

Income splitting: Who really benefits? [CA] ^[1]

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EXCERPTS

Finance Minister Jim Flaherty has let it be known the Conservative government wants to change the tax law to allow all couples - not just pensioners, as previously promised - to split their income at tax time.

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As with all tax reforms, there is a risk of the public misunderstanding what is really being proposed. Most beguiling is the claim that this change is designed to benefit the "middle class," a term that is often invoked but seldom defined by partisan tax reformers.

In reality only a minority of Canadians could obtain any benefits at all from income splitting. The biggest beneficiaries would be the three per cent of individuals who are fortunate enough to be in the top tax bracket.

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Here are some important issues that should be on the table in the upcoming public debate over income splitting.

Income splitting can be either real or fictional. Mr. Flaherty appears to prefer the fictional variety in which tax is computed as though spouses shared their income equally, without any requirement to actually do so. This was the model he adopted in the recently announced measure to allow splitting of pension income.

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Whether real or fictional, income splitting is only worthwhile if one spouse is in a higher tax bracket than the other. A couple can only get into the income splitting game if one member earns over \$35,000, roughly the point at which the tax rate increases from 15.25 per cent to 22 per cent.

Income statistics from 2004 show that only 40 per cent of tax payers earned over \$35,000. In reality, then, income splitting will benefit even fewer people than this 40 per cent. This is because it is worthless to spouses in the same tax bracket (such as two \$40,000 earners, or two \$80,000 earners), and also to those without a spouse.

Single parents, for example, would be entirely left out.

Also, the tax savings from income splitting will vary dramatically among income classes, genders, and regions.

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One effect of income splitting is to raise the effective tax rate on the lower earner because that person's wages are averaged with a partner's higher earnings. This means for example that a woman who is deciding whether to re-enter paid labour after a parental leave would face a higher tax on any wages, because she would already be "deemed" to be earning half of her spouse's income.

What this means is that for many Canadians who crave more time with their children, income splitting promotes only one model of work-life balance: Having one full-time breadwinner and one stay-at-home spouse.

Given social expectations and the economic realities of the gender wage gap, such a policy is likely to reduce women's labour force participation and increase their financial dependence on their male partners.

In this era, many men as well as women may prefer policies that promote work-life balance for both members of the couple.

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Canadian policy makers debated this issue fairly recently and decided not to move to an income splitting system. In 1999, in response to a parliamentary motion by the Reform party, the government asked the standing committee of finance to study whether our tax system discriminates against single-earner couples. After extensive research and consultation the Committee recommended maintaining individual taxation, due to the many concerns they heard about the inequities of income splitting.

Tax reform has become the policy instrument of choice these days for addressing any number of social and economic issues. Because of this, it is more critical than ever for citizens to understand the workings of the tax system and its impact on different individuals and groups.

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