

Income splitting for families with children

A government tax policy discussion document

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First published in April 2008 by the Policy Advice Division of Inland Revenue, PO Box 2198, Wellington.

Income splitting for families with children: a government tax policy discussion document.
ISBN 978-0-478-27163-8

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CHAPTER 1

Introduction

- 1.1 The possibility of allowing families with children to split their income for tax purposes is the subject of this discussion document, which is a direct result of a commitment made in the confidence and supply agreement between Labour and United Future.
- 1.2 The New Zealand tax system works on an individual basis, meaning that individuals are taxed on the income they earn. Income splitting, in its simplest form, would treat the family rather than the individual as the taxable unit. Family income would be split equally between parents for tax purposes, which would mitigate the effect of progressive tax rates – resulting in tax savings for many families.
- 1.3 The discussion document invites readers' views on whether introducing income splitting of the kind discussed here would be the best way to provide additional government support for families with children, provided they think additional support is needed. And if income splitting is not the answer, what other options should be considered?
- 1.4 The discussion document limits its consideration of income splitting to families with children, even though several countries allow income splitting for all couples. There are two reasons for that limitation: first, supporting families with children is one of the main priorities for this government, and, second, the fiscal cost of allowing income splitting for all couples would be very high.

Working for Families tax credits

- 1.5 Working for Families tax credits are the most notable way in which the government provides support for families with children. These tax credits help families by targeting support on the basis of family income. The level of support provided depends on the number and age of children in the family and whether the family is in work. As a result, Working for Families provides equal support to families that have the same family income, work status and number and age of children.
- 1.6 By the end of last year about 360,000 families were receiving assistance through Working for Families. On average, each family received \$5,600 in assistance.

Choices for families

- 1.7 The government is also committed to providing real choices to parents and carers in combining their work with their caring roles. Its “Choices for Living, Caring and Working” ten-year action plan, developed in 2006, involves initiatives in a number of areas that meet the needs of families as they move through their lives. These include parental leave, early childhood education, out-of-school services, the development of a carers’ strategy, and encouraging flexible work practices.
- 1.8 By helping single-earner families, income splitting may enhance the choices available to parents by helping to ensure that it is a viable option for one parent to stay at home, or work part-time, to care for their dependent children.

How income splitting would work

- 1.9 There are two broad ways to achieve income splitting for tax purposes. The first is to aggregate family income and (as the name suggests) split it evenly between the two partners. Total tax liability would then be determined by applying the tax rate schedule to the split level of income.
- 1.10 That would mean, for example, that a family with one partner earning \$80,000 a year and the other partner earning \$20,000 a year would be taxed as if both partners earned \$50,000 a year. Thus the highest tax rate applying to their joint income would be 33%, rather than the top rate of 39% that the high earning partner would attract under individual taxation. That would mean a tax saving of \$3,360 a year for the family.
- 1.11 The second way of achieving income splitting, and with the same effect, would be to provide a separate tax rate schedule for families, one where the tax-rate thresholds were twice as high as the thresholds that apply for an individual.
- 1.12 Whichever method was used, allowing income to be split on a 50/50 basis would change the taxable unit from the individual to the couple or family.
- 1.13 Possible variations of income splitting might include income splitting by more than two family members – for example, by including dependent children, elderly and disabled family members. There might also be a case for allowing only a 70/30 or 60/40 split rather than a 50/50 split.
- 1.14 Other important questions are how “family” should be defined for purposes of income splitting; what age restriction should be placed on children in the family for it to qualify for income splitting; and whether income splitting should be optional or compulsory.

- 1.15 These considerations are discussed in chapter 3, which outlines a possible approach to income splitting for New Zealand.
- 1.16 Chapter 4 looks at the impact of income splitting on families in terms of who would benefit financially and how effective marginal tax rates would change as a result of income splitting.

Criteria for assessing income splitting

- 1.17 Chapter 5 discusses the merits of income splitting against a set of criteria, including whether it would be complementary to the government's "Choices for Living, Caring and Working" action plan.
- 1.18 The main criterion, however, is fairness: would the introduction of income splitting for families with children lead, at a reasonable fiscal cost, to a fairer outcome for families than is currently the case?
- 1.19 It is debateable whether the introduction of income splitting would be fairer on families with children. That is highlighted in the example of two families with one child of the same age. Both families earn \$100,000 in total, but in Family 1 each partner earns \$50,000, while in Family 2 one partner earns \$100,000 and the other is not in paid employment. These families will receive the same level of support through Working for Families, but Family 2 will face a higher tax burden under the present system because some of its income is taxed at a higher rate than Family 1's income. If income splitting were to be adopted, Family 2 would pay less tax than it does now.
- 1.20 On the other hand, perhaps Family 2 is better able to pay more tax than Family 1 and so should face a higher tax burden. It may be that the partner in Family 2 who is not in paid employment is able to engage in valuable activities at home, such as full-time childcare, which neither partner in Family 1 can do.
- 1.21 Other important criteria are:
- Efficiency – would income splitting bias people's decisions to produce, consume, work, save and invest?
 - Simplicity – would income splitting be easy to understand and comply with, or would it create significant additional compliance costs for people?
 - Administrative costs – would income splitting be compatible with the current tax system, and would it be costly to implement and administer?

Timing of any possible changes

- 1.22 If submissions show strong support for allowing income splitting for families with children, the government will look at developing detailed proposals for further consideration, although that would not occur until early in 2009.

How to make a submission

- 1.23 The government invites submissions on the questions posed in this discussion document, as well as those on any other measures that could support families with children.

Special points for submissions

The government invites readers' views on the following matters:

- Is income splitting the best way to provide additional support for families with children?
- If not, what other options could be considered to provide additional support for families with children?

If income splitting is favoured:

- Should the split be on a 50/50 basis, a 70/30 basis or in some other way?
- How should a "family" be defined?
- What restrictions should be placed on the children's ages for a family to be eligible?
- Should it be optional or compulsory?

- 1.24 Submissions should be made by 30 June 2008 and can be addressed to:

Income splitting
C/- Deputy Commissioner
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington

Or email: policy.webmaster@ird.govt.nz with "Income splitting" in the subject line.

- 1.25 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for officials from Inland Revenue and the Treasury to contact those making submissions to discuss their submission, if required.
- 1.26 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Accordingly, those making a submission who think that any part of it should be properly withheld under the Act should indicate this clearly.

CHAPTER 2

Some useful information

- 2.1 This chapter provides background information relevant to the discussion in chapter 3 of a possible approach to the use of income splitting in New Zealand.

Current support for families with children in New Zealand

- 2.2 The government is committed to supporting families with children and, as such, provides a number of measures to assist them.
- 2.3 The Working for Families package, introduced in 2005 and extended in 2007, provides significant financial support to families with children. The package consists of four tax credits – the family tax credit, in-work tax credit, parental tax credit and minimum family tax credit; the childcare and Out of School Care and Recreation (OSCAR) subsidies; and the accommodation supplement. The accommodation supplement assists low-income and middle-income families with housing costs irrespective of whether they have children. The other measures are all targeted at families with children.
- 2.4 The main goals of Working for Families are to ensure income adequacy, to make work pay, and to support people into work. The measures are targeted at low-income and middle-income families: the minimum family tax credit ensures working families have a specified minimum level of income, while the other three tax credits abate as family income increases.
- 2.5 The family tax credit and the in-work tax credit are paid for families that have children under 18 years of age if the children are financially dependent on the principal caregiver. The amounts of the credits depend on family income and, for the family tax credit, the age of the children. To receive the in-work credit, parents must work a combined total of 30 hours or more per week. The parental tax credit is paid on the birth of a child for the first eight weeks of the child's life. It also depends on family income. However, it can be received only if the primary caregiver is not receiving paid parental leave.
- 2.6 The childcare subsidy is paid per hour per child under five¹ directly to the childcare provider at varying rates (depending on family income) and for up to 50 hours a week. It is abated by family income. If the child's primary caregiver is not in work or is studying (on an approved course) he or she will be eligible for up to nine hours of subsidised childcare.

¹ Technically, the childcare subsidy is payable until a child enters school, which can be at any time between age five and six.

- 2.7 The OSCAR subsidy is for children from five to 13 years of age, and is provided at the same rate and with the same abatement as the childcare subsidy. It is available for up to 20 hours a week in term-time, and 50 hours a week during school holidays.
- 2.8 Outside the Working for Families package, free early childhood education (ECE) is provided to three and four-year-olds for up to six hours a day, and a maximum of 20 hours a week. Families can choose between receiving free ECE, the childcare subsidy or a combination of both, but they cannot receive both for the same hours. Targeted assistance is provided to single parent families through the Domestic Purposes Benefit.
- 2.9 Paid parental leave is available for 14 weeks to eligible employees and self-employed parents, on the birth or adoption of a child. To be eligible, the parent must have worked for the same employer or have been self-employed for six or 12 months immediately before the expected date of birth or adoption, and have worked an average of at least 10 hours a week. Parents receiving paid parental leave receive their gross weekly rate of pay or the maximum rate of payment (currently \$391.28), whichever is lower. Employees who meet the 12-month criteria are also entitled to 38 weeks extended unpaid leave, which can be shared between eligible parents.
- 2.10 These, then, are the main forms of government support for families with children. The main question posed in this discussion document is whether income splitting would be the best way to provide additional support, provided readers think that additional support is needed.
- 2.11 Before looking at the specifics, however, it is useful to see how income splitting works elsewhere.

Income splitting in other OECD countries

- 2.12 Whether to allow income splitting is essentially a question regarding the appropriate unit of taxation – the family or the individual. New Zealand is not alone in taxing on an individual basis, and the international trend over the last 30 years has been away from family-based or “joint” taxation towards individual-based taxation.
- 2.13 At present, 17 OECD countries (including Australia, Canada and the United Kingdom) use pure individual taxation. Only four OECD countries (France, Luxembourg, Portugal and Switzerland) use pure joint taxation of earnings. In the Czech Republic, Iceland, the Netherlands, Norway, Poland and Spain, the individual is used as the tax unit but joint taxation is also possible (only capital income of married couples is taxed jointly in Iceland, while in the Netherlands certain parts of income, such as from owner-occupied housing and from savings, can be taxed jointly). In Germany and Ireland, spouses are normally assessed jointly but they have the option of being separately assessed. In the United States, married couples can file their earnings either separately or jointly

- 2.14 In every country where joint taxation is allowed, income can be split between partners² who do not have children. This is because the general rationale for taxing on a family basis is one of increasing fairness in the taxation of households with different compositions of income.³ In other words, why should two different couples with the same aggregate income pay different amounts of tax? With the partial exception of France, the support of children is not the rationale for income splitting, and consequently most countries also provide some form of additional assistance to families with children in the form of tax credits or targeted cash transfers.
- 2.15 Germany and the United States provide good examples of the alternative methods of achieving standard 50/50 income splitting, while France, Belgium and Denmark illustrate what variations from the standard model are possible.
- 2.16 In Germany, married partners are generally assessed jointly, but can elect to be separately assessed. The tax liability of jointly assessed married couples is determined by aggregating the total income of each partner and dividing by two. The progressive tax schedule is then applied to this figure, the result of which is multiplied by two to determine the family's total tax liability.
- 2.17 The United States also allows married partners to be assessed jointly or separately, by having a separate tax rate schedule for joint filers. Tax thresholds for joint filers are double those which apply to individuals for joint income up to \$63,700 (as of 2007), providing full 50/50 income splitting. Beyond this point the joint filing thresholds are less than double those for individuals. Consequently, it will be better for some couples that both earn significant incomes to file separately. The top tax rate (35%) applies from exactly the same income level (\$349,700) whether taxpayers file individually or jointly.
- 2.18 France provides an example of an extreme version of joint taxation, whereby taxpayers can split their income not just with their partner, but also with their children and any dependent adults in the family. The system was instituted just after World War II, the intent being to take into account the consumption capacity of each member of the family and to tax it accordingly.⁴ The tax unit is the "fiscal household" (*foyer fiscal*). This means the total family, including children if they are claimed as dependents. Since 2004, a family includes a French civil union (*pacte civil de solidarité*). Unmarried couples always constitute two separate fiscal households, while married persons can, in exceptional circumstances, file separately provided that they live apart.

² In some countries income splitting is restricted to married partners, while in other countries it is allowed for de facto partners and same-sex partners.

³ OECD, (2006) "Fundamental Reform of Personal Income Tax", OECD Publishing, Paris, at p55.

⁴ Ault, H., (1997) "Comparative Income Taxation: A Structural Analysis", Kluwer Law International, Amsterdam, at p273.

- 2.19 Income splitting occurs according to the *quotient familial* or “family share” system. A family is attributed a total number of family shares as follows: two shares are attributed to a married couple (or *pacte civil de solidarité*), one share for a single person, half a share for the first two dependents, and one share for each additional dependent (or for each dependent of a single parent). Total family income is then divided by total family shares. Tax liability is calculated according to the progressive tax rate schedule for one share and then multiplied by the total number of family shares to determine the family’s total tax liability.
- 2.20 The tax benefit available for half shares beyond the first two full shares (or one full share for an individual) is limited to €2,159 per half share. The tax benefit from the share attributable to the first dependent of a single parent is limited to €7,472. The benefit from additional dependents is limited to €4,318 (2 x €2,159). These limits have been set on equity grounds, in recognition that the tax benefit of income splitting is greater for households with higher incomes.
- 2.21 Belgium allows partial income splitting similar to that proposed for New Zealand in the 1982 McCaw Report (discussed in more detail in chapter 3). Spouses are generally taxed separately, but under the marital quotient system (*quotient conjugal*), a notional amount of income can be transferred between spouses if one earns no more than 30 percent of the couple’s combined income. In this case the amount transferred is limited to 30 percent of total family income less the secondary earner’s actual income. This effectively provides 70/30 income splitting. The amount transferred is limited to a maximum of €8,570 (in 2006).
- 2.22 Another alternative is employed in Denmark, where family members are taxed separately, but some unutilised “personal allowances” can be transferred between spouses. The low tax bracket (at central government level) taxes aggregate personal and net positive capital income under 265,500 Kroner at 5.48%. If a married individual cannot use all of his or her 265,500 Kroner “personal allowance”, the remainder can be transferred to the spouse. This cannot be done for personal allowances at higher marginal rates.
- 2.23 The next chapter looks at the possibility of a different form of income splitting for New Zealand, one aimed at providing support for families with children.

CHAPTER 3

How income splitting could work

- 3.1 This chapter outlines a possible approach to the use of income splitting in New Zealand and poses a number of questions in relation to its possible introduction.
- 3.2 Income splitting for tax purposes is allowed in a number of countries and takes a variety of forms, as discussed in chapter 2. In most countries, income splitting is a matter of allowing couples to lower their total tax liability by allocating some of the higher earning partner's income to the lower earning partner, thus mitigating the effects of the progressive nature of tax rates.
- 3.3 There are two broad ways to achieve income splitting. The first is to aggregate family income and (as the name suggests) split it evenly between the two partners. Total tax liability is then determined by applying the tax rate schedule to the split level of income, and multiplying the result by two. The second achieves the same effect by providing a separate tax rate schedule for families, one in which the tax rate thresholds are twice as high as the thresholds that apply to individuals. Effectively, allowing income to be split 50/50 would change the taxable unit from the individual to the couple or family.

New Zealand's past experience with income splitting

- 3.4 New Zealand currently taxes on an individual basis. Family-based taxation is not, however, an entirely new concept to New Zealand. Between 1939 and 1962 New Zealand required the aggregation of a married couple's incomes if it exceeded a moderately high level in aggregate. However, this measure was not targeted at families with children. In fact, because tax rate thresholds were not raised when aggregation was required, it acted to increase wealthier families' tax burdens rather than decrease them.
- 3.5 In contrast, the 1982 Report of the Task Force on Tax Reform (the McCaw Report) strongly recommended income splitting be allowed in New Zealand as a means of reducing the tax liability of many families. The recommendation did not require a family to have children to be able to split income. The rationale behind the recommendation was the concern about a lack of recognition of the costs associated with the family unit in the tax system at the time. Essentially, the differences in tax liability between one-income and two-income families with similar abilities to pay tax were seen as unfair.
- 3.6 Although the McCaw Report recommended a specific, limited form of income splitting, it can be designed in a number of ways. The remainder of this chapter looks at the main considerations in adopting income splitting for families with children.

Who would be able to split income?

- 3.7 A “family” could be defined as including married, civil union and de facto partners, a definition that would be consistent with eligibility for the Working for Families tax credits.
- 3.8 One of the first questions to be considered is what age restrictions there should be for the children of the families involved. Should it apply to families with children up to the age of 18? That is the age for which the Working for Families tax credits are available, and it is also the age at which parents are no longer responsible as guardians for the day-to-day care of their children.
- 3.9 The child would also need to be dependent on the principal caregiver. For purposes of Working for Families tax credits, a dependent child is defined as a child 18 years and under that is financially dependent on the principal caregiver. To be considered financially dependent, the child must be financially supported by the principal caregiver and not work more than 30 hours a week or receive a student allowance, benefit or other government assistance. For simplicity and consistency across government policy, it would be desirable to use the same test if an 18-year age limit were to be adopted.
- 3.10 An alternative is to limit income splitting to families with a younger child – say, one who has not yet started school.
- 3.11 The question of restrictions on the ages of the children concerned in families that split their income is a fundamental one, and the government is particularly interested in readers’ views on this matter.

In what way would income be split?

- 3.12 The standard model of income splitting would be to allow a straight 50/50 income split. However, a number of variations are possible. These include allowing income to be split amongst children as well as parents (as in France) or allowing a restricted form of income splitting such as a 70/30 split (as in Belgium). A further restricted option would be to adopt the transferable personal allowance approach taken in Denmark.
- 3.13 The McCaw Report favoured a limited form of income splitting similar to the Belgian 70/30 approach. The report recommended (with one member of the Task Force dissenting) that the government introduce:

“a voluntary scheme of ‘partial income splitting’ for married couples, whereby couples would have the option of notionally dividing their aggregate income by some divisor of between 1.3 and 1.8, with their total income being taxed at the average rate applicable to a single individual whose income equals that quotient.” (p101)

- 3.14 Dividing by two would provide full 50/50 income splitting, so in effect the Task Force's recommendation would allow only the majority of income to be split between partners, but would still provide a significant tax advantage to most couples with differing incomes. The Task Force favoured this restricted approach over a 50/50 split, to ensure that couples were not overly advantaged relative to individuals.
- 3.15 The Task Force considered that, in principle, income splitting should be allowed amongst children of the family as well, but for administrative ease, it recommended increased family benefit support instead. Similar administrative difficulties are likely to preclude a broader approach here also.
- 3.16 While not ruling out variations such as these, this discussion document concentrates on the standard 50/50 version, to illustrate the questions that would arise if income splitting were to be introduced in New Zealand.

Should income splitting be compulsory?

- 3.17 While no one would be financially worse off through 50/50 income splitting, the government's view is that, if adopted, income splitting should be voluntary. Partners who currently have very similar incomes may gain very little from income splitting, and they should have the choice not to participate if they think the compliance costs involved outweigh any benefit they would receive.
- 3.18 If a 70/30 split were to be adopted, it would result in families that are already closer to a 50/50 split being made worse off. In this case, there is even stronger justification for income splitting to be voluntary.

Fiscal cost of income splitting for families with children

- 3.19 The fiscal cost of allowing standard 50/50 income splitting for families with children who are under five years of age would be around \$160 million a year. Extending it to families with children who are 18 years and under would increase the cost to around \$370 million.

Administrative considerations

- 3.20 Two important issues to be considered in relation to the possible introduction of income splitting are determining how it should be administered and how the tax benefit would be paid out.
- 3.21 Because income splitting would be tied to the presence of children, the most administratively manageable, and compliance cost minimising, approach is likely to be for Inland Revenue to administer income splitting through the Working for Families tax credit system. This way Inland Revenue could adapt the current Working for Families tax credit system that is already in place, rather than develop entirely new systems and procedures.

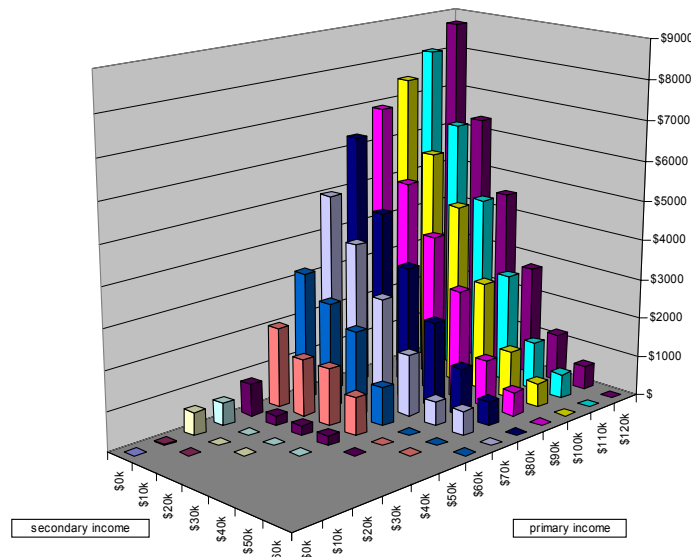
- 3.22 It may be possible for Inland Revenue to pay the tax benefit out during the year through the PAYE system by use of a special tax code. Further work would be necessary to determine if that were feasible. It would place some additional compliance costs on taxpayers by requiring them to estimate their correct tax rate having regard for the impact of their partner's income.
- 3.23 The alternative would be for the tax benefit to be paid at the end of the year as an "income splitting tax credit" through the standard tax assessment process. Most people who receive the Working for Families tax credits are already required to have an end of year tax assessment, so income splitting would not impose additional compliance costs on the vast majority of them. The tax credit could be paid to either partner, or split and paid to both.
- 3.24 Further administrative questions that would need to be considered in more detail if income splitting were to be implemented include how Inland Revenue would deal with couples who file tax returns (especially provisional taxpayers), with relationship changes, and with Working for Families and other payments such as child support, student loans and certain rebates that are currently linked to individual earnings. The implications of shared care of a child would also need further consideration, particularly for determining when a family is considered to have a child, and therefore is able to split its income.

CHAPTER 4

The impact of income splitting on families

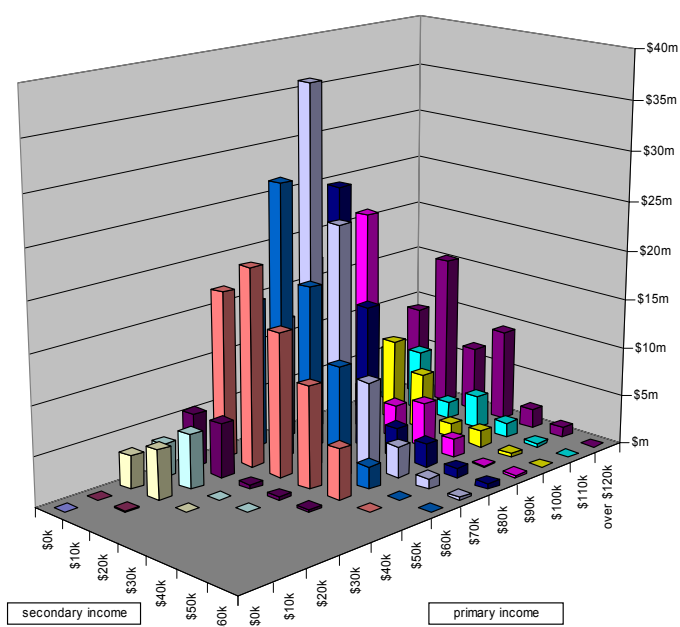
- 4.1 This chapter looks at the implications of income splitting in terms of who would benefit financially, and how effective marginal tax rates would change. It assumes 50/50 income splitting.
- 4.2 Figure 1 shows the reduction in tax paid (the “tax benefit”) for different combinations of primary and secondary earner incomes. For any level of primary earner income, the tax benefit from income splitting increases as the secondary earner’s income falls, with the maximum tax benefit going to couples in which the secondary earner is not earning any income.
- 4.3 Figure 1 shows that, for every level of secondary earner income, the tax benefit increases as the primary earner’s income increases. It reaches its maximum when the primary earner earns \$120,000. Beyond this level the couple gains no additional benefit as all additional income will be taxed at the top marginal tax rate.
- 4.4 When both partners earn the same amount of income, or if the secondary earner earns \$60,000 or more, there is no tax benefit from income splitting. In neither case can the partners move some income from a higher marginal tax rate to a lower one. Notably, families with a secondary earner who receives up to around \$30,000 can still gain a significant tax benefit from income splitting.
- 4.5 Figure 1 is reproduced in table form in the Annex (Table A). This shows the exact dollar tax benefit going to each primary/secondary earner combination. The exact benefit is dependant on statutory tax rates and would alter if tax rates were to change. However, the same pattern would result, with the tax benefit increasing as primary income increases, and as secondary income decreases.

FIGURE 1: GAIN PER COUPLE UNDER INCOME SPLITTING



- 4.6 Figure 2 uses the current distribution, according to primary and secondary earner income, of families with children aged 18 and under in New Zealand to show how much tax benefit in aggregate would go to families with different combinations of primary and secondary earner incomes. The distribution is reproduced in Table B in the annex and is based on Inland Revenue sample data.
- 4.7 As illustrated in Figure 1, the greatest tax benefit from income splitting would go to a couple where the primary earner earns \$120,000 or more and the secondary earner receives no income. Figure 2 shows that, because there are relatively few couples in this position, only a relatively small amount of the total tax benefit from income splitting goes to these couples.
- 4.8 The largest aggregate tax benefit would go to families in which one partner earns around \$60,000 to \$80,000 and the other earns less than \$20,000.
- 4.9 Families in which a secondary earner receives up to around \$30,000 would still receive a significant amount of the aggregate tax benefit from income splitting.
- 4.10 Figure 2 is reproduced in table form in the Annex (Table C). This shows the exact aggregate tax benefit going to each primary/secondary earner combination. Again, the exact benefit is dependant on statutory tax rates, but also on any changes to the income distribution.

**FIGURE 2:
DISTRIBUTION OF TAX BENEFITS FROM INCOME SPLITTING**



- 4.11 Not only would income splitting provide tax reductions to families with various combinations of primary and secondary earnings, it would also alter the effective marginal tax rates (EMTRs) faced by both primary and secondary earners. (As used in this discussion document, the term “effective marginal tax rate” means the proportion of an extra dollar of income that is lost as a result of taxation, benefit abatements and other income-related obligations such as ACC levies and child support payments.)
- 4.12 Table 1 shows the percentage point changes in primary earners’ EMTRs for different combinations of primary and secondary income. Table 2 shows the effect on secondary earners’ EMTRs.
- 4.13 Table 1 shows that primary earner EMTRs will decrease for a large number of combinations of primary and secondary income. For couples in which the primary earner has income between around \$40,000 and \$70,000 and the secondary earner earns less than \$30,000 there tends to be a significant fall in the primary earner’s EMTR. The largest drop is 18 percentage points for couples in which the primary earner earns around \$60,000 to \$70,000 and the secondary earner receives around \$10,000 or less.
- 4.14 Table 2 shows that secondary earner EMTRs would increase for a large number of combinations of primary and secondary income. When the primary earner has income of \$80,000 or more, EMTRs would increase substantially for all secondary earners with less than \$60,000 of income. The largest increase would be 24 percentage points when the primary earner earns around \$120,000 or more, and the secondary earner receives less than \$9,500.

**TABLE 1:
PERCENTAGE POINT DECREASE IN PRIMARY EARNER’S EMTR**

		Secondary earner income						
		\$0k	\$10k	\$20k	\$30k	\$40k	\$50k	\$60k
Primary earner income	\$0k	0%						
	\$10k	6%	0%					
	\$20k	0%	0%	0%				
	\$30k	0%	0%	0%	0%			
	\$40k	12%	12%	12%	12%	0%		
	\$50k	12%	12%	12%	0%	0%	0%	
	\$60k	18%	18%	6%	6%	6%	6%	0%
	\$70k	18%	6%	6%	6%	6%	0%	0%
	\$80k	6%	6%	6%	6%	0%	0%	0%
	\$90k	6%	6%	6%	0%	0%	0%	0%
	\$100k	6%	6%	0%	0%	0%	0%	0%
	\$110k	6%	0%	0%	0%	0%	0%	0%
	\$120k	0%	0%	0%	0%	0%	0%	0%

**TABLE 2:
PERCENTAGE POINT INCREASE IN SECONDARY EARNER'S EMTR**

		Secondary earner income						
		\$0k	\$10k	\$20k	\$30k	\$40k	\$50k	\$60k
Primary earner income	\$0k	0%						
	\$10k	0%	0%					
	\$20k	6%	0%	0%				
	\$30k	6%	0%	0%	0%			
	\$40k	6%	0%	0%	0%	0%		
	\$50k	6%	0%	0%	12%	0%	0%	
	\$60k	6%	0%	12%	12%	0%	0%	0%
	\$70k	6%	12%	12%	12%	0%	6%	0%
	\$80k	18%	12%	12%	12%	6%	6%	0%
	\$90k	18%	12%	12%	18%	6%	6%	0%
	\$100k	18%	12%	18%	18%	6%	6%	0%
	\$110k	18%	18%	18%	18%	6%	6%	0%
	\$120k	24%	18%	18%	18%	6%	6%	0%

- 4.15 Table 3 shows the number of taxpayers that would face these varying EMTR changes, given the current income distribution. Of all primary earners who would benefit from income splitting, 56 percent would not have any change to their EMTR, while four percent would have their EMTR fall by the maximum of 18 percentage points.
- 4.16 For secondary earners that benefit from income splitting, 52 percent would not face an increase in their EMTR. Five percent would face an increase of 18 percentage points, while one percent would face a 24 percentage point increase.
- 4.17 The average percentage point decrease in EMTRs for primary earners is 4.56, while the average increase in secondary earner EMTRs is 4.28 percentage points.

**TABLE 3:
NUMBER OF TAXPAYERS FACING PERCENTAGE POINT
CHANGES IN EMTRs**

Primary earners			Secondary earners		
change	Number	percentage	change	number	percentage
0	236,250	56%	0	221,900	52%
-6	70,525	17%	6	129,850	31%
-12	101,150	24%	12	48,300	11%
-18	16,625	4%	18	21,875	5%
			24	2,625	1%

CHAPTER 5

Assessing income splitting against the criteria

- 5.1 This chapter assesses the idea of income splitting against the criteria outlined in chapter 1.

Fairness

- 5.2 The decision to tax on a family basis by allowing income splitting may increase perceived fairness in some areas at the expense of others. Whether taxing on a family basis is a good thing depends on the relative weightings given to different goals.
- 5.3 With individual taxation, as at present, a one-earner family will pay more tax than a two-earner family when the two have the same total family income. In fact, whenever one partner contributes more to total family income than the other, the tax system will impose at least as high and generally a greater burden than if they both contributed the same incomes. This may be seen as unfair, particularly when considered in light of the Working for Families package.
- 5.4 Working for Families uses the family, rather than the individual, as its basis for determining the appropriate level of assistance for families. As such, it provides equal support to families in similar circumstances that have the same total family income (and the same number, and age, of children). However, while those families are treated equally for Working for Families purposes, some will still end up worse off than others because of the individual basis of the tax system. Allowing income splitting for families would ensure that such families are treated consistently.
- 5.5 Furthermore, limiting income splitting to families with children would also ensure that a couple with a child would pay less tax than a couple without a child when both had the same aggregate income.
- 5.6 It is also arguable that income splitting recognises the contribution of stay-at-home parents, when the current individual system of taxation does not.
- 5.7 On the other hand, it is arguable that family income does not always accurately capture a family's ability to pay tax, and so is not the fairest means of determining tax liability. This is because family income does not take account of the hours worked by family members. While it may be considered unfair for different couples working full-time with the same aggregate income to face different tax burdens, if one partner in a family is not in paid employment he or she will have additional time available for valuable activities at home, such as childcare.

- 5.8 Compare the following two families: Family 1 has both partners working full-time for 40 hours a week, earning \$50,000 each. Family 2 has one partner working full-time for 40 hours a week and earning \$100,000, with the other partner not in paid employment. Family income is the same, so income splitting would allow these two families to pay the same amount of tax. But do these families have similar abilities to pay tax? If both families have young children needing to be cared for, Family 1 may need to employ childcare as both parents work full-time, whereas Family 2 may not need to do so. Individual taxation places a higher burden on the single-income family and so it may possibly be argued to be fairer in this situation.
- 5.9 It may also be perceived as unfair that the benefit from income splitting increases as primary income increases, providing more benefit to families with higher incomes.

Providing choice to families

- 5.10 The government is also committed to providing real choices to parents and carers in combining their work with their caring roles through the government's "Choices for Living, Caring and Working" ten-year action plan.
- 5.11 Parents raising children often face the choice between both parents working (and employing childcare), or one parent staying at home or working part-time to care for a dependent child or children.
- 5.12 In some cases, both parents in a two-parent family may wish to work but may be deterred by the cost of childcare, as may a sole parent who wishes to work. The government has acknowledged this concern, and the childcare and Out of School Care and Recreation (OSCAR) subsidies, along with the recently introduced free Early Childhood Education programme, are ways of alleviating this concern.
- 5.13 In other cases, one parent may wish to stay at home and care for dependent children but may not see this as a viable option because of financial considerations. At present, there are no government measures specifically designed to make staying at home or working part-time a more viable option in this situation, although Working for Families does implicitly aid this goal by providing financial support to families.
- 5.14 Income splitting may enhance the choices available to parents by making it easier for a partner to stay home to care for dependant children, if he or she wishes to, as single earner families would benefit the most from 50/50 income splitting.
- 5.15 Even so, income splitting may not target support very well if this is the goal to be achieved. As Figure 1 shows, the greatest benefit from income splitting goes to families on higher incomes, and these families may not necessarily be the families who most need assistance.

- 5.16 For families with lower incomes, for whom the financial constraints may be greater, income splitting would provide only small amounts of support. For example, a one-earner family receiving \$40,000 would gain only \$600 a year from income splitting.

Efficiency

- 5.17 The impact on economic efficiency of income splitting is not immediately obvious because effective marginal tax rates (EMTRs) increase for some people (secondary earners) and decrease for others (primary earners).
- 5.18 Taxation of labour income will distort price signals and alter people's work decisions, leading to an inefficient allocation of resources. This inefficiency increases the higher the tax rate is, and the more responsive people are to the imposition of the tax. Therefore the reduction in primary earner EMTRs will increase efficiency, while the rise in secondary earner EMTRs will decrease efficiency.
- 5.19 The average decrease in primary earner EMTRs and the increase in secondary earner EMTRs is roughly the same, so the efficiency gains from the reduction of higher primary earner EMTRs would appear likely to outweigh the negative effect of the increases in lower secondary earner EMTRs. However, if labour supply responsiveness differs between these groups, this may not be the case.
- 5.20 Empirical evidence⁵ suggests that secondary earners, especially women, are far more responsive to changes in the return to labour than primary workers. Consequently, the negative impact on efficiency of an increase in secondary earner EMTRs may outweigh the positive impact of the reduction in primary earner EMTRs. For example, a full-time worker may decide to continue working full-time under any circumstances, whereas a part-time worker is more likely to reduce hours of work or leave the workforce altogether if EMTRs become too high.
- 5.21 Even in the absence of income splitting, EMTRs can be high for many people as a result of the abatement of the Working for Families package, the ACC earner premium, student loan repayments and child support obligations. As such, the efficiency impact of a further change in EMTRs as a result of income splitting would be greater for such people than for those with a lower pre-income splitting EMTR.
- 5.22 There may also be further efficiency impacts beyond those directly relating to the tax system. The lower EMTRs on primary income earners are likely to provide greater incentives for them to acquire new skills and move to better remunerated jobs, which, by itself, is likely to boost labour productivity. However, the higher EMTRs for secondary earners create incentives to reduce hours of work, or to leave the workforce temporarily, which may

⁵ See, for example, Blundell, R. and McCurdy, T. (1999) "Labour supply: A review of alternative approaches", in O Ashenfelter and D Card (eds.), "Handbook of Labour Economics", Volume 3, North Holland, Amsterdam.

adversely affect labour productivity. Evidence suggests⁶ that once people have been outside the workforce for more than a year their skills may begin to atrophy, resulting, in the long term, in a less productive workforce, which may have an impact on economic growth.

Simplicity

- 5.23 By implementing income splitting through the existing Working for Families tax credits system, income splitting is likely to be relatively simple for people to comply with. If they were able to use a special tax code to receive the tax benefit from income splitting during the year, there would be some increase in compliance costs. That is because they would need to estimate their correct tax rate having regard for the impact of their partner's income on their tax liability.
- 5.24 If the income splitting benefit were paid out after the end of the tax year the only families who might face a significant increase in compliance costs would be those who were eligible to split their income but who were not eligible for Working for Families tax credits. The reason is that they may not previously have been required to file a tax return, but might now have to do so in order to receive the tax benefit from income splitting.

Administrative costs

- 5.25 Income splitting would be very expensive to implement and administer irrespective of the specific design. However, it might be possible to implement it through the current Working for Families tax credits system, which would restrict costs to an extent.

⁶ See, for example, Jaumotte, F., (2003) "Female labour force participation: past trends and main determinants in OECD countries", OECD Economics Department working papers No. 376; Fagan, C. and Walthery, P. "The role and effectiveness of time policies for reconciliation of care responsibilities", paper presented to the OECD Conference on Life Risks, Life Course and Social Policy, Paris, 31 May – 1 June 2007.

ANNEX

**TABLE A:
GAIN PER COUPLE UNDER INCOME SPLITTING**

		Secondary earner income						
		\$0k	\$10k	\$20k	\$30k	\$40k	\$50k	\$60k
Primary	\$0k	0						
earner	\$10k	30	0					
income	\$20k	570	0	0				
	\$30k	570	0	0	0			
	\$40k	810	240	240	240	0		
	\$50k	2,010	1,440	1,440	960	0	0	
	\$60k	3,210	2,640	2,160	960	0	0	0
	\$70k	5,010	3,960	2,760	1,560	600	600	0
	\$80k	6,330	4,560	3,360	2,160	1,200	600	0
	\$90k	6,930	5,160	3,960	2,760	1,200	600	0
	\$100k	7,530	5,760	4,560	2,760	1,200	600	0
	\$110k	8,130	6,360	4,560	2,760	1,200	600	0
	\$120k	8,730	6,360	4,560	2,760	1,200	600	0

**TABLE B:
DISTRIBUTION OF COUPLES BY PRIMARY/SECONDARY EARNER INCOME⁷**

		Secondary earner income						
		\$0	\$0k - \$10k	\$10k - \$20k	\$20 - \$30k	\$30 - \$40k	\$40 - \$50k	\$50 - \$60k
Primary	\$0	0						
Earners	\$0 - \$10k	175	0					
Income	\$10 - \$20k	175	350	0				
	\$20 - \$30k	9,100	21,175	175	0			
	\$30 - \$40k	5,425	16,800	0	175	0		
	\$40 - \$50k	8,750	14,875	3,675	2,625	1,575	0	
	\$50 - \$60k	11,900	16,975	17,850	12,250	10,675	0	0
	\$60 - \$70k	5,600	11,375	8,925	7,000	4,725	0	0
	\$70 - \$80k	2,975	9,275	7,875	4,375	5,075	3,500	1,575
	\$80 - \$90k	3,150	5,250	4,025	1,400	2,100	1,400	1,400
	\$90 - \$100k	1,225	3,675	875	1,575	1,225	175	1,225
	\$100 - \$110k	175	1,225	1,225	350	700	525	0
	\$110 - \$120k	700	875	350	875	700	525	0

⁷ Based on Inland Revenue sample data.

**TABLE C:
DISTRIBUTION OF TAX BENEFITS FROM INCOME SPLITTING (\$M)⁸**

	Secondary earner income						
	\$0	\$0k - \$10k	\$10k - \$20k	\$20 - \$30k	\$30 - \$40k	\$40 - \$50k	\$50 - \$60k
Primary \$0	0						
Earners \$0 - \$10k	0	0.1					
Income \$10 - \$20k	3.4	5.0	0				
\$20 - \$30k	3.4	5.5	0	0			
\$30 - \$40k	5.5	5.5	0.4	0.3	0.1		
\$40 - \$50k	17.0	20.2	14.7	10.3	5.1	0	
\$50 - \$60k	15.1	27.8	18.3	11.2	2.2	0	0
\$60 - \$70k	12.5	37.0	23.7	8.7	3.2	1.0	0.3
\$70 - \$80k	17.8	26.0	14.5	3.0	2.4	1.0	0.5
\$80 - \$90k	8.0	22.5	3.4	4.6	1.9	0.2	0.3
\$90 - \$100k	2.5	8.2	5.6	1.4	1.7	0.4	0
\$100 - \$110k	5.5	6.2	1.7	3.4	1.5	0.4	0
\$110 - \$120k	9.1	15.4	6.6	9.3	1.9	1.1	0

⁸ Based on Inland Revenue sample data.

Regulatory Impact Statement

This discussion document incorporates the substantive regulatory impact analysis elements.