

# TAXING THE FAMILY UNIT: INCOME SPLITTING FOR ALL?

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There is a contradiction in the family income splitting debate. Such measures are seen and represented as being a way of providing tax relief to families, whilst it is not acknowledged that Australia presently has a discriminatory system of family income splitting, based not on need but on access to business or property income.

This article examines arguments for family income splitting. It canvasses the proposition that families could be better assisted, not by extending income splitting, but instead by reducing the current tax-avoidance practices and using the improved revenues to fund tax expenditures and/or social security relief for all taxpayers.

## 1 The contradiction in the family income splitting debate

The importance of the family unit in contemporary Australia is debated in many contexts ranging from taxation to law and order. In the areas of taxation and social welfare there are numerous related issues impacting on the debate including; tax or social security relief in respect of child-care expenses, family income splitting, and tax rebates in respect of dependants.

This article proposes that taxation should, as far as is possible, be a neutral consideration in respect of workforce participation,

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regardless of the composition of a "family" unit. Neutrality can be promoted by improved tax and/or social security expenditures in respect of both those parents who choose to remain in the workforce and those who do not. The nature of such expenditures as the "ends" is to be canvassed only superficially and is properly the subject of further study. This article is, instead, intended to examine some of the "means" by which such suggested tax relief for families can be funded.

The recurrent political appeal to family values, which is not the monopoly of any particular political party, takes many forms. However, models for family income splitting and any redefinition of the taxable unit, from the individual to the family, present a contradiction in the family taxation debate.

Whatever the claims made in recent political debate as to family income splitting, Australia already has a discriminatory "family income-splitting" tax regime. This system of tax relief is based not upon need, but upon access to certain classes of income which generally are not within the domain of many of Australia's individual taxpayers.

This article proposes the removal of the inconsistency which exists in the tax treatment of families. By doing so and thereby reducing the practice of income splitting, which undermines the tax base, the improved revenues can be applied to the benefit of all taxpayers so as to promote, amongst other things, the neutrality which has been advocated.

## 2 Australia's existing family income splitting regime

Australia's tax system is based upon the individual as the tax unit, to whom progressive marginal rates of tax apply. This provides an incentive to split income, where possible, amongst taxpayers so as to take maximum benefit from the lower marginal tax rates. Typically, the benefits of income splitting are most readily utilised by adult resident individuals.<sup>1</sup> The enactment in 1980 of Division 6AA<sup>2</sup> of the Income Tax Assessment Act 1936 (ITAA), with its penalty rates of tax on certain income of children, has removed much of the incentive to include minors as part of any family income splitting plan.

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<sup>1</sup> See s 12(1) Income Tax Rates Act 1986, Sch 7.

<sup>2</sup> Section 102AA - s 102AJ.

Income can be split or alienated by a range of transactions or devices including:

- the alienation of property from which income is derived;
- under more limited circumstances, the alienation of the right to receive income from property without the disposal of the property itself; and
- the use of interposed entities such as trustees, companies, or legal structures such as partnerships, to divert and/or direct the derivation of income amongst taxpayers.

This is a simple analysis of the range of income diverting strategies and it is acknowledged that they are used extensively in normal commercial dealings. It is also acknowledged that the use of a particular income producing structure will often be influenced by important non tax considerations such as limiting personal liability for debts.

In order to implement a successful income splitting tax plan it is essential that a structure, transaction or scheme has two important characteristics:

- legal effect; and
- tax effect.

The first requirement relates to matters such as the legal or equitable effects of a transaction, without which it is not even necessary to consider whether it is struck down by any provision of the tax legislation.<sup>3</sup> This condition will also encompass considerations of the somewhat more narrow tests to determine whether a transaction is a sham.<sup>4</sup>

Once it is determined that an arrangement can be given legal or equitable effect, the second condition is that anti-avoidance provisions of the ITAA not apply so that the arrangement is not set aside for tax purposes.

Income splitting is not available to all taxpayers because of a combination of the following factors:

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<sup>3</sup> See *Norman v FCT* (1963) 9 ATR 85.

<sup>4</sup> See *Alloyweld Pty Ltd v FCT* (1984) 84 ATC 4328.

- legal or equitable effect is only extended to the alienation of limited classes of income, principally from property and certain business income;
- whilst there are exceptions to the application of anti avoidance provisions such as Part IVA and its predecessor s260, based upon “ordinary family dealings”,<sup>5</sup> such exceptions are predicated not upon any test of what is an “ordinary family”, but again more by reference to the type of income involved; and
- there has been a consistent denial of income splitting or alienation in relation to attempts to divert income from personal exertion, which is that derived by taxpayers providing dependent or independent personal services.<sup>6</sup>

In summary, an Australian family can presently split its income amongst its members so as to reduce the tax burden, if it has access to income from the ownership of property such as: dividends, interest, or rents; income from businesses carried on in partnership; income from businesses which rely on service trust arrangements;<sup>7</sup> or income from businesses carried on through family trusts or companies.

As such, income splitting is available only to the families of persons carrying on business or to the owners of property, and not to wage and salary earners. This is the basis for the earlier assertion that the tax system is discriminatory. This differential in access to income splitting was recognised by the present government in its 1985 Draft White Paper.<sup>8</sup>

Professor Ross Parsons, a member of the Asprey Committee, describes the differences in tax-planning opportunities between those taxpayers on either side of the income-splitting debate:

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<sup>5</sup> *Newton v FCT* ( 1958 ) 7 ATR 298, Denning LJ in the Privy Council, at 304-305. See also Taxation Ruling IT 2330 at paras 7 and 42.

<sup>6</sup> As in “the doctors” cases, *FCT v Gulland, Pincus, and Watson* ( 1985 ) 17 ATR 1. It is submitted that the decision of Hill J in *Leidig v FCT* (1994) 28 ATR 141 turns on some important findings of fact by the AAT and should not alter the general proposition in relation to income from personal exertion.

<sup>7</sup> *Phillips v FCT* ( 1979 ) 8 ATR 783.

<sup>8</sup> *Reform of the Australian Tax System* (1985 AGPS) at paras 6.17 ff.

Dramatic I think is a fair word to describe the tax savings that attend transfers of income. Stark is a fair word to describe the discriminations in regard to the opportunities to transfer.<sup>9</sup>

Despite the 1985 government report and discussion paper, there has been no legislative action to reduce income splitting, which in the same document was estimated to be costing the revenue \$500 million annually<sup>10</sup> compared then with a total annual Commonwealth revenue of \$58,989 million.<sup>11</sup> As total Commonwealth revenues have grown,<sup>12</sup> the "loss" from income splitting must now surely exceed \$1,000 million annually.

The somewhat controversial proposals canvassed in this article are aimed at substantially reducing this annual loss in order to contribute to funding improved tax expenditures, such as tax-deductibility of child-minding expenses and improved dependant spouse rebates, or similar payments by way of social security transfer.

### 3 Alternative approaches

In broad terms the approaches to family taxation can be summarised as follows:

- tax relief through family taxation or income splitting for all families; and
- the reduction of income splitting so as to fund improved tax expenditures for families.

#### 3.1 Family taxation

Family unit taxation can take many forms, ranging from the elective joint taxation of the income of spouses, as applies in the United

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<sup>9</sup> Parsons RW, "Asprey Committee Proposals for Family Unit Taxation" *Taxation and the Family Unit*, papers presented at a seminar conducted by the Taxation Institute Research and Education Trust, Sydney, 30 May 1979, 1 at 6.

<sup>10</sup> Above n 8 at para 6.17.

<sup>11</sup> Australian Bureau of Statistics, *Taxation Revenue, Australia* (1992 AGPS).

<sup>12</sup> *Ibid*, eg, \$93,323 million by 1991.

States, to the more complex aggregation of family income, which occurs in France and which includes the income of children.

In Australia discussion of family unit taxation has tended to focus on elective spousal income splitting, which over the years has been raised in various forums. In 1975, the report of the Asprey Committee<sup>13</sup> recommended that the government prepare, for public examination and discussion, a detailed scheme for elective family unit taxation.<sup>14</sup> In 1985, the topic of family unit taxation was again raised in the Labor government sponsored Draft White Paper.<sup>15</sup>

Somewhat more recently, income splitting between spouses has been advocated by John Howard, the Leader of the Opposition.<sup>16</sup> Mr Howard argued for elective family income splitting only in the case of a family with dependant children which relies on a single income. He also stated that it should, nevertheless, be based on an income test to ensure that "high income earners were not unduly enriched".<sup>17</sup> Whilst this second point recognises that income splitting is of more value to the higher income earners, it is arguable that such reasoning represents a conservative populist approach to what should really be achieved by improved dependant tax rebates, which by their nature are of greater value to lower income earners.

In Mr Howard's defence, he did acknowledge that income splitting was not the only way in which to give relief to sole income households. He also referred in his discussion to improved rebates and child-care subsidies.

There are some problems with simplistic analyses of family income splitting. The following is an example: <sup>18</sup>

### Scenario 1

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<sup>13</sup> *Taxation Review Committee Full Report (Asprey Report) (1975 AGPS)* at para 10.33.

<sup>14</sup> This part of the report's recommendations was subject to reservation by the Chair of the committee, Mr Justice Asprey.

<sup>15</sup> Above n 8.

<sup>16</sup> The Honourable John Howard MP, "Towards an Economic Policy for the Family", speech delivered to the Council for the National Interest, Sydney, 7 March 1994.

<sup>17</sup> *Ibid* at 10.

<sup>18</sup> Given the present difficulty with the passage of amending legislation, unless otherwise stated, the law which is referred to and applied for the purposes of comparison is as stated at 31 December 1994.

For the year ended 30 June 1994 the taxpayer is the sole family income earner with a dependant spouse and 1 child. The total taxable income for the year is \$50,000.

The tax and medicare levy payable will be \$15,256.50 (\$14,556.50 + \$700), which must be reduced by the dependant spouse rebate of \$1425, leaving a net tax payable of \$13,831.50, or an average tax rate of 27.66% on taxable income.

## Scenario 2

For the same year a family has one child and the same taxable income. However, in this case, each spouse earns \$25,000. Each spouse will pay tax and medicare levy of \$4,936.50 (\$4,586.50 + \$350). This gives a total family tax bill of \$9873, or 19.76% of earnings on the same level of "family" taxable income as in scenario 1.

The populist view is to stress the inequity of a tax system which makes the single income family pay almost \$4,000 more tax on the same family income.

What is often ignored in the debate is that the two income family will usually incur a greater amount of the inevitable non-deductible work-related expenses, such as travelling to and from work, will probably incur a net (after social security subsidy) child-minding expense which is also non-deductible, and does not have the real and valuable benefit of a full-time home-maker, which should not be under estimated. In relation to this last point, a two income family (although perhaps not at the income level of the family in scenario 2) may also incur non deductible expenses on domestic help in the home, in order to compensate for the lack of a home-maker.

The size of the tax differential between the two families may not be justifiable. However, it is strongly arguable that for the purposes of the comparison it must be reduced, perhaps considerably, so as to take into account the value of benefits accruing to the single income family. The validity of this adjustment cannot be ignored.

Another problem with family taxation relates to its effect on the choice that parents have, most typically women, as to whether to return to the workforce after the birth of a child, or perhaps upon children commencing school. Using Mr Howard's model, the loss of any benefits of income splitting may well influence women not to

return to the workforce, especially as it will often be the female who is the "secondary income earner".<sup>19</sup>

A similar disincentive operates under other family taxation models, such as that operating in the United States. This model was mooted by the Asprey Committee and extends income splitting to dual income families. Unlike the Howard model with its "threshold disincentive", by which all income splitting benefits are forfeit on the return to work of the second earner, these models impose a higher rate of tax on the secondary earner, usually the woman. This "penalty" tax rate attaching to the return to work increases in proportion to the differential between the earnings of the primary and secondary earner.

Consider the following example for the year ended 30 June 1994:

#### Scenario 1

The primary earner derives taxable income of \$50,000. Tax and medicare levy payable will be \$15,256.50 (\$14,556.50 + \$700), an average rate of tax of 30.5%.

The secondary earner returns to the workforce (perhaps by job-share after having a child) and earns taxable income of \$17,000. Tax and medicare levy payable will be \$2558 (\$2320 + \$238) or 15%.

Total family tax will be \$17,814.50 or 26.5% of family taxable income.

#### Scenario 2

Under a family taxation system the income of the family earners is aggregated and divided equally between them to determine the applicable family average tax rate.

The primary earner will be taxed on income of \$50,000 at an average tax rate of 24% (including medicare levy). This is calculated as follows:

$$\frac{(\$50,000 + \$17,000)}{2} = \$33,500$$

<sup>19</sup> Apps P, "Tax Reform and the Tax Unit" (1984) 1 *Australian Tax Forum* 467 at 468.



Tax and medicare levy on \$33,500 for an individual is \$8,073 (\$7,604 + \$469), an average rate of 24%. The tax and medicare levy payable by the primary earner is \$12,000 (\$50,000 × 24%).

The secondary earner will pay tax at the same average family rate of tax on taxable income of \$17,000. In this case \$4,080 (\$17,000 × 24%).

Total family tax under this scenario will be \$16,080 or 24% of taxable income.

In the above example, the same result will ensue whether each partner lodges their own return or whether a consolidated return is lodged. The result is that for a family tax saving of 2.5% of taxable income (\$17,814.50 - \$16,080 = \$1734.50) the incidence of taxation on the income of the secondary earner, usually the woman, has gone from \$2558 to \$4080. This increase represents 9% of her income, but is an increase of almost 60% in tax payable.

Such consequences are seen as being inconsistent with any notion of equal opportunity,<sup>20</sup> are a disincentive to workforce participation<sup>21</sup> and could not be justified on equity grounds. There is significant empirical evidence from Europe supporting the disincentive effects of higher tax rates on the family secondary earner under a family taxation system in situations such as that illustrated by the example.<sup>22</sup>

Such arguments are also reinforced by evidence which indicates that it is, in any event, unsafe to assume that there is a full pooling of resources within family units. In an archetypal case this might suggest that a wife would not have access to the earnings of the husband and may not even know what he earns.<sup>23</sup> In the 1970s, such equity issues were amongst those which caused OECD countries such as Denmark, Sweden, Austria, the Netherlands, Finland, Belgium, Italy, and Ireland (optional only) to change from married couple to individual taxation.

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<sup>20</sup> Ibid at 368.

<sup>21</sup> Groenwegen PD, "Taxation and the Family Unit: Some Economic Aspects" *Taxation and the Family Unit*, above n 9, 11 at 16.

<sup>22</sup> Spahn PB, Kaiser H and Kassella T, "The Tax Dilemma of Married women in Germany" (1992) 13 *Fiscal Studies* 22.

<sup>23</sup> Edwards M, "Taxation and the Family Unit: Social Aspects" *Taxation and the Family Unit*, above n 9, 29 at 35.

Another difficulty with models based on family taxation is the definition of a "family". Despite Mr Howard's assertion that questions of definition are "largely irrelevant",<sup>24</sup> the practical issues arising in the administration of such a system cannot be dismissed.

The definitions of "spouse" for the various purposes of income tax and social security legislation have been amended to give legislative recognition to de facto marriages,<sup>25</sup> depriving tax administrators of the more arbitrary and objective tests of formal or legal marriage as being the sole test of the existence of a "family". In these days of various anti-discrimination statutes, an example of the legislative problems created by taxing provisions based upon formal marriage is the former s 102AC(2)(a) of the ITAA, which provided to a married minor an exemption from the penal rates of tax imposed by Division 6AA. This was repealed with effect from 1 July 1993, as it was inconsistent with the Sex Discrimination Act 1984 to extend tax relief when there were different legal age requirements for the marriage of boys (18 years) as opposed to girls (16 years).

The difficulty of enforcing family taxation laws was recognised by the Asprey Committee<sup>26</sup> as entailing an "unacceptable invasion of privacy." Tax audits could become burdened with even more intrusive aspects of determining whether a "family" relationship exists. Such problems would be similar to those encountered in social security disputes where co-inhabitants of the same dwelling are allegedly in receipt of inconsistent benefits. An example would be where a Supporting Mother's Benefit recipient resided with a male receiving Unemployment Benefits. A Family Benefit might be argued by the Department of Social Security to be appropriate under the circumstances, on the basis that the two were living in a de facto relationship. In the tax context the situation would instead be reversed and the taxpayers would be contending for the existence of the "family" relationship.

Practical administrative problems of definition cannot be ignored. The arguments are compounded when one goes beyond de facto marriages and considers whether income splitting available to dual income "families" should be extended to homosexual couples. There are bound to be equity and anti-discrimination arguments to support such a notion, which would undoubtedly prove controversial.

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<sup>24</sup> Above n 16 at 2.

<sup>25</sup> For example s 6(1) Income Tax Assessment Act.

<sup>26</sup> Above n 13 at para 10.29.

Such problems raise the spectre of the tax file number system being used as a cross-referencing "register of relationships" on a much more pervasive scale than is presently applied to the system of dependant rebates. It is submitted that, in relation to the privacy issue, the Asprey Committee was correct when it expressed its fears in this regard. The practical problems identified belie Mr Howard's assertion that the "great advantage of income splitting is its relative simplicity".<sup>27</sup>

Another problem of family taxation is that of funding the associated tax cuts. The cost of such tax cuts would depend on the extent of the family income splitting which is to be permitted. The recent Liberal model would be less costly as regards tax expenditures than would a comprehensive elective family taxation system open to dual income families, including those without dependent children.

The revenue cost of the more generous elective family model was quantified as far back as 1979 as being as high as \$1,750 million annually.<sup>28</sup> Whilst that figure is now dated, the then estimated across the board increase in personal income tax rates of 17% necessary to fund such a tax system is arguably still applicable. In the Draft White Paper in 1985 the annual cost to the revenue of such tax cuts was estimated to be \$2 billion.<sup>29</sup>

Tax cuts for families funded by tax increases elsewhere would cause a substantial shift in the tax burden. It would shift away from single income families with dependant children to single taxpayers and to two income households where there was not a great difference in incomes, including those households splitting property or business income.<sup>30</sup>

Under the various forms of family unit taxation, the tax burden of family income splitting will still fall substantially on the wage and salary earners: the class of taxpayers who are least able to divert their income and, with it, their liability to tax. The increased personal income tax rates will take from within a class of taxpayers and distribute to another sector within that same class, instead of extracting greater revenue from other sectors of the tax-paying

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<sup>27</sup> Above n 16 at 10.

<sup>28</sup> Eric Ristrom, quoted in the *Sydney Morning Herald* 17 May 1979.

<sup>29</sup> Above n 8 at para 6.12.

<sup>30</sup> Groenwegen, above n 21 at 23-24.

community, such as companies, people carrying on business, and property owners able to engage in tax-planning.

Arguably, Mr Howard ignored this aspect of his family taxation policy when he stated that:

many self employed and professional people can already split their incomes and the extension of income splitting to other tax payers would redress a disadvantage suffered by PAYE tax payers.<sup>31</sup>

This is a half-truth in that it will redress the disadvantage of some PAYE taxpayers but at the expense of other PAYE taxpayers. For the reasons set out above, it is not a policy with meaningful distributional aspects in that the tax burden ultimately stays within the one class of the tax paying community.

### 3.2 Reduced income splitting - increased family assistance

Whatever the form of improved family assistance, it must be funded. It is a regressive measure which simply shifts the tax burden to other PAYE taxpayers not entitled to such family based relief.

If initiatives are to be funded by improved revenues extracted from the existing income tax rates scales, then income splitting should be reduced. This would recover a substantial portion of the \$1,000 million, which on a conservative estimate, as has already been stated, is lost to the revenue annually.

The revenue could be channelled not only into across the board tax or social security relief for families, but also into tax cuts for all taxpayers, either in the form of reduced rates or, preferably, by broadening the brackets at which the higher rates of tax are imposed. There are several methods to combat income splitting including:

- enacting more effective anti-avoidance legislation capable of annihilating family income splitting arrangements under a broader range of circumstances than is presently possible. For example, under Part IVA there should be no need for the Commissioner to establish any tax-avoidance purpose whatsoever;

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<sup>31</sup> Above n 16 at 10.

- imposing gift or transfer tax on the transfer of assets between associates, in particular in those cases where Part IIIA and the deeming rules for market value consideration<sup>32</sup> fail to bring to account an assessable gain on the asset transfer;
- attributing and taxing “unearned” income to the primary income earner in a “family”,<sup>33</sup>
- taxing partnerships and trusts as if they were companies.<sup>34</sup>

Just as family taxation proposals are open to challenge, such strategies have their faults. The issue is, which system, or combination of systems, best serves the needs of Australia’s tax constituency from the perspectives of economic efficiency and distributional effect, equity, the ability to be both complied with and administered, and politics?

It is submitted that general anti-avoidance legislation drafted in broad terms would not be the best method to combat income splitting. Part IVA and its predecessor s 260 have been, and are subject to, the vagaries of judicial interpretation.<sup>35</sup>

The present debate as to the application of Part IVA, following the decision of the High Court in *FCT v Peabody*,<sup>36</sup> is also testimony to the fact that general annihilating provisions operate at the expense of certainty in the law. They affect the efficiency of the tax system and contribute to both compliance and administration costs. As such, it is suggested that whilst they be retained in an improved form to reinforce anti-income splitting measures, they should not be used as a principal taxing measure in their own right.

The introduction of an asset transfer tax or gift duty would attack the alienation of income from property. As adverted to earlier, such a tax could complement any capital gains tax imposition in respect of the same transfer.

To reinforce the gift duty, the assignment to associates of income only should either be denied for tax purposes or subject to the transfer impost as if the underlying asset had been assigned. These are, however, only threshold disincentives relating solely to property income and there would be a point where eventual income

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<sup>32</sup> Sections 160ZD(2) and 160ZH(9).

<sup>33</sup> Draft White Paper, above n 8 at para 6.25.

<sup>34</sup> Ibid.

<sup>35</sup> Such as the “resurrection” of s 260 after its repeal, by a “re-constituted” High Court in the doctors’ cases - see above n 6.

<sup>36</sup> (1994) 28 ATR 344.

tax savings from an assignment would override the impediment. Having said this, the gift duty remains a valuable supporting component of the anti-income splitting regime.

Groenwegen<sup>37</sup> refers to Treasury submissions made to the Asprey Committee and gives support to a system of taxing unearned income in the hands of the primary income earner in any one family. There are several issues which arise in relation to an anti-income splitting regime which seeks to tax unearned "family" income in the hands of a single taxpayer. Such issues include:

- How broadly should "unearned income" be defined?
- How should the "family" be defined?
- Should the measures only apply after, and in respect of, assets transferred between associates?
- Should there be any exceptions to accommodate "genuine family" businesses where members contribute to the income producing activity?
- Are such measures consistent with the principles of the individual identity and property rights of women?

Compulsory joint taxation of unearned income exists in countries such as Canada and Sweden. This is distinct from any notion of family taxation, but is an anti-avoidance device to tax the proper taxpayer, being the person exercising ultimate control over the income.

In Canada the system operates following the transfer of assets between spouses or to minors.<sup>38</sup> In the international context, Australia has enacted "transferor trust" attribution provisions<sup>39</sup> to prevent, amongst other things, the abuse of non-resident family discretionary trusts for tax-avoidance purposes.

At the very least, income from assets transferred to or for the benefit of a spouse or child of a transferor should remain the income of that transferor. This would be consistent with feminist arguments upholding the capacity of women to acquire and own property in

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<sup>37</sup> Above n 21 at 20.

<sup>38</sup> Canada, Income Tax Act, s 74.

<sup>39</sup> Division 6AAA of the ITAA, s 102AAA - s 102AAZG.

their own right, for instance where income-producing property is brought into a marriage.

Unfortunately, overseas experience has shown that such measures are relatively easy to circumvent. For example, if a spouse sells one income-producing asset and gives the proceeds of sale, perhaps after being mixed with other funds, to his/her spouse, who then acquires a different income-producing asset, the Commissioner would need to be assisted by comprehensive tracing provisions in order to apply the "transferor taxation" to the person who owned the original asset. The use of loans and interposed entities also adds complexity to such issues.<sup>40</sup>

It is submitted that transferor taxation measures would not go far enough to prevent avoidance of tax and may be of questionable value, especially when the added complexity which they would bring to the tax system is assessed.

Another view is that based on the Treasury submission to the Asprey Committee, which in effect recommended that all non-PAYE income be treated as unearned income. This could be taxed in one of two ways. It could simply be subject to a higher rate of tax in the hands of the recipient, or instead it could be attributed to the family's primary income earner and taxed at the higher marginal rates, which would be attracted by the concentration of the income in the hands of one taxpayer.

Taxing the unearned income to a single taxpayer is preferable as an anti-income splitting measure, as it would have less of a distorting effect on investment than would the universal imposition of higher rates of tax on unearned income. Attributing income to a single taxpayer may offend some feminists. However, it is arguable that this is the lesser of two evils in seeking to reinforce the integrity of the tax base for the benefit of the majority of individual taxpayers.

This attribution approach would suffer from similar problems of definition of the "family" unit, as referred to in relation to the Howard proposals, except that, in this scenario, it would be the Taxation Office contending for the existence of a "family" relationship where unmarried people shared a domestic relationship. There would also be practical problems following marital breakdown and the interim division of assets, before such

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<sup>40</sup> See Arnold BJ, "Once More Into the Breach: Recent Developments in Canadian Tax Reform" (1987) *Australian Tax Forum* 197 at 203.

matters are formalised pursuant to the Family Law Act or equivalent legislation covering de facto relationships.

There is merit in treating non-PAYE income as unearned income. This would ensure that business and property income derived by associates through family trusts and partnerships would be taxed to the primary earner in any one family. Characterising non-PAYE income as unearned income is arbitrary, but from an administrative point of view it is objective.

The small business lobby may protest. However, it is arguable that legitimate income splitting should be limited to the payment of salaries to associates, subject to the "reasonableness" limits imposed by s 65 ITAA. Anything more is a tax subsidy to business paid for by PAYE taxpayers. The annual ritual of dividing family partnership or trust income amongst family members cannot be justified on horizontal equity grounds, given the constraints placed on wage and salary earners in this regard.

This approach would have the incidental effect of moving family taxpayers into the PAYE system. This would take them out of the almost universally misunderstood and decried system of provisional tax, which is merely an attempt by the government to bring forward the payment of tax on such "provisional" income at least to the same income year as that which applies to PAYE taxpayers, even if it is only collected on an annual or quarterly basis.

Division 6AA presently provides exemptions from penalty tax where children are paid an arm's length amount for services rendered in a family business<sup>41</sup> and there should be no reason why similar tests could not be applied in respect of family members working in a family business. Such tests could be applied merely to the levels of salary, or to exempt an amount of distributed income from attribution to the primary earner. It is submitted that the former approach gives more certainty and is to be preferred as an anti-income splitting measure.

An issue arises as to what extent family companies ought be targeted as part of the anti-alienation regime. However, given that the imputation system effectively treats companies as a withholding tax vehicle through which profits and tax credits pass to be taxed in the hands of the taxpayer, it should be sufficient that

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<sup>41</sup> Sections 102AE(6) and 102AG(3).



the dividends and any associated franking credits are attributed to the primary family earner when they emerge.

#### 4 Conclusion

There is evidence which indicates that family income splitting is a popular concept and was, for example, the subject of numerous submissions to the Economic Advisory Council on Taxation Reform prior to the release of the Draft White Paper in 1985.<sup>42</sup> Most submissions contained the two basic flaws, which arguably characterise the populist side of the debate:

- a failure to address the issue of the funding of family income splitting tax cuts; and
- a failure to take account of and attribute any value to the benefits accruing to families which have a full-time homemaker.

The family income splitting debate ignores a more fundamental defect in Australia's tax system which, if countered, would improve revenues so as to fund tax relief for families and taxpayers in general. The defect is the discriminatory forms of tax relief which are available to a limited number of individual taxpayers with access to non PAYE income.

The anti-income splitting measures advocated are admittedly extreme, but they are aimed at what is an abuse of the tax system which is legitimised and regarded as the right of those with access to property or business income. If any concessions are to be made, it may be in the area of business income derived through partnerships. However, there would need to be stronger measures and, in particular, concerted audit activity to counter arrangements which do not satisfy the criteria for the existence of a partnership. All family property income and income derived through trusts should at least be subject to attribution to the family primary income earner.

Family income splitting is seen as a popular and populist "political football" and Mr Howard has been one of a line of mainly conservative politicians to pick it up and run with it. It is submitted, however, that the debate is not constructive and does not address what is a real opportunity to improve the horizontal equity and overall integrity of Australia's tax base for the benefit of all

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<sup>42</sup> EPAC, *An Overview of Submissions Received on Taxation Reform* (1985 AGPS) Attachment C.

taxpayers. Unfortunately, income splitting is now more a “political hot potato” and is unlikely to be the subject of reforming attention from either side of the political fence.