Excerpt from John G. Head and Richard Krever, Editors, *Tax Units and the Tax Rate Scale*, Australian Tax Research Foundation (1996).

CHAPTER 1

Marital Income Splitting in the Modern World: Lessons for Australia from the American Experience

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Over the past decade, Australia has subjected most of the fundamental features of its income tax structure to serious public scrutiny. Its family taxation rules, however, have largely escaped public review, notwithstanding the dramatic changes in the economic, social, and political position of married persons in Australia since the adoption of a national income tax in 1915. While in opposition, the Liberal-National Coalition (which has now formed the government) hinted that it would introduce marital income splitting to Australia if it were to win the next election. This political initiative has provoked a serious public reexamination of Australia's current family taxation rules. As a long-time advocate of marital income splitting, I welcome the attention that this important tax policy issue is now receiving in Australia.[1]

In this paper I attempt to contribute to the Australian debate over family taxation by distilling some lessons for Australia from the American experience with marital income splitting since its adoption in 1948. My focus in section III, below, is on the spirited academic debates over family taxation issues that have taken place among American tax specialists during the past two decades. Section I sets the stage for that discussion by suggesting why marital income splitting should be the system of choice for contemporary societies that aspire

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* I am indebted to Michael Brooks and Richard D. Pomp for helpful comments on a draft of this paper.

[1] For my earliest published work on the taxation of the family, see Michael J. McIntyre & Oliver Oldman, 'Taxation of the Family in a Comprehensive and Simplified Income Tax,' 90 *Harvard Law Review* 1573-1630 (1977); Michael J. McIntyre & Oliver Oldman, 'Treatment of the Family,' Chapter 6 of *Comprehensive Income Taxation* 205-234 (J. Pechman, ed.) (1977). For my most recent major piece on this topic, in which I extended my analysis from the income tax to other types of personal taxation, see Michael J. McIntyre, 'Implications of Family Sharing for the Design of an Ideal Personal Tax System,' Chapter 6 of *The Personal Income Tax: Phoenix from the Ashes* 145-183 (R. Bird and S. Cnossen, eds.), (1990) (revision of paper presented at International Seminar of Public Economists, Rotterdam, Jan. 5, 1989).

to equal tax treatment of men and women. Section II provides a brief explanation of the weaknesses in the traditional argument for separate filing on economic efficiency grounds. The final section contains my specific advice for Australian policy makers in formulating family tax policy.

I. THE FAIRNESS CASE FOR MARITAL INCOME SPLITTING

In a marital income splitting system, the two members of a marital partnership are each subject to tax on one half of the taxable income of the partnership. The objective of such a system is to tax both spouses on the income that they consume or save without reference to the source of the income that financed their consumption or saving. According to its supporters, marital income splitting is *ideally* suited for a society in which marital partners share equally in the material gains of their partnership. Of course no society has achieved the ideal of full marital sharing. Supporters of marital income splitting contend, nevertheless, that their favored system is *well* suited for societies such as the United States and Australia where substantial sharing typifies most marital relationships and full sharing is celebrated as the ideal.

The case for marital income splitting rests on one normative proposition and one empirical proposition. The normative proposition is that the proper taxpayer on income is the person who enjoys the benefits of that income through personal consumption or savings. This proposition may be referred to as the 'benefit principle' or the 'enjoyment principle.' I use that latter term here. The empirical proposition is that marital partners typically share approximately equally in the material benefits financed by income derived through their marital partnership. Strong arguments can be advanced in support of both propositions.

A traditional and appropriate starting point in formulating principles to govern a personal income tax is the Haig/Simons income definition. According to that definition, income is defined to be the sum of the taxpayer's marketplace consumption and the net change in the market value of the taxpayer's savings. This income concept embodies two value-laden judgments: (1) that material well being for tax purposes should be measured by actual outcomes of the marketplace, not on expectancies; and (2) that the source of economic gains contributing to market consumption and savings should be irrelevant in fixing tax liability. These judgments are not self-evidently correct and are not accepted by all tax analysts. The Haig/Simons income concept, nevertheless, has broad acceptance and is honored, albeit sometimes in the breach, in the design of all modern income tax systems.

The enjoyment principle rests on the same basic judgments as the Haig/Simons income definition. It taxes consumption to the consumer and savings to the saver, thereby conforming to the value judgement that actual consumption and actual savings are the proper measures of well-being for tax purposes. In addition, it taxes each marital partner on his or her own consumption and savings, without reference to the source of the income out of which the consumption and savings were acquired.

The empirical proposition underlying the case for full income splitting is that marital partners enjoy approximately equal amounts of marketplace consumption and savings. In theory, the truth or falseness of this proposition is susceptible to verification through empirical research. In practice, its validity remains open to question and is likely to remain so for some time.

Empirical evidence of marital sharing. Marital partners typically live in the same house, eat the same types of food, and dress and entertain in accordance with the same set of social pressures. National spending surveys show that marital households typically spend 35 to 40 percent of disposable income on housing, another 20 percent for food and beverages, and approximately 20 percent for transportation. Because these expenditures are likely to provide approximately equal benefits to the spouses, we can say with reasonable certainty that at least 75 to 80 percent of disposable marital income devoted to consumption is shared in the typical case. It seems likely that some substantial portion of the remaining 20 to 25 percent of marital consumption is shared in many cases. For example, many spouses vacation together, share a common pet, or otherwise spend money on common leisure activities.

That portion of marital income that is saved also tends to be shared. Sharing is normal, for example, with respect to life insurance, pensions, and equity in the home. Marital partners with children typically make a common investment in the future of their dependent children. In addition, the marriage laws of most countries reinforce the general inclination of marital partners to share savings by providing that both spouses will obtain a significant portion of marital property when the partnership ends through divorce or death.

The supporters of marital income splitting do not contend that marital partners share every dime. Nor do they contend that both spouses typically have equal say in how marital income is spent. Their more modest (but nearly unassailable) claim is that very substantial sharing of savings and consumption within marriage is commonplace in a healthy marriage and that the best way to estimate the consumption and savings of a married person, at least at low- and

middle-income levels, is by applying a 50/50 splitting formula to the aggregate income of their marital partnership.[2]

It should be noted that the case for marital income splitting does not depend on an empirical finding that marital partners 'pool' their income by spending, for example, out of a joint checking account. Some American couples make a point of keeping separate accounts, treating each other to dinner from their own funds, and otherwise keeping track of the spending financed by their separate incomes. These internal accounting systems of the marital partners do not matter under the enjoyment principle. What matters is whether the marital partners end up enjoying approximately the same standard of living.

It also should be noted that the empirical case for full marital sharing is weakest at high income levels. Thus the case for allowing high-income marital partners to enjoy the benefits of full income-splitting is concomitantly weak. To deprive them of those benefits, a tax system might employ a rate schedule that had double-width brackets at low- and middle-income levels and something less than double-width brackets at high income levels. To eliminate the marriage penalties otherwise resulting from this system, married taxpayers could be given the option to file separately -- an option that only high income marital partners having approximately equal separate incomes would benefit from electing. To reduce otherwise difficult administrative problems, marital partners filing separately should be required to allocate by formula (pro rata to their earned income) their allowable deductions and their gross investment income. I favor this approach for the United States.

Separate filing. The chief alternative to marital income splitting, and the family taxation system currently used by Australia, is separate filing for all individuals, whether married or single. In such a system, individuals are taxable, with some important exceptions, on the income that they earn or that is attributable to income-producing property that they are deemed to own or control. The US income tax included this 'separate filing rule' from the adoption of the tax in 1913 until the introduction of marital income splitting in 1948.

The primary case for applying a separate filing rule to marital partners rests on two contentious propositions. The first is that *the proper taxpayer with respect to income is the person who controls the production and/or disposition of that income*. This proposition may be referred to as the 'control principle.' The second

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[2]For fuller discussion of marital sharing practices, see Michael J. McIntyre, 'Tax Consequences of Family Sharing Practices Under New York Law: A Critique and a Proposal for Reform,' 49 *Albany Law Review* 275-351, 286-290 (1985). See also McIntyre (1989), supra note 2 at 155-156. For a contrary view and a summary of various studies that focus primarily on control over marital income, see Marjorie E. Kornhauser, 'Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return,' 45 *Hastings Law Review* 63-111 (1993).

proposition is that *income derived by marital partners is controlled by the person who earns it, in the case of personal services income, and by the person who holds legal title to the income-producing property, in the case of property income*.

Problems under Haig/Simons. The control principle is inconsistent with the two judgments discussed above that underlie the Haig/Simons income definition. First, the control principle is inconsistent with the proposition that *actual* consumption and savings is the proper measure of taxable capacity. As suggested above, actual consumption directly affects the well being of the consumer, not the well being of some individual who had the ability to consume but did not do it. Similarly, actual savings directly affects the well being of the saver. If the persons having the ability to save or consumer is the proper taxpayer, then the proper measure of well being should be *the ability to consumer or save*, not actual consumption or savings.

Some economists contend that ability to consume or save is the proper measure of taxable capacity. From a utilitarian perspective, a plausible case might be made for that position, although such a tax would be impossible to administer in practice and would threaten basic civil liberties by imposing impossibly high tax burdens on individuals who chose not to maximize the return on their services. Not to worry! No modern income tax system makes a systematic attempt to tax individuals with respect to their ability to earn. For example, if two Australian workers are given the opportunity to work overtime and only one does so, Australia would tax only the worker who actually earns the overtime pay. Similarly, individuals who actually earn investment income are taxable on that income, whereas individuals who spend their savings on consumption are not taxable with respect to the investment income that they could have earned if they had chosen to do so.

Of course the proponents of the control principle are not arguing for a tax on the ability to earn income (potential income). The point is, however, that they *should* be making that argument if they think control over income is the proper income attribution rule. In a coherent personal tax system, the rules designed to attribute income to particular taxpayers should be coordinated with the rules for defining taxable capacity. Both sets of rules serve the common purpose of sorting individuals according to the agreed measure of their taxable capacity. In the US income tax and in the Australian income tax, the measure of taxable capacity is actual savings and consumption, not potential savings and consumption. For consistency, therefore, the taxpayer on that savings and consumption should be the actual saver or consumer, not the potential saver or potential consumer.

The control principle is also inconsistent with the Haig/Simons prescription against source distinctions. If actual consumption and savings is the proper measure of taxable capacity, then the source of an individual's consumption or

savings should not matter in fixing that individual's tax burden. In a separate filing system, however, the source of consumption and savings matters a lot. The most important violation of source neutrality is the rule that consumption and savings obtained by a marital partner are taxable to that person if the source is that person's own earnings, but they are taxable to the other spouse if the source is the earnings of the other spouse. Another major source-neutrality violation is that the spouses are free to allocate property income to the lower income spouse by reshuffling nominal ownership rights, but they are not provided a comparable benefit with respect to earned income.

Double tax on gifts. Proponents of the control principle could minimize source distinctions by imposing a 'double tax' on intra-marital gifts. Assume, for example, that Husband and Wife are marital partners and are sharing equally in the material gains of their partnership. Assume also that all of the income of the partnership is earned by Husband. In such circumstances, Husband, as the earner, must be taxable under the control principle on the entire income. In addition, Wife should be taxable on half of that income because she obviously controls the portion that she consumes or saves. By subjecting Wife to the double tax in such circumstances, the proponents of the control principle would avoid introducing a source distinction into their preferred tax system. That is, spouses would be taxable on income they controlled whether they derived that income from their own earnings or from a spousal transfer. The cost of this consistency to proponents of separate filing, however, would be high. They would end up championing a tax system that was absurd on its face and that would never be adopted by any democratic government.[3]

Marital sharing of control. Like the question of who enjoys the benefits of marital income, the question of who controls income within a marital partnership should be susceptible to empirical inquiry. In fact, however, empirical studies of control over marital income are unlikely to ever yield definitive results. A few studies have been made, and they have reached some common sense conclusions. They suggest, for example, that the patterns of control within a marital partnership are extremely complex, and that control is exercised through many different mechanisms. They suggest that some pooling of marital income is common but that full pooling is not. They also suggest that the person earning income obtains some extra leverage over how the income is spent.[4] They do not support the fundamental premise of separate filing -- that

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[3]For my more extended diatribe against the double tax on intra-marital gifts, see McIntyre (1990), supra note 1, at 150-154. The counter position is articulated in Krever (1983), at 647-650.

[4]See, e.g., the discussion of marital sharing in Kornhauser (1993), supra note 2. Although Professor Kornhauser is attempting in her article to show that marital partners do not share the benefits of marital income, the studies she discusses all focus on the sharing of control over marital resources.

earned income is controlled only by the earner and that property income is controlled only by the property owner. Indeed, they go a long way towards establishing the contrary premise.

To determine who controls income within a marriage, it is necessary to specify the meaning of 'control' with some precision. Does 'control' mean control over production of income or control over its disposition? The person who earns income obviously has substantial control over its production, but he or she may share control over its disposition. When a husband supports a non-earner wife, for example, is he exercising control over his earnings, or is he responding to the strong social and legal pressures that virtually close off for him the option of leaving his wife destitute. Does the husband or the wife control income that is spent to purchase a family automobile if he picks the make and model after his wife has decided whether to buy a new car? Does the wife control an amount spent to redecorate the family living room if she had to beg her husband for months before he agreed to the expenditure? Who controls when one spouse has veto power and declines to exercise it? Proponents of the control principle should answer these impossible questions and thousands more in some principled way before they undertake research into marital sharing patterns.

Harmonizing control and enjoyment principles. Because 'control' is such a nebulous concept, the control principle comes very close to being incoherent. To give some specificity to the meaning of control, its proponents might indulge the assumption that marital partners are likely to utilize their control over income to obtain its benefits for themselves. Under that assumption, the control principle is subsumed into the enjoyment principle.

False arguments against marital income splitting. According to some commentators, a marital income splitting rule is unfair to two-earner couples because it treats them the same as equal-income one-earner couples despite the likelihood that one-earner couples are obtaining greater imputed income from self-performed services. This criticism of marital income splitting is patently unfair. Whether some forms of imputed income from homemaking should be included in the tax base is an issue of legitimate debate within the tax literature.[5] If such income is to be made taxable, however, policy makers should do so explicitly rather than implicitly through the adoption of otherwise inappropriate family taxation rules. In any event, the criticism misses the mark in a society in which the overwhelming majority of married couples are two-earner couples. In such a society, a separate filing rule would be a totally ineffective proxy for taxing imputed income from self-performed services.

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[5]My view is that it should not be taxable. See McIntyre & Oldman (1977), supra note 1, at 1609-1613.

Some commentators have suggested that marital income splitting, although perhaps an appropriate rule for the 1950s, has become obsolete in the 1990s due to the marked increase in the US workforce participation rates of married woman. These commentators have gotten the tax significance of this historical trend exactly backwards. It should be noted, first of all, that women were participating in the workforce in very large numbers even in the 1950s. The participation rate in the United States in 1950, for example, was 34 percent. It borders on the absurd to think that US policy makers had forgotten about working wives when they fashioned the US income splitting rule. More importantly, income splitting would be the ideal rule for a society in which all husbands and wives worked in the labor force. In such circumstances, the economic circumstances of equal-income couples generally would be the same except for differences in the sources of their income -- differences that ought not to matter in an ideal income tax system.

Some proponents of separate filing find fault with marital income splitting because it does not take account of sharing between members of certain quasi-marital relationships ('unmarried sex partners'). The implicit point of the criticism is that a tax regime designed in accordance with the enjoyment principle should extend income splitting to members of a household if those members are in fact sharing consumption and savings. This criticism has no force. Leaving aside possible political and administrative restraints, policy makers could extend an income splitting system to unmarried sex partners if they wanted to do so. Some administrative problems are likely to arise in identifying those unmarried couples that have entered into long-term sharing relationships.[6] These same problems would arise, however, in designing a separate filing system that took into account the impact of such relationships in the control of income.[7]

Even if the proponents of separate filing are able to demonstrate some important weaknesses in the case for marital income splitting, they would not

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[6]No empirical studies establish the degree of sharing between unmarried sex partners. An assumption that unmarried sex partners typically share resources extensively is probably unwarranted for the following reasons. First, many of those relationships are of short duration. Second, unmarried partners, by definition, do not have a marriage contract, and most have not entered into a legally binding agreement that is functionally equivalent to a marriage contract. The marriage contract does not guarantee full sharing, but it generally does guarantee that each partner will receive a substantial portion of the savings of the couple upon dissolution of the relationship. Third, the important social pressures that tend to guarantee sharing within marriage probably do not apply, or do not apply very strongly, to unmarried couples. Fourth, as suggested in the text, the presence of dependent children in a household is probably an important impetus to sharing, and most unmarried sex partners do not have children.

[7]For example, a tax system designed in accordance with the control principle should impose a double tax on gifts between unmarried sex partners, just as it should impose a double tax on intra-marital gifts under that principle.

have scored important points for their position. Separate filing is not the default position, to be adopted unless the proponents of some alternative system of family taxation can demonstrate that their proposed system is free of all substantial defects. To make out a case for separate filing, its proponents must begin by advancing affirmative arguments in its support. They have trouble doing so, partly because the case for the control principle is unpersuasive and partly because separate filing is not an appropriate mechanism for implementing that principle.

Some separate filing advocates have pointed to trends in Europe to suggest that their favored reform is the wave of the future. In my view, they have misread the European situation. At the start of the 1970s, many European countries employed a joint filing system that required the aggregation of marital income but did not permit income splitting. Limited relief for family circumstances was granted through deductions and credits. Such a system is clearly unfair to married persons and deserves consignment to the dustbin of history. Many European countries that abandoned marital aggregation without splitting moved either to a separate filing system or to a marital aggregation system with an election for separate filing. Revenue considerations as well as tax ideology were important in shaping those reforms. Countries such as Germany that already had marital income splitting systems retained those systems, and at least one country (Belgium) moved in the direction of full income splitting. I view the European reforms as all movements in the right direction. Marital income splitting, with its emphasis on fairness to the individual spouses, is much more in harmony with separate filing and elective separate filing than with marital aggregation without splitting. Marital aggregation without splitting should be viewed by all tax reformers as the common enemy.

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