with a system of individual returns, there are strong arguments for modifying the current law so as to more strongly restrict income splitting. Of the methods discussed above, the suggestion regarding tightening the general anti-avoidance provision would be most consistent with the current income tax system, and would present the best trade-offs concerning the criteria of equity, efficiency and simplicity.

VI Conclusion

The current approach to income splitting, where it is only available in any meaningful degree to certain taxpayers, who are often higher income earners, results in inequitable outcomes. Many are instinctively averse to a regime that allows property owners and some business owners to split income but denies it for income derived from one's exertion. Although an all-or-nothing approach to income splitting might

[276] But see Cooper (n 162) 94, where the author's reservation about such a policy is based on the unpredictability of how such a provision would be interpreted by courts. However, careful drafting of the relevant provisions could minimise, though not eliminate, such unpredictability.

[277] Smith (n 104) 18.

[278] Zelenak (n 108) 388.

[279] Cooper (n 162) 95–6.

[280] See generally Kesselman (n 99) 23.

seem simplistic, this article suggests that, broadly speaking, this should indeed be the policy aspiration.

The current law, which to a large degree allows income splitting of certain types of business income and passive property income, but not of personal exertion income, is arbitrary and inequitable. The recent ATO professional services guidelines addressed in this article continue to cement such an approach.

The issue of introducing a law allowing couples to file joint returns, and so endorsing income splitting for such couples, is a highly complex one with many trade-offs. Notwithstanding some downsides and problems in its initial implementation, there are clear positives to such a policy. Arguments against joint returns give undue focus to the asymmetric legal control of incomes in couples with a dominant income earner. This article argues that such a perspective gives a disproportional emphasis to form over substance, while not giving sufficient emphasis to the economic realities of couples, such as the ability to pay tax. However, given the current state of play of Australian politics, where there is a general absence of politically radical decisions,[281] and with a budget forecast to be in deficit for several years following a surplus in the 2022–3 financial year,[282] it is extremely unlikely that such a policy would be advanced for public consultation and discussion.

Assuming that the status quo of individual returns for spouses continues, if the law is to continue to treat property income, whether from passive investments or through certain businesses, as radically different from personal exertion income, there should at the very least be stricter limits on splitting such income. The ATO's curtailing of income splitting in situations where the legal recipient of income does not in substance receive the funds is a welcome development. However, strong consideration should be given to expanding the principle that income splitting of property income should only be available to those who in substance own the property. As discussed in this article, such an approach would in many instances prevent the use of a discretionary trust to split income. An arguably superior approach would be for the government to introduce laws which, as suggested in this article, strongly limit income splitting of property income, whether this be passive or earned through a business.

It is hoped that the need for substantial tax reform on income splitting — as opposed to the burden of change falling entirely on the ATO's tightening of its application of the current law — will be subject to greater public debate, with the aim of improving the equity of the Australian tax system.

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281 Editorial, 'Neither Side Is Showing the Courage Needed To Tackle Our Big Economic Challenges', *The Age* (online, 16 May 2022) <https://www.theage.com.au/politics/federal/neither-side-is-showing-the-courage-needed-to-tackle-our-big-economic-challenges-20220516-p5alog.html>.

282 Commonwealth of Australia, 'Budget Strategy and Outlook' (Budget Paper No 1, Budget 2023–24, 9 May 2023) 7 <https://budget.gov.au/content/bp1/download/bp1_2023-24_230727.pdf>.