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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

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¹For 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. Clossen, eds.), (1990) (revision of paper presented at International Seminar of Public Economists, Rotterdam, Jan. 5, 1989).

societies that aspire 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*

²For 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).

of that income. This proposition may be referred to as the ‘control principle.’ The second 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

³For 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.

the income is spent.⁴ They do not support the fundamental premise of separate filing -- that 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

⁴See, 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.

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

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.

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

⁶No 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.

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 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.

II. Marital Income Splitting and Economic Efficiency

A. Outline of Efficiency Argument

Various economic studies purport to demonstrate that a country is likely to suffer some efficiency costs from adopting a marital income splitting rule rather than a separate filing rule. The basic argument goes as follows. Labor-

⁷For 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.

response studies suggest that married women tend to be more sensitive to the after-tax marginal wage rate than married men. Thus a tax system designed to promote efficiency would tax married women at the margin as lightly as possible. Married women typically earn less than married men. Thus their marginal tax rates under a separate filing system typically are lower than the marginal rate on married men and lower than they would be in a marital income splitting system that raised an equal amount of revenue.⁸

The argument sketched above is based on three premises. The first is that married women typically earn less than their husbands. This premise, although rooted in historical fact, is far less true in many countries than it once was. In the United States, for example, women who graduated recently from college typically earn as much as their male counterparts, and the overall trend is towards greater sexual equality in the workplace. Many married women in the United States now earn more than their husbands. The premise is valid, nevertheless, and is likely to remain valid as long as large numbers of married women continue to seek only part-time employment outside the home.

The second premise is that married women are more sensitive than married men to the marginal after-tax wage rate. That is, married women are more likely than married men to respond to a decrease in the after-tax wage rate by reducing their participation in the labor market. The third premise, which is the focus of this section, is that the effective marginal tax rates on married women generally would be higher in a marital income splitting system than they would be in a separate filing system.

The validity of the second premise is a matter for empirical inquiry. Early econometric studies, conducted in the United States in the late 1970s and early 1980s, suggested that the labor-supply response of married female workers to the after-tax wage rate was high.⁹ Later studies provide much lower estimates of the response of women in the workforce to the after-tax wage rate.¹⁰ Obtaining reliable estimates of the impact of the after-tax return

⁸Taxing married men at higher effective tax rates than equal-income married women would violate a traditional norm of tax fairness. In a society with a high preference for fairness, the social welfare costs of violating that norm would exceed the potential efficiency gains from inducing married women to work longer hours in the workforce.

⁹See, e.g., Jerry A. Hausman, 'Taxes and Labor Supply,' in 1 *Handbook of Public Economics* 213-263, A. Auerbach and M. Feldstein, eds., (1985) at 247 (reporting from a survey of the literature that the estimates of the uncompensated net-wage elasticity for married women ranges from -0.2 to 2.3). Hausman's own estimate was 0.91.

¹⁰See, e.g., Ronald Triest, 'The Effect of Income Taxation on Labor Supply in the United States,' 25 *Journal of Human Resources* 491-516 (1990); Barry Bosworth & Gary Burtless, 'Effects of Tax Reform on Labor Supply, Investment, and Saving,' 6 *Journal of Economic Perspectives* 3-25 (1992) (finding that US married women in the bottom income quintile increased hours worked from 1967 to 1989, although their taxes went up during this period);

from labor on the labor supply of married women is complicated by the likelihood that the inclination of married women to work in the labor market probably is correlated positively with income, family size, and marital status.¹¹ In addition, studies of work-force participation rates typically rely on highly questionable assumptions about the value of imputed income derived by wives working outside the labor market.

Some recent studies suggest that much of the labor response of married woman is due to variations in their workforce participation rates rather than to variations in their hours worked.¹² This distinction between participation rates and hours worked is important to the debate over joint filing because workforce participation rates are probably much more sensitive to *average* tax rates than to *marginal* tax rates.¹³ Recent research also indicates that only certain identifiable subgroups of married women, particularly older women, vary their work hours substantially in response to changes in marginal tax rates.¹⁴

Given the trends in the tax literature, I suggest that economists be cautious in making strong claims about the impact of taxes on the labor supply of married women. In any event, the long-term validity of the premise that working wives are more sensitive to taxes than working husbands appears to be on a collision course with the changing role of women in society. Analysts generally believe that the observed sensitivity of married women to the wage

Nada Eissa, 'Taxation and Labor Supply of Married Women: The Tax Reform Act of 1986 as a Natural Experiment,' Working Paper No. 5023, National Bureau of Economic Research (1995) (finding a moderate but significant increase in hours worked of high-income married women after reduction in their marginal tax rates by 1986 reform).

¹¹See, e.g., Daniel Feenberg, 'Are Tax Price Models Really Identified: The Case of Charitable Giving,' 40 *National Tax Journal* 629-633 (1987) ('The variables that determine marginal tax rates, chiefly income and marital status, are quite plausibly determinants of the behavior being modelled'); see also Thomas Mroz, 'The Sensitivity of an Empirical Model of Married Women's Hours of Work to Economic and Statistical Assumptions,' 55 *Econometrica* 765 (1987).

¹²See, e.g., Triest, *supra* note 11.

¹³For example, a wife who is already in the workforce can add an hour of work with few dislocations and is likely to make her decision about working an extra hour without reference to fixed costs. That is, the decision is made 'at the margin.' A wife currently working at home, however, cannot simply add an hour of work in the workforce without significant dislocations. She may decide to work an 'extra' hour only if she decides to make a rather significant change in her way of life. For an early discussion of this point, see Michael J. McIntyre, 'Individual Filing in the Personal Income Tax: Prolegomena to Future Discussion,' 58 *North Carolina Law Review* 469-489 (1980).

¹⁴See Bosworth & Burtless (1992), *supra* note 11. This research is far too preliminary to draw strong conclusions from it.

rate is due to their historical status as 'secondary workers.' Married women are very rapidly shedding that status in many countries, including Australia and the United States.

Analysts generally have assumed that the validity of the third premise -- that married women pay tax at the marginal rate of the marital partnership in a joint return system -- was a matter of simple logic. They are wrong, for reasons discussed below.

B. Marginal Tax Rates of Working Wives in a Joint Return System

Just as the sensitivity of working wives to the wage rate is an issue for empirical inquiry, so also is the effective incidence of the tax imposed under a joint filing system. The validity of the assumption that a working wife pays tax at the joint return marginal rate depends upon the results of an empirical inquiry into the way that marital partners share taxable income. If they share at the margin, then the premise is valid. Otherwise it is not, as the following example illustrates.

Assume that Country A allows marital partners to elect between two tax regimes. The first election is to be taxable under a full marital income splitting regime. That is, each spouse will be taxable on one half of the aggregate marital income. The alternative election is to be taxable on their separate incomes. For simplicity, assume that individuals in Country A only have wage income. Country A has adopted the following rate schedule, applicable to all individuals, whether single or married.

Rate Schedule for Country A	
<i>Taxable Income</i>	<i>Tax</i>
\$0 to \$20,000	10%
over \$20,000	\$2,000 plus 40% of excess over \$20,000

Full marital sharing. Husband and Wife are a married couple residing in Country A. Husband has annual income of \$40,000, and Wife's annual income is \$8,000. If they elect to file separate tax returns, Husband will pay a tax of \$10,000 (\$2,000 + \$8,000) and Wife will pay tax of \$800, for an aggregate tax on the couple of \$10,800. If they elect marital income splitting, each spouse will have taxable income of \$24,000 (\$48,000/2) and will pay tax of \$3,600 (\$2,000 + 40% of \$4,000), for an aggregate tax on the couple of \$7,200. Thus by filing a joint return, Husband and Wife can cut their aggregate tax bill by \$3,600 (\$10,800 – \$7,200). Wife, however, would have her tax liability increased from \$800 to \$3,600, for a net increase of \$2,800. No one should

expect that a rational wife would bear that extra tax unless she felt she was compensated somehow for doing so.

Under these facts, Wife certainly will elect to split income with Husband if they are sharing equally in the income of the marital partnership. Because of the sharing relationship, she bears the burden of one-half of the tax imposed on herself and one-half of the tax imposed on her husband. Thus any arrangement that cuts her tax or her husband's tax would inure to her benefit.

Adversarial marriage model. Assume, however, that the relationship between Husband and Wife is totally adversarial. That is, their marriage is red in tooth and claw, and they accommodate each other only if so doing serves their individual interests. In such circumstances, Wife will agree to file a joint return only if her husband agrees to pay at least the extra \$2,800 that she would be liable for by filing a joint return with full income splitting. Husband, of course will be anxious to file jointly since he will save \$6,400 (\$10,000 minus \$3,600) in tax by so doing. Given the assumed adversarial relationship between the spouses, she probably would bargain for some additional share of the marital tax savings. How much more she would be able to bargain for would depend on so many possible factors that the outcome of the bargain would be difficult to predict. Thus the effective tax rate on the Wife is difficult to estimate. It definitely would be less than 40 percent -- the nominal marginal rate applicable to the couple. It almost certainly would be less than ten percent -- the average and marginal rate at which Wife would pay under a separate filing system. Indeed, it plausibly could be zero, or even negative.

To make the point illustrated above with respect to marginal tax rates, assume that Wife contemplates earning an additional dollar of income, thereby bringing her taxable income to \$8,001 and the marital partnership's income to \$48,001. Assume also that Wife is not sharing with Husband. If Husband refuses to divert a fair share of the benefits of joint filing to Wife, she will elect to file separately. In that event, her marginal tax rate on the extra dollar of income will be ten percent. If she works out an arrangement with Husband that makes it profitable to her to file jointly with Husband, the marital tax rate on the extra dollar will be 40 percent, but she will bear only a portion of that burden, with the remainder shifted to Husband. Although the resulting effective marginal rate on Wife is difficult to predict, it should be something less than 10 percent, for the reasons set forth above.¹⁵

¹⁵Under the assumed facts, Wife would not bargain separately over the marginal tax because she can not elect to file separately at the margin. It is the election to file separately that gives her leverage, and she would not rationally give up that leverage by committing to file jointly before knowing the total amount of the income she would be earning for the year. If she were forced to bargain at the margin -- because, for example, she had committed to filing jointly before she expected to earn additional money at the margin -- she would end up bearing the burden of the full 40 percent marital rate.

Partial Sharing Model. Of course the red-in-tooth-and-claw model of family sharing sketched above is totally unrealistic, notwithstanding some theories of marriage that seem to have adopted it. Altruism is a common and probably an essential feature of marriages that last beyond the honeymoon. Indeed, most marital relationships would not come about without some degree of altruism between the spouses.¹⁶ It is useful, therefore, to consider the effective tax rate on wives in a marriage that includes some adversarial features but also includes substantial sharing. For reasons discussed below, I suggest that in such a marriage, the assumption that the wife pays tax at the nominal marital tax rate is probably wrong.

Consider, for example, a marriage in which the marital partners generally share income from their regular jobs but do not share windfalls, modest amounts of overtime pay, and the like. Wife earns a bonus of \$100 at work for the best on-time record for the month of May. A tax of \$10 is withheld on the bonus payment. Wife's understanding with Husband is that she is not expected to share small windfalls such as the \$100. Because they generally are sharing, Husband and Wife certainly will file a joint return, so the marital tax rate on the \$100 will be 40 percent. The question is whether Husband will bear any of the burden of that tax. The answer is uncertain.

One possibility is that Husband and Wife will bargain at arm's length. Wife would have no special advantage in such a negotiation, however, because she is committed by self-interest to file a joint return. Thus the outcome of the negotiation cannot be predicted. An alternative, perhaps more likely, possibility is that the matter will be settled according to some internal family standard of fairness. Husband and Wife may conclude, for example, that Wife should pay the marginal tax because she is enjoying the marginal income. In that event, her marginal rate is 40 percent. Or they may conclude that the tax should be paid out of pooled income.¹⁷ In that event, the marginal tax rate on Wife would be 20 percent (one-half of 40%). A third possibility is that they will share only the amount of tax in excess of the amount withheld ($\$40 - \$10 = \$30$), resulting in an effective marginal tax on Wife of 25 percent ($(\$10 + \30

¹⁶Rawls asserts that family sharing tends to refute the utilitarian premise that individuals always seek to maximizing the sum of advantages to themselves. John Rawls, *A Theory of Justice* (1971) at 105.

¹⁷One possible reason for paying the tax out of pooled income is that Husband and Wife view the tax as akin to other unreimbursed work expenses, such as commuting costs and laundry costs for work clothes, that they generally pay out of pooled income. Another reason is administrative convenience. A third reason is that Husband is willing to pay the tax on Wife's windfall income out of pooled resources on the understanding that the tax on windfall income that he may receive will also be paid out of pooled income.

$\times 0.5)/\$100$).¹⁸ A fourth possibility is that Husband and Wife will decide that Wife, in fairness, should be responsible only for the \$10 of tax that would have been due if she had filed separately.¹⁹

In the discussion above, the assumption was made that Country A gave marital partners the right to file either separately or jointly.²⁰ Such an election is an appropriate and common feature of a marital income splitting system; it costs the government nothing and gives appropriate leverage to lower-income spouses.²¹ The basic point illustrated by the example is not dependent, however, on the existence of the election. With or without the election, marital partners who are not sharing resources at the margin will determine through negotiations the share of the taxes they will each bear with respect to income earned at the margin.²²

Marriage as indentured servitude. The assumption was made in the discussion above that Husband and Wife were independent economic actors. Some of the radical critiques of male-female relationships coming out of the 1970s suggest an alternative image of marriage. The suggestion is made that in the typical marriage, one spouse (the husband) so dominates the other (the wife) that the spouses will not be bargaining over taxes or anything else. In such a marriage, the dominant spouse will dictate how the total marital

¹⁸I think this outcome is likely one for many US married couples. I suspect that Wife will spend the \$90 of after-withholding bonus money on herself in the year received. In the subsequent year, Husband and Wife will compute their joint tax liability and pay the additional tax due on the bonus income through a reduction in their refund (the typical case) or by drawing down funds from joint savings.

¹⁹In effect, Husband and Wife would be adopting the fairness standard promoted by the advocates of separate filing. I do not consider this outcome to be a likely one, as I do not think that many spouses will view the 'separate filing' result to be the fair result for them. Separate filing advocates, however, ought to be slow to argue that the fourth possibility is unlikely. If they do so, however, they should admit that they have thereby undercut their fairness case for separate filing.

²⁰The United States permits marital partners to make an election comparable to the election in the example; the percentage so electing is small. A relatively small number of divorcing couples elect in the year of divorce; some do so because of certain restrictions on joint filing (e.g., both spouses generally must be US residents) or because of the way certain limitations on deductions have been designed.

²¹Marital partners generally would lower their tax bill by filing jointing in a full income splitting system. A government that permits full income splitting would increase its revenue by providing the election to file separately if some marital partners having unequal separate incomes actually exercised it.

²²A married person can 'elect' to file separately by filing for a divorce. The divorce election is less useful as a bargaining stick than a straight-forward tax election because of the possible nontax collateral consequences of divorce.

income will be distributed without regard for the welfare of the subordinate spouse. The subordinate spouse's work effort in such circumstances is not a function of either the marginal tax rate of the married couple or the marginal rates of the individual spouses. Economic analysis of the work incentives of the spouses is beside the point -- the subordinate spouse will work according to the instruction of the dominant spouse.

I doubt that very many marriages in Australia resemble the Tarzan-Jane model suggested above. If such marriages are in fact commonplace in Australia, then the efficiency case for separate filing in Australia is eliminated. What the fair result in this model would be is hard to say -- perhaps aggregation of marital income with some modest allowance for the subordinate spouse. Both separate filing and marital income splitting would be unfair in this model.

Conclusion. To the best of my knowledge, all of the studies of the disincentive effects of joint filing indulge the assumption that the effective marginal tax rate of each marital partner is the marginal rate of their marital partnership. The analysis above, by calling that assumption into question, casts some doubt on the validity of all of those studies. In general, the work disincentives of marital income splitting is overestimated by those studies to the extent that marital partners do not in fact share resources at the margin.

The analysis presented above also suggests that researchers should be cautious in drawing conclusions about the elasticity of working wives to the wage rate in a particular country from studies conducted in another country having a different family taxation regime. For example, studies of the labor-supply response of married women conducted in the United States using tax data from the 1970s and early 1980s may have limited relevance for Australian policy makers.

C. Inconsistency of Positions Taken by Many Proponents of Separate filing

Many proponents of separate filing for marital partners claim that their favored system is both fairer and more efficient than a joint filing system with full income splitting. Their fairness and efficiency positions, however, are logically inconsistent. As discussed above, the studies suggesting that separate filing would produce some efficiency gains is based on the proposition that marital partners share resources at the margin. In contrast, their fairness case against marital income splitting is largely premised on the proposition that a significantly large number of marital partners do not share income. At least one of these two propositions must be wrong.

The assumption that marital partners share income at the margin is much more aggressive than the assumption of substantial sharing on average that is indulged by proponents of marital income splitting. To defend marital income splitting, its proponents need only show that most marital partners enjoy approximately the same standard of living (measured by their consumption and savings) and that the separate incomes of the marital partners are often a poor index of their economic well being. For fairness purposes, what happens at the margin is largely irrelevant. In contrast, the efficiency case for separate filing under standard economic theory depends only on what happens at the margin, where the probability of full marital sharing is fairly low.

III. American Experience with Income Splitting: 1948 to 1996

A. Adoption of Income Splitting in 1948

By 1948, US family taxation policy was in disarray. US Supreme Court decisions handed down in the 1930's established the following three inharmonious rules:

(1) *Wages taxable to earner in common law states.* The wage income of a married individual residing in a common law state (i.e., a state, such as New York or Michigan, that has adopted family property laws derived from the English Common Law) was taxable to that individual, notwithstanding the existence of a legally binding contract assigning the income to the individual's spouse.²³

(2) *Income splitting in community property states.* One half of the wage income of a married individual residing in a community property state (i.e., a state, such as Washington or Louisiana, that has adopted family property laws derived from the community property law of Spain or France) was taxable to that individual's spouse.²⁴

(3) *Easy assignment of property income.* Whereas spouses residing in common law states faced serious obstacles to shifting earned income, they were free to shift property income as long as they were prepared to transfer nominal ownership rights to the income-producing property to their mate.²⁵ Sometimes the shifting involved an outright transfer of all property rights, but in other cases, the shifting was

²³Lucas v. Earl, 281 U.S. 111 (1930).

²⁴Poe v. Seaborn, 282 U.S. 101 (1930).

²⁵See, e.g., Blair v. Com'r, 300 U.S. 5 (1937).

arranged through short-term trusts, intra-marital loans, and similar measures. Of course spouses residing in community property states were allowed full splitting of their property income whether or not they arranged an actual transfer of nominal ownership rights.

The three rules summarized above created significant disparities in the federal tax burdens imposed on equal-income married couples, with those disparities being a function of their state of residence and the source of their individual incomes. The consensus view among US tax specialists of the day was that these disparities in the treatment of equal-income couples were not justified by real differences in the economic position of the spouses.

From a political perspective, the most important of those disparities in tax burdens were those between married couples residing in common law states and equal-income married couples residing in community property states. By 1948, political leaders concluded that something had to be done at the federal level rather soon. An increasing number of states were converting from common law jurisdictions to community property jurisdictions simply to provide a tax break for their residents. The result of this trend was a depletion of federal revenues with Congress getting no credit with the voters for the implicit tax reduction -- a lose-lose situation for federal politicians. The 1948 tax act ended the tax disparities between common law and community property states by extending marital income splitting to married persons residing in common law states.

The extension of marital income splitting to the common law states was not the only method available to Congress for ending the geographical disparities in the taxation of equal-income married couples. An alternative method not accepted by Congress was the retention of separate filing and the adoption of a federal income attribution rule for wage income that ignored community property laws. This approach to geographical uniformity is used by Canada, which taxes wages to the wage earner notwithstanding the community property laws of its province of Quebec. The other major alternative to income splitting was the adoption of a marital income aggregation rule without income splitting. The US Treasury, acting on the advice of leading public finance economists, promoted this alternative during World War II but found strong resistance in Congress. This marital unit alternative was promoted for Canada in the 1960s by the Carter Commission and retained broad support among public finance economists into the 1970s.²⁶

²⁶For a criticism of the Carter report for its advocacy of marital income aggregation without splitting, see Michael J. McIntyre, 'What Should Be Redistributed in a Redistributive Income Tax? Retrospective Comments on the Carter Commission Report,' in *The Quest for Tax Reform: The Royal Commission on Taxation Twenty Years Later*, W. N. Brooks, ed. (1988).

The geographical nonneutralities of pre-1948 law undoubtedly put family taxation issues high on the Congressional tax reform agenda. The congressional choice in favor of income splitting, however, was also a rejection of the distinctions between earned income and investment income and between husband's income and wife's income that are inherent in a separate filing system. Congress concluded, properly in my opinion, that disparities in the treatment of marital partners due to the source of their income were not an appropriate features of an income tax. The goal of the 1948 reform, largely realized, was the elimination of such source distinctions as well as the elimination of geographical distinctions.

B. US Political Environment of the 1970s -- Revival of Interest in Separate Filing

1. Background

From 1948 until the mid-1960s, the US political commitment to income splitting was largely unchallenged. As the 1960s drew to a close, however, income splitting fell under attack, largely because of allegations that it was unfair to single persons. Commentators generally agreed that the tax burden on a single person at a particular income level ought to be greater than the burden imposed two marital partners with the same total income. Some analysts contended, however, that the benefits that marital partners obtained from income splitting were too large. The comparison typically made was between two marital partners with one wage earner (a one-earner couple) and a single individual with the same wage income. It was shown that the tax paid by the single individual could be as much as 140 percent of the tax paid by the one-earner married couple with the same income.

That single individuals would pay 140 percent of the tax paid by a married couple does not necessarily reflect some problem with US tax policy. As noted above, almost all US analysts agreed at that time that a single individual ought to pay something more than two married individuals having the same aggregate income. The question for debate was how much more. That question was a difficult one, and no one had a good standard for answering it. Single individuals, nevertheless, did have solid grounds for complaint. During the 20 years following the extension of income splitting to common law states in 1948, the United States had made no changes in the width of the tax rate brackets. Those brackets, adopted during World War II, were designed to force Americans enjoying large profits during the war to contribute large sums to the public fisc. By the late 1960s, inflation and economic growth had radically changed the political significance of those brackets. By almost any standard, the US tax system had become too progressive in the middle income range. A proper response to the complaint of single individuals about paying too much relative to equal-income married couples would have been to flatten the rate scale in the middle range, preserving the high rates for high-income taxpayers.

Congress did respond to the political complaint of single taxpayers, but not with general rate relief. Taking the narrowest possible approach to the issue presented to it, Congress adopted in 1969 a special tax rate for single individuals that guaranteed that they would never pay more than 120 percent of the tax imposed on marital partners having the same aggregate income. This 120-percent rule obviously was not strongly rooted in tax theory. The revenue cost of introducing the 'singles' rate schedule was modest -- on the order of \$200 million per year in forgone revenue. The cost was low because most US taxpayers were married, and the minority who were unmarried were clustered at the low end of the income scale. Despite the low cost, the implications of this change for family taxation in the United States were very large.

Prior to the 1969 reforms, the US tax code provided two rate schedules. The primary rate schedule was used both by married persons and by most single persons. A secondary rate schedule, called the 'heads of households' schedule, extended some of the benefits of income splitting to one-parent families. That schedule was adopted without much controversy in 1951 on the theory that marital income splitting generally provided a benefit to two-parent families, notwithstanding the fact that marital income splitting was equally available to childless couples and to couples with adult children no longer dependent on their parents.

Under the system adopted in 1969, marital partners became taxable on their aggregate incomes as a unit, under a rate schedule with brackets exactly twice as wide as the brackets under the old rate schedule. The equivalence of income splitting on a single-width rate schedule and marital unit taxation on a double-width schedule is well known; indeed, for administrative reasons, the US tax authorities had included a double-width marital rate schedule in the tax return booklet distributed to taxpayers. The brackets on the marital unit schedule, however, were less than twice as wide as the brackets on the newly created schedule for single persons. The effect was that two marital partners having approximately equal separate incomes would pay less in tax if they were allowed to file separate tax returns and to compute their separate tax liabilities on the new singles schedule. The only way to do so, however, was to terminate their marriage.

The tax savings that marital partners could obtain from getting a divorce and filing separately came to be called a 'tax on marriage' or a 'marriage penalty.' Some analysts sought to justify this extra burden resulting from marriage, but none of those attempts was very convincing.²⁷ The taxpaying public concluded, correctly in my view, that the tax on marriage was unfair. To eliminate the marriage penalty, Congress had two choices, both of which it

²⁷The arguments made in favor of some extra burden on married couples are roundly criticized in McIntyre & Oldman (1977), *supra* note 2, at 1607-1624.

found unattractive. The first was to incur the wrath of single people by returning to full income splitting. The second was to incur the wrath of a substantial majority of married people by adopting a separate filing system. Although it made some changes in family taxation rules in the 1970s, it left in place the basic structure of the 1969 reform and avoided making a definitive choice between the proponents of separate filing and the proponents of income splitting.

2. Conflict Among Goals

In proposing the 1969 reforms of family taxation, tax specialists in Congress and the Nixon Treasury candidly acknowledged that the 120 percent rule described above, with its resulting special rate for single persons, was no more or less than a political compromise between competing viewpoints. They contended that the American public had shown support for an income tax that was progressive, that would impose equal taxes on equal-income married couples, and that was marriage neutral. They correctly understood that no income tax could satisfy all three of these criteria.²⁸ What they did not seem to realize is that this conflict gives cause for rethinking one or more of these goals. As I have noted elsewhere, 'family taxation rules designed according to logically inconsistent criteria are destined to be complex, ineffective, and unprincipled.'²⁹

The goal of progressivity is a controversial but defensible principle of distributive justice. That goal is typically achieved through the use of graduated rates. It has received broad political support in the United States for over eight decades, although it is currently under attack by supporters of the so-called flat tax. Despite their rhetoric to the contrary, however, even the flat-tax supporters would pursue a redistribution tax policy in favor of low-income individuals -- a policy they would implement through large personal exemptions and dependency exemptions rather than through a graduated rate structure.³⁰

What led to the compromise legislation of 1969 was the irreconcilable conflict between the goal of imposing equal aggregate tax burdens on equal-

²⁸See Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, *Tax Treatment of Single Persons and Married Persons Where Both Spouses Are Working: Hearings Before the House Comm. on Ways and Means*, 92d Cong., 2d Sess. 73-95 (1972); see also Boris Bittker, 'Federal Income Taxation and the Family,' *27 Stanford Law Review* 1389-1463 (1975) at 1419.

²⁹McIntyre (1985), *supra* note 3 at 338.

³⁰Of course a personal exemption is tantamount to a zero tax rate on the first layer of income. The use of exemptions does not limit progressivity, at least in theory. The combination of a high zero bracket and a high flat rate (e.g., 100%) can result in a steeply progressive tax system.

income married couples and the goal of marriage neutrality. These goals are incompatible because they rest on inconsistent factual premises.

Marriage neutrality makes sense as a tax policy goal only on the factual premise that the marriage of two individuals typically has no important economic consequences for them. If marriage typically is accompanied by changes in the well being of the marital partners, those changes presumptively ought to be taken into account in fixing their tax burdens. In contrast, equal treatment of equal-income married couples makes sense only on the factual premise that marital partners typically pool resources or otherwise enjoy comparable standards of living. This factual premise is the exact converse of the premise underlying the goal of marriage neutrality.

Given the conflict in premises described above, the choice between the two goals should not be difficult to make, at least in theory. To a large extent, the choice simply depends on a factual inquiry. As discussed in section I, above, the exact sharing practices of married couples is not known and may be unknowable. It is obvious, however, that the factual premise underlying the goal of marriage neutrality -- that marriage does not have significant economic consequences for most marital partners -- is false for Australia and the United States. It is also obvious that the premise underlying the goal of equal treatment of equal-income married couples, although unproven, has a substantial basis in fact.

Of course analysts might argue for marriage neutrality on social policy grounds unrelated to taxation. The case for such neutrality on social policy grounds, however, is far from obvious. I do see some important advantages to society in avoiding tax provisions that result in marriage penalties.³¹ Marital income splitting, however, never produces a marriage penalty. If it is to be condemned for its lack of marriage neutrality, it is because of the incentive to marry that it provides. It should go without saying that marriage penalties and marriage bonuses are not moral or social equivalents. Most social commentators, concerned about the effects on children of high illegitimacy rates, tend to favor social measures that encourage marriage. Indeed, I always felt that US proponents of separate filing advanced the political prospects for marital income splitting when they angrily denounced income splitting on the ground that it gave some unmarried couples an incentive to marry.

³¹The marriage penalties of US law fortunately appear to be having little or no effect on the decision of American couples to marry. See David L. Sjoquist & Mary Beth Walker, 'The Marriage Tax and the Rate and Timing of Marriage,' 48 *Nat'l Tax Journal* 547-558 (1995) (finding no effect of marriage penalty on marriage rate) and James Alm & Leslie A. Whittington, 'Does the Income Tax Affect Marital Decisions,' 48 *Nat'l Tax Journal* 565-572 (1995) (finding strong evidence of a small but statistically significant impact of marriage taxes on the marriage rate).

3. Resurgence of Support for Separate Filing

The US political and academic consensus in favor of income splitting dissolved in the 1970s. By the end of the 1970s, a substantial portion of the US academic community favored some form of separate filing.³² Separate filing also enjoyed considerable political support. Set forth below are some of the major factors that led to those developments.

Many tax specialists came to support separate filing in the 1970s because they believed that such a system would enhance the economic efficiency of the income tax. As discussed in section II, above, several studies published in the 1970s tended to show that the labor supply response of married women to the wage rate was fairly elastic. These studies were thought to make a case on efficiency grounds for a separate filing system. The development of that case virtually guaranteed substantial support for separate filing among the upcoming generation of economists, who have tended, with many notable exceptions, to give decisive weight to efficiency issues in formulating their recommendations on tax design.

Separate filing was also promoted on fairness grounds. The fairness case in the 1970s for separate filing was essentially a negative case. Its supporters generally viewed it as the default system, to be adapted in the absence of compelling arguments for some alternative. They correctly viewed the existing joint filing system as unfair to those married couples subject to a marriage penalty. They contended, incorrectly in my view, that a return to full income splitting would be unfair to single individuals. Although they appreciated the need for geographical uniformity, they felt that such uniformity could be achieved by requiring married individuals residing in a community property state to report their income without reference to community property laws.

The political prospects for separate filing were enhanced in the 1970s by its association with the movement for equal rights for women. In my view, this

³²Some analysts would have retained marital joint filing as the general rule but would have allowed marital partners the option of filing separately. This hybrid approach would have eliminated most marriage penalties, although it would have continued so-called marriage bonuses. Advocates of income splitting generally oppose granting such an election because they believe it is unfair to low- and moderate-income marital partners having substantially uneven separate incomes. As discussed in the text, an election to file separately would be acceptable if the marital rate schedule provided full income splitting for low- and moderate income married couples. In that event, only well-to-do marital partners having fairly equal separate incomes would make the election. In their case, the election would be appropriate in that the separate incomes of the electing spouses would provide a reasonable proxy for the amount of their marital sharing.

association is unjustified.³³ Whether justified or not, however, it was a clear reality of the 1970s and lingers with substantially reduced force into the 1990s.

Politics is more than demographics, but demographic trends clearly count for something in the political arena. In 1948, nearly two-thirds of married couples had only one breadwinner. The importance of one-earner couples as voters undoubtedly had some impact on the decision of Congress to adopt legislation that favored their economic interests. By 1970, the tables were turning. The two-earner couple was in the ascendancy, representing nearly 50 percent of the taxpaying population. And the trend toward even higher participation rates for married women in the workforce was clear to everyone. In such circumstances, one would expect some improvement in the legislative prospects of a tax reform that would be more favorable to two-earner couples than existing law. Indeed, the surprise is that the supporters of separate filing were unable to convert those improved prospects into major legislative gains.

Although the supporters of separate filing won no clear legislative victories in the 1970s, they did have some modest successes. Inflation during the 1970s was high by historic US standards. Because the tax code was unindexed during that period, most taxpayers would have experienced real increases in their tax burdens as a result of merely nominal increases in their taxable income unless Congress granted them tax relief. Congress did adopt several ad hoc tax cuts during the 1970s. The relief, however, was not granted across the board. The per capita personal exemptions and dependency exemptions were frozen at US \$600 per individual, resulting in a significant diminution of their real value. Low- and middle-income relief was granted instead through a low-income allowance or standard deduction. This relief was not granted on a per capita basis. The result was that single persons received larger per capita benefits than married persons. Several other features of the US tax system were modified similarly to give a relative advantage to single individuals.

C. Revival of Income Splitting in the 1980s

Although the proponents of separate filing appeared poised for political success at the end of the 1970s, their fortunes reversed decisively in the 1980s. The major factors that led to this result are discussed below.

³³The US women's movement in the 1970s was led largely by unmarried women and married women working full-time in the labor market. Some of these leaders had the unpleasant habit of condescending to and even stigmatizing married women who worked in the home. By the 1980s, however, mainstream women's groups were emphasizing the importance to women of having choices without intentionally stigmatizing the choice of the full-time homemaker.

The demise of separate filing as a viable political option for the 1980s was probably sealed when Congress adopted the 1981 tax act. That legislation cut income taxes sharply, thereby creating very large projected federal budget deficits for the indefinite future. For the rest of the 1980s, tax reform proposals that would result in significant tax reductions became nearly impossible to enact. All of the politically viable proposals for adopting a separate filing rule, however, would have resulted in significant tax revenue losses.

The 1981 act did cut significantly the marriage penalties of existing law by granting to two-earner couples a deduction equal to ten percent of the wages of the lower-earner spouse. This ad hoc rule was promoted primarily by separate filing advocates and was repealed in 1986 when the joint filing advocates gained the upper hand. It had the effect, nevertheless, of undermining the political prospects for separate filing, which were fueled in substantial measure by public dissatisfaction with the marriage penalties of existing law.³⁴

In 1986, Congress engaged in the major overhaul of the US tax system that led to enactment of the landmark Tax Reform Act of 1986. This overhaul should have provided a moment of opportunity for proponents of separate filing. By that time, however, the bloom was off the separate-filing rose. It had lost much of its cache among academics and the tax professionals in Treasury and Congress.³⁵ It was receiving mixed reviews from organized women's groups. As mentioned above, the politically sensitive marriage penalty problem had been defused by the enactment of the two-earner deduction. More fundamentally, the individualistic perspective of the separate filing

³⁴In the 1970s, some commentators argued for a return to the pre-1948 system on the ground that it would encourage the trend toward the adoption of state community property laws that was truncated by the extension of full income splitting to the common law states. That argument lost steam, however, as common law states adopted 'equitable distribution' rules that provide for substantial sharing of marital assets on dissolution of a marriage by divorce or death. The equitable distribution rules generally are at least as favorable to wives as the modernized community property rules. The premise of marital sharing on which the case for equitable distribution (and modern community property law) is grounded also underlies the case for joint filing with income splitting.

³⁵Proponents of separate filing maintained solid support among many US academics throughout the 1980s, and that support remains strong today. But the emerging consensus of the 1970s among tax professionals in favor of separate filing clearly dissolved. Some academics, myself included, and many staffers in Treasury and Congress found the affirmative case for income splitting set forth in section I to be persuasive. Other tax professionals turned sour on separate filing as they discovered that it would create its own set of marriage tax problems and would present substantial problems for the tax administrators. For an influential argument for income splitting on utilitarian grounds, see C. Eugene Steuerle, 'The Tax Treatment of Households of Different Size,' in *Taxing the Family* 73-97, R. Penner, ed. (1983); see also Geoffrey Brennan & Michael Brooks, 'Towards a Theory of Family Taxation: The Equity Dimension,' in *Taxation Issues of the 1980s* 119-132, J. Head, ed. (1983).

advocates fit badly with the pro-family political position initially staked out by the Republican party but quickly imitated by many Democrats.

Of course the tax reform agenda proposed by most separate filing advocates was not anti-family, notwithstanding its individualistic perspective. The underlying theory, rigorously applied, however, would result in various tax measures that would disadvantage families.

First, as discussed above, separate filing advocates ought to favor a 'double tax' on intra-marital gifts.³⁶ The double tax argument is equally applicable to sharing with children. The logic of the control principle is that the costs of raising children are a form of personal consumption; those costs not only should be fully taxable to the parents, they also should trigger the double tax on gifts. Fortunately, separate filing proponents making reform proposals in the political arena typically were able to overcome their commitment to a false tax theory and have advocated some allowances for children.³⁷

Second, under the theory underlying separate filing, the earner in a one-parent family should be equated for tax purposes with a single person without dependents. Many separate filing advocates were certainly sympathetic to the harsh financial circumstances faced by many low- and middle-income unmarried mothers. Whatever relief they proposed for such individuals, however, was based on feelings of sympathy and was not grounded on tax theory.

Third, and perhaps most embarrassing from the political perspective of the mid-1980s, separate filing advocates contended that mothers who stayed at home taking care of their children should be make taxable, at least in principle, on the imputed value of their child-care and homemaking services. They never called for a direct tax on such imputed income, but they did devise various tax credit schemes for two-earner couples that were premised on the belief that imputed income from homemaking ought to be taxable.

The Tax Reform Act of 1986 disappointed separate filing advocates by retaining the joint filing rule. In addition, it made several changes, some fairly subtle and unnoticed in the political debates, some major, that moved the US tax system closer to the ideal championed by the advocates of marital income

³⁶Imposing a double tax on one-earner marital couples would create a major marriage penalty because a government could not administer a double tax on unmarried couples. This marriage-penalty problem may seem illusory because no government could enact an explicit double tax on marital partners. Indirect methods for imposing such a tax, however, are not unthinkable.

³⁷For an early defense of liberal allowances for children on income splitting grounds, see McIntyre & Oldman, *supra* note 2, at 1602-1607.

splitting. Among other things, it greatly liberalized the deduction for dependent children (up from around \$1,000 to \$2,000, with indexing for inflation). The effect of this change was to move more closely to the distribution of tax burdens that would result from partial income splitting within the family. It also restructured the tax rate schedules so that the schedule for married couples at low and middle income levels was somewhat closer to a full splitting schedule than prior law.³⁸ This change, coupled with the widening of the tax brackets, reduced marriage penalties and allowed for the repeal of the special deduction for two-earner couples.

Although the result of the 1986 reform is properly viewed as a victory for joint filing proponents, it was hardly a decisive victory. The US system remains a hybrid -- an uneasy compromise between the separate filing and joint filing perspectives.

D. Backsliding in the 1990s

The political prospects for separate filing seem to have been revived in the early 1990s. The tax bill passed by the Republican-controlled Congress in late 1995 and vetoed by President Bill Clinton would allow marital partners suffering a marriage penalty to file separately as single individuals. This measure is estimated to cost around US \$1.5 billion per year in forgone revenue. It appears to be a direct response to the increases in marriage penalties for high-income married couples resulting from the tax increase adopted by the Democratic-controlled Congress in 1992.

The 1992 tax act imposed new marriage penalties on married couples with an aggregate income of over US \$250,000. Those penalties result from the addition in 1992 of a 39.6 percent tax bracket for both married couples and single individuals having taxable incomes over US \$250,000. To avoid introducing new marriage penalties into the tax system, Congress had two choices, both of which it found unpalatable. It could have raised the starting point of the 39.6 percent tax bracket for married couples from US \$250,000 to some much higher number (to US \$500,000 to achieve no new marriage penalty). Alternatively, it could have lowered the starting point of the 39.6 percent bracket for single individuals below US \$250,000 (to US \$125,000 to achieve no new marriage penalties). Neither alternative was politically attractive. Lowering the bracket point for single individuals substantially below US \$250,000 would have been inconsistent with the Clinton administration's pledge to raise taxes only on the rich. Raising the bracket

³⁸Some of the reform proposals given serious consideration by Congress in 1985 and 1986 provided for less marital splitting than existing law. For criticism of those proposals, See Michael J. McIntyre, 'Fairness to Family Members Under Current Tax Reform Proposals,' 4 *American Journal of Tax Policy* 155-192 (1985), reprinted in revised form in *Tax Notes*, May 19, 1986, pp. 713-24.

point for married couples would have reduced the revenue yield substantially, thereby jeopardizing the Clinton administration's deficit reduction policy.

Many low-income taxpayers have also seen a marked increase in their marriage penalties during the early 1990s. Those marriage penalties are the result of certain design features of a tax credit available to low-income households, called the Earned Income Credit. Although the Earned Income Credit dates back to the 1970s, the tax benefits it provides were increased substantially in the 1980s and again in the 1990s. Initially the credit was only available to taxpayers having dependent children. In the 1990s, the credit was extended to certain individuals without dependents. The credit is phased out as income rises, and the phase-out rules create major marriage penalties. Those penalties increased when the amount of the credit was increased, and they increased sharply when the credit was extended to individuals without dependents. The Republican majority in Congress would deal with these marriage penalties by repealing the Earned Income Credit.

American academics have shown a renewed interest in the separate filing approach to family taxation in the 1990s. Several dozen recent articles have responded to the arguments made for income splitting and have criticized the family taxation features of current US law.³⁹ They give heavy emphasis to the alleged efficiency costs of joint filing. In some cases, they challenge the assumption of marital sharing that underlies the case for income splitting. Like the separate filing literature of the 1970s, the current articles have continued to treat separate filing as the default system. Most of these analysts give only passing attention to developing normative tax policy grounds for taxing wages to the wage earner and property income to the nominal property owner.

IV. Some Lessons for Australia

Separate filing was adopted in the United States at a time when women were not allowed to vote and married men residing in community property states were legally permitted to manage the money of their marital community without serious regard for the financial interests of their spouse. Australia adopted its separate filing rule around the same time. I do not know much about the status of women in Australia at that time. I am confident, however,

³⁹See, e.g., Kornhauser (1993), *supra* note 3; Edward J. McCaffery, 'Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code,' 40 *U.C.L.A. Law Review* 983-1060 (1993); Lawrence Zelenak, 'Marriage and the Income Tax,' 67 *Southern California Law Review* 339-405 (1994). Professor Kornhauser alleges that marital couples do not share the benefits of marital income. Professor Zelenak believes that sharing of benefits is commonplace but that separate filing is justified under the control principle. Professor McCaffery argues, in effect, that the findings of game theory undermine the relevance of actual patterns of sharing for purposes of designing family taxation rules.

that the Australian family tax rules developed eight decades ago are ripe for reexamination.

That reexamination may lead to a celebration of the status quo. Many old tax rules stand up well to the test of time. For example, the US commitment in 1913 to the principle of taxation without reference to source remains attractive, even if that principle tends to be honored mostly in the breach. The current interest of Australians in reexamining the old separate filing rule is a positive development, whatever the outcome. The United States certainly benefitted from the reexamination of its joint filing system that took place in the late 1970s and early 1980s, notwithstanding the fact that it elected to retain its joint filing system.

For reasons explained above, I favor joint filing with full income splitting for low- and middle- income marital partners under the economic, social, and political conditions that currently exist in the United States. My commitment to that position, however, is not an absolute one. All family taxation systems involve some tradeoffs, and the tradeoffs are dependent on the political options open to a country. In my academic writing on family taxation issues, I have been much more concerned with developing a methodology for judging the merits of alternative family taxation schemes than with promoting any particular scheme.⁴⁰

As an outsider to Australia politics, I am not in a position to judge whether the Opposition Party's current proposal for marital income splitting has important support or is just a passing fancy. I predict with some confidence, however, that Australia will not adopt a marital income splitting rule without a lot more public efforts at building a consensus for that reform than I have witnessed so far. In my experience, governments do not switch easily from a separate filing system to a joint filing system, or vice versa. The inertial forces preserving the existing regime, whatever it may be, tend to be powerful. I was heavily involved in a tax reform project in New York State from 1985 to 1987 that resulted in a successful transition from a separate filing system to a joint filing system with full income splitting. I was amazed at the success of that project in 1987, and I continue to be amazed.

Those of us working on family taxation reform in New York recognized that consensus building was a precondition for any major change in family taxation policy. The state legislative was divided, with the House under the control of the Democrats and the Senate under the control of the

⁴⁰For a presentation of my methodology, see Michael J. McIntyre, 'Implications of U.S. Tax Reform for Distributive Justice,' 5 *Australian Tax Forum* 219-256 (1988); revised and reprinted in 'Contributions Made by the US Tax Reform of 1986 to Distributive Justice,' Chapter 2 of *Flattening the Rate Scale: Alternative Scenarios and Methodologies* 33-74, J. Head & R. Krever, eds. (1990).

Republicans. Neither party was likely to support a shift to marital income splitting if any of its major constituencies opposed such a shift, and support from both parties was obviously necessary for the reform to go forward. In that political environment, the challenge for the designers of the reform plan was to make sure that it advanced important positive goals of both political parties and minimized their political risks.

The reform package that New York ultimately enacted had special appeal to the Republican leadership of the New York Senate because it gave meaningful tax relief to upper-middle income one-earner married couples. These couples tended to vote Republican in New York. The package had special appeal to the leadership of the New York House because it gave meaningful tax relief to predominantly Democratic constituencies -- one-parent families, low-income taxpayers, and middle-income married couples. Both sides favored the administrative simplicity achieved under the reform package, and both sides agreed that the recipients of relief under that package were deserving. The Republicans were fairly enthusiastic about the fairness case for low-income families and for one-earner households. The Democrats tended to view the relief granted to upper-income one-earner couples as an appropriate adjustment for the tax increases that those taxpayers otherwise would suffer from the impact on New York tax law of the base broadening measures included in the 1986 federal tax reforms.⁴¹

At the national level, reform of US family taxation rules also has seemed to require bipartisan support. When income splitting was adopted in 1948, the White House was controlled by the Democrats and the Congress was controlled by the Republicans. In 1969, when the United States abandoned full income splitting in favor of a marital unit system with only partial income splitting, the White House was controlled by the Republicans and the Congress was controlled by the Democrats. The major reforms of 1986 took place with a Republican in the White House and the Democrats in control of Congress. In contrast, the Democrats were unable to push through any family taxation reforms in the late 1970s, when they controlled both branches of government, and the Republicans had no more success with their reform agenda in the early 1980s, when they controlled the White House and had a voting majority on tax matters in the Congress.

If the two major political parties in Australia should become interested in forging some consensus on family taxation policies, they might start by embracing a pro-family agenda. That agenda is easy to embrace as long as its

⁴¹For an account of the successful New York reform, see Michael J. McIntyre, 'Tax Justice for Family Members After New York State Tax Reform,' 51 *Albany Law Review* 789-816 (1988). The driving force behind the New York tax reform was Richard D. Pomp, Professor of Law at the University of Connecticut. Professor Pomp served as the Director of the New York Tax Study Commission, which designed the reform package. I served as a consultant to the Tax Study Commission.

content is kept sufficiently vague. Filling in the agenda will almost certainly lead to some conflicts. Based on the US experience, I offer some tentative suggestions on how a consensus reform agenda might be developed.

First, I suggest that Australia reject outright any form of joint filing that does not provide for full income splitting at low- and middle-income levels and that does not eliminate marriage penalties at high-income levels. The US system of joint filing with partial income splitting adopted in 1969 has generated considerable controversy and opposition, largely because of the marriage penalties that it produces. Full income splitting is a type of individual filing. It simply uses a splitting formula to allocate income to particular taxpayers instead of the attribution rules currently used by Australia. A 50/50 splitting formula is not perfect and sometimes produces unwarranted results. The deviations from fairness, however, are almost always very modest. In contrast, the outmoded attribution rules that attribute wages to the wage earner and property income to the nominal property owner systematically produce improper results, and the deviations from fairness are major.

Second, I urge Australian policy makers to give a high priority to the design of appropriate low income relief. As the US experience with the Earned Income Credit illustrates, low-income relief measures can create marriage penalties and welfare traps if they are not well designed. My experience in New York suggests that per capita relief provided to families has three outstanding virtues. It is simple for taxpayers to understand, it is fairly simple to administer, and it eliminates all marriage penalties and most of the classical welfare traps. It typically would cost more than family relief measures designed to take into account the economies of joint living that some low-income married couples may enjoy. The extra cost, however, is well worth paying for the gains in fairness, accountability, and stability.

Third, I suggest that Australian policy makers identify the family groupings within the low and middle classes that have been put most at risk by the social and economic changes of the past two decades and design tax measures to protect the individuals in those groupings. In the United States, and I suspect in Australia as well, the two groupings most at risk are low- and middle-income one-parent families and one-earner couples. These are the two groupings that would benefit the most from the income splitting approach I favor. The benefits to one-earner married couples are obvious. The extent to which one-parent families would benefit would depend on how the new system is designed. I would favor a separate rate schedule for one-parent families that incorporated realistic assumptions about income splitting within such families. I also would favor making alimony payments deductible to the

payor and taxable to the payee -- an extension of income splitting to formerly married spouses.⁴²

Fourth, I suggest that Australian policy makers look behind the facade of separate filing that appears in the statute to see the reality of self-help income splitting that almost certainly is going on between high-income marital partners. My experience in New York convinces me that a tax department is nearly powerless to prevent large numbers of high-income married taxpayers from shifting gross income and deductions in a way that comes very close to achieving full income splitting. New York extended full income splitting to all married couples, without the income limitation I have suggested above. The simulations of revenue cost undertaken by the New York Tax Study Commission indicated that the revenue cost to the state of extending income splitting to high-income married couples was a small fraction of the amount that one would estimate from looking only at the statutory rules. I suspect that gaming of the separate filing rules by high-income taxpayers is commonplace in Australia. I see no good policy reason why Australia should grant income splitting, in effect, to the well-to-do while denying it to those of modest means.

Fifth, I would urge Australian policy makers to take a long view. The basic design of country's family taxable system is difficult to change and will not change often.⁴³ Choices regarding the design features of family taxation rules should be based on long-term values. They should not be based on political fads or on economic studies that perhaps have some current validity but are unlikely to be valid in the future as marital relationships become more equal.

Achieving major reform of family taxation in Australia will not be easy. The debates over alternative plans are likely to be spirited, and rightly so, for important values are at stake. I make a plea here for some modest degree of civility in those debates. My experience in the United States suggests that discussions of family taxation can get overheated and degenerate into name calling. Just as countries do not change their position on family taxation very

⁴²Australia follows the logic of separate filing and does not currently offer a deduction for alimony payments. In general, the deduction would benefit the recipient because, by increasing the amount of the payor's after-tax income, it allows for larger alimony payments. That is, the extra tax paid by the recipient is almost always less than the increase in the alimony payment permitted by giving the payor a deduction because alimony typically flows from the higher earner to the lower earner. In the United States and elsewhere, the level of alimony payments set by the courts take this tax savings to the payor explicitly taken into account. A change to a taxation-of-the-payee rule in Australia would create a problem for individuals currently receiving alimony. A solution might be to allow the payee to elect to be taxable, thereby giving the payee leverage to negotiate a higher alimony payment.

⁴³In John Head's phrase, fundamental family taxation rules are quasi-constitutional. See John G. Head, 'Tax Reform: A Quasi-Constitutional Perspective,' paper presented at a conference on 'Tax Avoidance and the Rule of Law', Sydney, May 1995.

often, so also most academics have some rigidities on this topic. They will not leave their separate filing or joint filing church without an epiphany. All of us need to show some kindness, therefore, to the idiots who disagree, however irrationally, with our positions on family taxation. We need to show them the consideration that we typically show to devote individuals who hold religious beliefs that diverge from our own.

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