

2014

Real Versus Notional Income Splitting: What Canada Should Learn from the US 'Innocent Spouse' Problem

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Recommended Citation

Philipps, Lisa, "Real Versus Notional Income Splitting: What Canada Should Learn from the US 'Innocent Spouse' Problem" (2014).
Osgoode Legal Studies Research Paper Series. 74.
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LEGAL STUDIES RESEARCH PAPER SERIES

Research Paper No. 63

Vol. 10/ Issue. 14/ (2014)

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Philipps, L. (2013). Real versus Notional Income Splitting:

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Canadian Tax Journal/Revue Fiscale Canadienne, 3, forthcoming.

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Abstract:

Canada’s individual tax unit historically has allowed a spouse to report only income over which she or he has legal control. Income splitting therefore typically requires transferring ownership of income earning property in some fashion. I refer to this as ‘real’ income splitting to contrast it with the purely notional assignment of income to a spouse’s tax return, first introduced in 2007 for pension income only. This ‘notional’ income splitting allowed spouses for the first time to shift income between their individual tax returns to achieve a lower tax rate, without any obligation to share the underlying pension entitlement. The federal government has promised to expand notional income splitting to benefit all couples with dependent children once the federal deficit is eliminated (currently projected for 2015-16). This paper challenges advocates of income splitting to address its differential impact on men and women and argues that notional income splitting worsens gender economic inequality. It highlights the egregious risk that under notional income splitting some individuals, overwhelmingly women, will be targeted for enforcement actions to collect unpaid taxes on income they have never received or controlled. Known in the U.S. as the “innocent spouse” problem it is the most acute, but not the only way in which women are systematically disadvantaged by notional income splitting. Of broader concern are the economic incentives created by notional income splitting for second earners to be financial dependents, rather than income earners or property holders in their own right. The paper urges Canadian policy makers, if they are intent on liberalizing spousal income splitting, to condition it upon a transfer of legal control over income or property to the lower-earning spouse.

Keywords:

Personal income tax policy, income splitting, gender, Canada, U.S., innocent spouse, pension income splitting

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**Real versus Notional Income Splitting:
What Canada Should Learn from the US “Innocent Spouse” Problem**

Lisa Philipps*

Any evaluation of tax policy choices in the area of spousal income splitting must include consideration of its effects on gender equality. Applying the classic tax policy criteria of equity, efficiency and administrative simplicity in a way that avoids gender is particularly unsatisfying in this context, because income splitting has such obviously gendered dynamics. It is incumbent on income splitting advocates to consider how the rules can best be designed to enhance rather than detract from women’s economic equality, autonomy and security. In order to do so, I argue, income splitting must be conditioned on a transfer of legal control over income or property between spouses. I refer to this as ‘real’ income splitting in order to contrast it with the purely notional assignment of income to the tax return of a lower earning spouse.

Notional income splitting was introduced for the first time in Canada in 2007, through the pension income splitting rules.¹ This comment discusses why notional income splitting is damaging to gender equality, and why real income splitting is a superior model. It highlights the egregious risk that under notional income splitting some individuals, overwhelmingly women, will be targeted for enforcement actions to collect unpaid taxes on income they have never received or controlled. This is because the legislation imposes joint and several liability of the spouses for any tax owing on pension income that is shifted between tax returns, regardless of who owns or has influence over the expenditure of that income.² Joint and several liability continues indefinitely and given the time lag from filing to assessment, audit and enforcement, an individual may be pursued by tax authorities even after a relationship has ended to cover unpaid taxes of a former partner who has since become judgment proof.³ Known in the U.S. as the “innocent spouse” problem it is the most acute, but by no means the only way in which women are systematically disadvantaged by such rules. Indeed it is likely that many more women will be negatively affected by the economic incentives under notional income splitting

* Professor, Osgoode Hall Law School of York University. I am indebted to Brent Cook for timely research assistance and helpful conversations, and grateful to Kim Brooks, Rhys Kesselman and Kevin Milligan for insightful comments on an earlier version. All errors and omissions remain the sole responsibility of the author.

¹ Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended, (“ITA”), s. 60(c), 56(1)(a.2), 60.03.

² ITA s.160(1.3).

³ ITA s.160(2).

for second earners to be financial dependents rather than income earners or property holders in their own right. Far from eliminating “second class taxpayers”, as claimed by Krzepkowski and Mintz, this comment explains why notional income splitting reinforces women’s second class economic status, by erecting new tax barriers to their financial autonomy.⁴

Statistics on the take up of pension income splitting confirm that men are the primary beneficiaries by a significant margin. In 2010, 82% of the over one-million individuals claiming the deduction for split pension income were men, and they accounted for 89% of the total dollar amount of claims.⁵ The revenue cost of these provisions to the federal government is projected to rise to over \$1 billion per year in 2012. Thus pension income splitting has provided a substantial tax reduction for a select, male-dominated group of taxpayers who have had a portion of their income reported on the tax returns of their lower earning spouses, almost always women. Interestingly, household income data for the same year indicate that men were the sole or higher earners in only about 69% of couples with some earnings, yet they captured an even higher proportion of the benefits of pension income splitting.⁶ These data drive home the need to consider intra-household economic disparities between men and women in any policy analysis of income splitting. Its proponents tend to gloss over these intra-household effects, preferring instead to focus on comparing the aggregate tax burdens of single and dual earner households.⁷ It was this logic that framed the Conservative Party’s 2011 election promise to introduce “income-sharing” for all couples with dependent children under 18, allowing “spouses the choice to share up to \$50,000 of their household income, for federal income-tax purposes”, once the federal budget is balanced.⁸ Before moving ahead the government should undertake a full evaluation of the effects of pension income splitting.⁹ In considering different ways to deliver on

⁴ See Matt Krzepkowski and Jack Mintz, “No More Second Class Taxpayers: How Income Splitting Can Bring Fairness to Canada’s Single-Income Families” (April 2013) Vol.6, Issue 15 *SPP Research Papers* (The School of Public Policy, University of Calgary), at 1.

⁵ Canada Revenue Agency, *Preliminary Income Statistics – 2012 Edition* (Table 4, All returns by age and sex, line 34).

⁶ Statistics Canada, CANSIM 202-0105. By way of speculation, the reasons may relate to men’s higher average incomes increasing their potential benefit from income splitting, or to intra-household income distribution among the specific demographic that receives private pension income.

⁷ See for example Krzepkowski and Mintz, *supra*.

⁸ Conservative Party of Canada, *Here for Canada: Stephen Harper’s Low-Tax Plan for Jobs and Economic Growth* (undated), 26.

⁹ See John Lester’s proposal for regular benefit-cost evaluation of all tax expenditures that are close substitutes for program spending, in which he includes the pension income splitting rules: “Managing

its election promise it should pay especially close attention to the distinction between real and notional income splitting.

DISTINGUISHING REAL AND NOTIONAL MODELS OF INCOME SPLITTING

A critical variable in assessing the gender equality effects of income splitting is whether the higher income spouse must cede legal control over the split income (or the underlying asset which generates the split income) in order to achieve a reduction of tax liability. Until 2007 this was always the case in Canada. That is, a transfer of income or assets in favour of the lower income spouse was required in order to split income for tax purposes. The pension income splitting rules departed from this norm. For the first time in the history of Canadian income tax law, a tax reduction can be obtained for individuals through a purely notional transfer of income on paper, from the tax return of the spouse who legally owns the income to the return of the non-owning spouse. In other words, pension income splitting allows for a shifting of tax liability to the lower earning spouse without any corresponding shift of legal control over economic resources.¹⁰ Rather than “income sharing”, “tax sharing” would be a more accurate term to describe these provisions.¹¹

The tax policy arguments against spousal income splitting are linked to the well-known arguments in favour of maintaining an individual, versus joint marital or familial, taxation unit.¹² The case for joint taxation of couples is based on the view that “the income and expenditure of two individuals are not independent when they live together.”¹³ However empirical studies have shown that it is far too simplistic to assume all income is pooled and shared equally within all

Tax Expenditures and Government Program Spending: Proposals for Reform” (Vol.5, Issue 35) *SPP Research Papers* (University of Calgary School of Public Policy), 13.

¹⁰ See Frances Woolley, “Liability Without Control: The Curious Case of Pension Income Splitting” (2007) 55 *Canadian Tax Journal* 603.

¹¹ The phrase “income sharing” is used in the Conservative Party’s 2011 election platform, *supra*.

¹² For more detailed discussion of the tax policy case against joint taxation see Grace Blumberg, “Sexism in the Code: A Comparative Study of Income Taxation of Working Wives and Mothers” (1971) 21 *Buffalo Law Review* 49; Neil Brooks, “The Irrelevance of Conjugal Units in Assessing Tax Liability”, in John Head and Richard Krever, eds., *Tax Units and the Tax Rate Scale* (Burwood, Victoria: The Australian Research Foundation, 1996); and House of Commons Standing Committee on Finance, *For the Benefit of the Children: Improving Tax Fairness* (Nineteenth Report of the Standing Committee on Finance, Sub-Committee on Tax Equity for Canadian Families with Dependent Children (Ottawa: Queen’s Printer, 1999).

¹³ Krzepkowski and Mintz, *supra*, at 2.

households. Rather, couples are highly diverse in the degree to which they share decision making about the use of household income, who manages the finances, and who benefits from consumption.¹⁴ The studies indicate that even where funds are pooled in a joint account, the legal earner or owner still enjoys more control over how money is spent.

From a gender equality perspective the objections to spousal income splitting (or any other shift toward joint taxation of couples) typically include that it: 1) mainly benefits higher income married men, 2) privileges couples with a sharply gendered division of labour over all other household forms, 3) discourages wives' participation in paid work by raising the tax rate on 'secondary' earned income, and 4) reduces government revenues that could be used to fund transfers or services aimed at reducing labour force barriers and promoting gender equality.¹⁵ While agreeing with this critique overall, I also suggest it is insufficiently nuanced in tarring all income splitting with the same brush. I have argued elsewhere that a feminist case can be made for permitting real income splitting, conditioned on shifting legal control of income or property to the lower income spouse.¹⁶

If properly designed, real income splitting rules could incentivize higher income earners to transfer title over income or assets to their lower earning spouses, potentially enhancing the latter's economic autonomy and security both during the marriage, and in the event of relationship breakdown. Such transfers would also serve materially to recognize and compensate, at least in part, the unpaid caregiving and other household labour performed by a much lower earning spouse, usually a woman. These incentive effects have been documented in the UK which moved from joint marital taxation to an individual unit in 1990, but allowed

¹⁴ See Peter Burton, Shelley Phipps and Frances Woolley, "Inequality with the Household Reconsidered", in S Jenkins and J Micklewright, eds., *Inequality and Poverty Re-examined* (Oxford: Oxford University Press, 2007); and Marjorie Kornhauser, "Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return" (1993) 45 *Hastings Law Journal* 63.

¹⁵ See Jonathan Kesselman, *Income Splitting and Joint Taxation: What's Fair?* (Montreal: Institute for Research on Public Policy, 2008) 25-34; Kathleen Lahey, *Women and Employment: Removing Fiscal Barriers to Women's Labour Force Participation* (Ottawa: Status of Women Canada), 2005; Alexandre Laurin and Jonathan Rhys Kesselman, *Income Splitting for Two-Parent Families: Who Gains, Who Doesn't, and At What Cost?* (Toronto: CD Howe Institute Commentary 335, 2011), at 3, 13-15; Lisa Philipps, "Income Splitting and Gender Equality: The Case for Incentivizing Intra-Household Wealth Transfers", in Kim Brooks, Asa Gunnarson, Lisa Philipps and Maria Wersig (eds.), *Challenging Gender Inequality in Tax Policy Making: Comparative Perspectives* (Oxford: Hart Publishing Inc., 2011) 177-194; Woolley, *supra* note 16; and Lawrence Zelenak, "Marriage and the Income Tax Act" (1994) 67 *Southern California Law Review* 339, at 380.

¹⁶ Philipps, *supra* note 21. .

outright transfers of property between spouses without attribution of income.¹⁷ Likewise, Schuetze found that self-employed men in Canada are more likely to allocate salary, wages or profits to their wives for tax purposes, compared to their counterparts in the US who need only file a joint return with a lower earning spouse to reduce their personal tax rate.¹⁸ Even if the sole motive for such transfers is tax minimization, they must be legally enforceable to have the desired effect.

A possible objection to real income splitting is the difficulty of ensuring that inter-spousal transfers actually take place and are legally effective rather than sham transactions. One simple way to encourage compliance would be to require a declaration in prescribed form by the transferor spouse that legal ownership of the split income has been gifted or otherwise transferred absolutely to the other spouse. The existing pension income splitting rules already require a joint election and certification that both spouses agree to the designated amount being deducted on the pensioner's return and included in the other spouse's income, and understand that they are jointly and severally liable for any resulting tax, interest and penalties.¹⁹ Undoubtedly the transferor spouse would in many cases retain some informal influence or would benefit from the expenditure of the funds, but this does not take away the value of giving lower earning spouses legal title to a greater share of the household income. Studies of family economic behaviour indicate that legal ownership comes with a greater sense of entitlement to participate in decision making.²⁰ As Zelenak suggests, property owners often make consumption decisions cooperatively with a spouse, but ultimately "they still have control over the source of the income (as well as control over whether to stay married)."²¹ On divorce, family law rights to claim a share of assets can be difficult and expensive to enforce against an unwilling ex-spouse. Gaining documented title to assets is therefore an important source of future economic security for a low earning spouse, providing a more meaningful option to exit from relationships which

¹⁷ M Stephens and J Ward-Batts found that lower income spouses reported a larger share of household investment income after the reform than they had before providing "strong evidence" of tax motivated property transfers, though most couples did not take full advantage of the potential for reducing taxes in this manner: "The Impact of Taxation on the Intra-Household Allocation of Assets: Evidence from the UK" (2004) 88 *Journal of Public Economics* 1989.

¹⁸ Herbert Schuetze, "Income Splitting Among the Self-Employed" (2006) 39 *Canadian Journal of Economics* 1195.

¹⁹ Canada Revenue Agency, *Joint Election to Split Income* (Form T1032).

²⁰ See P Burton, S Phipps and F Woolley, "Inequality within the Household Reconsidered" in S Jenkins and J Micklewright (eds), *Inequality and Poverty Re-Examined* (Oxford: Oxford University Press, 2007).

²¹ Zelenak, *supra* note 21, at 357.

should also translate into greater bargaining power within them.²² For all these reasons, tax rules that allow for real income splitting could have some gender equality-enhancing effects.²³

By contrast, notional income splitting of the kind introduced in Canada in 2007 reinforces gender inequalities, because it involves the transfer of tax liability without any legal requirement to share control over the income that gives rise to it. The drafters of this policy presume that income is pooled within the household and this is precisely the problem. As Lahey has pointed out, “[g]iving people who do not share incomes or property the benefit of presumed sharing eliminates any incentive they might otherwise have to share.”²⁴ If the law is amended to allow notional income splitting of up to \$50,000 per annum, many couples who would otherwise engage in real income splitting through existing legal means such as spousal RRSPs or payment of wages or dividends to a spouse, will likely opt instead simply to shift income on paper. Doing so would often be simpler, and would allow the wealthier spouse to avoid transferring title to any assets or income. Notional income splitting would push couples away from existing tax planning mechanisms by which a non-earning or low earning spouse currently can acquire some independent financial resources.

A further challenge is that any income earned independently by the transferee spouse will be stacked on top of the split income, raising fiscal barriers to women’s equal participation in paid labour. This is the primary reason why most tax policy analysts reject joint taxation.²⁵ The proposal by Krzepkowski and Mintz to eliminate the spousal credit for couples who split income, replacing it with an employment income credit for the lower earning spouse, is an unsatisfying response.²⁶ While alleviating the stacking effect on the first \$10,822 (in 2012) of employment income received by a second earner, any dollars above that modest amount would still be exposed to steeper tax rates because she (usually) is also reporting a share of the primary breadwinner’s income. Moreover, it is unclear why the second earner should not be able to claim the credit on investment, business or other independent sources of income. Contrary to its claim, the proposal would create “second class taxpayers” who lose access to a comprehensive

²² For a more detailed elaboration of these arguments in favour of real income splitting see Philipps, *supra* note 21, at 240-250.

²³ For a similar analysis see Laurin and Kesselman, *supra* note 21, at 17-18.

²⁴ Lahey, *supra* note 21, at 26. See also Woolley, *supra* note 16, at 613.

²⁵ See articles and reports cited *supra* at notes 18 and 21.

²⁶ Krzepkowski and Mintz, *supra*, at 10-11.

basic personal credit that is available to every other Canadian resident, and are exposed to relatively high marginal tax rates on any income beyond \$10,822 of wages.

Notional income splitting therefore tends to exacerbate economic inequality between spouses, because it disincentivizes both intra-household transfers and independent earning by the partner who is reporting split income. In theory, wives should be able to bargain for a redistribution of income or property in return for signing a joint election to split income. In practice, many economically dependent wives lack the information, the sense of entitlement, or the bargaining power to demand greater control over household resources. It is common simply to trust that the higher earning spouse will do the right thing in covering taxes and providing for family expenses. The potential for this to go badly wrong for some people is illustrated vividly in the “innocent spouse” cases which have plagued the US income tax system. I elaborate on the innocent spouse problem below in order to demonstrate the challenges raised by notional income splitting.

THE US “INNOCENT SPOUSE” PROBLEM

The nature of the problem is best illustrated through a story. One of many well publicized innocent spouse cases in the US involved Carol Ross Joynt, whose husband, Howard Joynt, died after evading payroll and business income taxes for years. In her memoir Carol described suffering occasional physical abuse by Howard but also enjoying a privileged lifestyle funded (she believed) through her husband’s inherited wealth and the popular bar and restaurant he owned in Washington DC.²⁷ Though a successful journalist who earned a salary of her own, Carol wrote that she knew little of Howard’s business affairs and deferred to his insistence on managing the household finances exclusively. Her occasional questions were met with reassurances that she need not worry, and she signed joint returns trusting that the accountants who prepared them had done so correctly. All seemed well until Howard’s death, when Carol learned he had been audited by the IRS and she was now the defendant in a claim for over \$3 million in unpaid taxes, penalties and interest, an amount that exceeded the value of his entire

²⁷ Carol Ross Joynt, *Innocent Spouse* (New York: Broadway Paperbacks, 2011).

estate.²⁸ Following a protracted appeal and with the help of legal advice she eventually reached a settlement with the IRS, which accepted at least in part her claim for relief under the “innocent spouse” provisions of the Internal Revenue Code.²⁹

The US legislated joint liability for spouses who file a joint marital return in 1938.³⁰ Importantly, this liability is not limited to the taxes shown as owing on the face of the return, but applies to all taxes subsequently assessed on unreported or misreported income.³¹ The liability is not limited in time or affected by the terms of a divorce decree or separation agreement.³² Thus the US system poses an especially grave risk to those who are unaware that their spouses are engaging in aggressive avoidance or evasion of tax. The only defense available to an unwitting spouse under the 1938 legislation was to invoke a common law doctrine such as duress or fraud to invalidate the signature on the joint return. The harsh effects of the law were revealed in a series of cases involving wives who were made to pay taxes and penalties on the ill-gotten gains of their judgment proof ex-husbands, even if, for example, the unreported income had been embezzled from the wife’s own business.

Judicial calls for legislative relief were answered with the enactment of the first generation of innocent spouse provisions in 1971. These rules protected spouses from liability in limited circumstances involving an omission of income from the return and only in cases of serious financial hardship.³³ Experience showed the law did not provide relief in all deserving cases, and public and judicial outcries led to successive waves of reform in 1980, 1984 and 1998 to expand the grounds for relief. Not surprisingly the reforms have also made the rules more

²⁸ For a media account of the Joynt case and several others see Sandra Block, “IRS ‘innocent spouse’ rules can be tough”, *USATODY.com*, June 24, 2011. For more scholarly accounts of litigated cases see for example Natalie Hoyer Keller, “Do You, Elizabeth, Promise to Pay John’s Taxes? I Do: A Review of the Innocent Spouse Provisions and a Proposal for Change” (1996) *Utah L. Rev.* 1065; Stephen A. Zorn, “Innocent Spouses, Reasonable Women and Divorce: The Gap Between Reality and the Internal Revenue Code” (1996) 3 *Mich. J. Gender & L.* 421; and Christopher B. Wyrick, “Till Death Do Us Part Including Our Taxes: Inequity Abounds in Spousal Joint and Several Tax Liability and the ‘Innocent Spouse’ Rule” (1997) 6 *Kan. J.L. & Pub. Pol’y* 163.

²⁹ IRC 6015, discussed *infra*.

³⁰ See now IRC 6013(d)(3). The legislative history of joint return liability and innocent spouse relief is reviewed in Richard C.E. Beck, “The Failure of Innocent Spouse Reform” (2006/2007) 51 *N.Y.L. Sch.L.Rev.* 929, at 933-943; Michelle Lyon Drumbi, “Decoupling Taxes and Marriage: Beyond Innocence and Income Splitting” (2012-13) *Colum. J. Tax. L.* 94; and Stephanie Hunter McMahon, “An Empirical History of Innocent Spouse Relief: Do Courts Implement Congress’s Legislative Intent?” (2012) 12 *Fla. Tax Rev.* 629, at 635-645. See also US Department of the Treasury, *Report to the Congress on Joint Liability and Innocent Spouse Issues* (February 1998).

³¹ Beck, *supra*, at 930.

³² US Department of the Treasury, *supra*, at 9.

³³ McMahon, 638-639.

complicated. It is now possible to apply for innocent spouse relief under three separate heads with overlapping but distinct criteria that require the claimant to show, for example, that she did not know (and in some cases did not have reason to know) of the understatement of tax, and that it would be inequitable to hold her liable for the unpaid tax.³⁴ These ambiguous provisions have generated extensive interpretive debates and must often be applied based on limited evidence such as the inconsistent testimony of spouses, with the IRS delving into allegations of abuse, mental illness, and other intimate details of a former marriage.³⁵ The cost to the government of administering these provisions is substantial. The IRS maintains a centralized, dedicated office for processing innocent spouse claims, which were listed by the National Taxpayer Advocate as one of the IRS's top ten litigated issues in all but one year in the last decade.³⁶ From a taxpayer perspective, Drumbl has underlined the access to justice and fairness issues created when separated or divorced spouses, often single parents far less privileged than Carol Ross Joynt, must hire professional advisors and prosecute multiple levels of appeal to win the right to innocent spouse relief.³⁷ While most critiques have focused on the deserving cases that still fall through the cracks, McMahon has also argued that the current rules are at the same time too liberal, opening opportunities for spouses to collude in abusing the provisions to evade taxes.³⁸

While there is a range of opinions about how best to fix the innocent spouse rules, US commentators seem to agree that they are costly and unfair despite several rounds of legislative and administrative reform. Moreover, it is overwhelmingly women who bear the brunt of this problem. Tax policy makers ought to consider whether Canada risks importing this problem as it implements notional income splitting rules akin to US joint filing.

LESSONS FOR CANADIAN TAX POLICY MAKERS

³⁴ IRC 6015(b), (c) and (f).

³⁵ For discussion of the interpretive and evidentiary challenges of applying the rules see Drumbl, *supra*; Stephanie Hunter McMahon, "What Innocent Spouse Relief Says About Women and the Rest of Us" (2013) SSRN; and Lily Kahng, "Innocent Spouses: A Critique of the New Tax Laws Governing Joint and Several Tax Liability" (2004) 49:2 Villanova Law Rev. 261. .

³⁶ McMahon (2013), *supra*, at 4.

³⁷ Drumbl, *supra*.

³⁸ McMahon (2013), *supra*.

Notional income splitting carries a real risk that taxes owing on income earned by a wealthier spouse will be unjustly recovered from the other. Admittedly, Canada's existing pension income splitting rules do not create the same degree of risk as the US joint filing system. First, the joint liability of spouses is limited to taxes owing on the split income, unlike the US where it extends to all unreported income of the other spouse, from any source. In addition private pension income is subject to withholding at source under s.153(1) of the ITA, and s.153(2) provides that,

If a pensioner and a pension transferee (as those terms are defined in [section 60.03](#)) make a joint election under [section 60.03](#) in respect of a split-pension amount (as defined in that section) for a taxation year, the portion of the amount deducted or withheld under subsection (1) that may be reasonably considered to be in respect of the split-pension amount is deemed to have been deducted or withheld on account of the pension transferee's tax for the taxation year under this Part and not on account of the pensioner's tax for the taxation year under this Part.

In most cases, this deeming rule will protect the spouse who reports the income from unexpected tax liabilities after the fact. But it is not a foolproof system. A payor may fail to withhold or remit taxes as required under s.153(1), or the amount withheld may turn out to be inadequate to cover tax liability as assessed (particularly if the transferee spouse has other sources of income).

Nor does the law require pension payors or recipients, or the CRA, to share information slips so that a spouse can see for themselves how much tax has been paid in advance in respect of pension income being reported on her return. The CRA's Q and A Release on pension income splitting states:

Q.2 Is it necessary to contact the payer of the pension?

A.2 Splitting eligible pension income does not have any effect on how or to whom the pension income is paid, so it does not involve the payer of the pension. Information slips will be prepared and sent to the recipient of the pension income in the same manner as previous years....

Q.6 Who will claim the tax withheld at source from the eligible pension income?

A.6 The income tax that is withheld at source from the eligible pension income will have to be allocated from the pensioner to the spouse or common-law partner in the same proportion as the

pension income is allocated.³⁹

The Q&A responses suggest that spouses have no right to demand copies of information slips provided to pension recipients. The Release is silent as to who bears the responsibility for ensuring an appropriate allocation of withheld amounts to the spouse.

These concerns are mitigated to some degree by CRA's prescribed form for making the joint election, which does require the parties to provide information about the amount of tax deducted at source in respect of the split income.⁴⁰ Further, the ITA provides that "[a] joint election is invalid if the Minister establishes that a pensioner or a pension transferee has knowingly or under circumstances amounting to gross negligence made a false declaration in the joint election."⁴¹ Thus an unscrupulous spouse who purposely understates source deductions may remain solely responsible for tax on the pension income, if the form is challenged and the Minister can prove the requisite state of mind. However these measures may not assist in cases where the pension recipient is abusive or domineering, or simply makes an error, and the reporting spouse trusts the information provided, or is not willing or able to challenge or verify information about withholding. Just as in the US, not all Canadian marriages are open and cooperative, and both relationship and financial circumstances of a taxpayer can change in unpredictable ways between the time when a joint election is signed, and the time when tax is finally assessed and must be paid. Realistically, though, the scale of this risk under the current pension income splitting rules should not be exaggerated. While we should not overlook individual cases of injustice or hardship that may arise, these should be relatively rare instances because source deductions on pension income will usually ensure the reporting spouse has no additional tax to pay.

A far more significant risk of innocent spouse liability will arise if notional income splitting is opened up to a wider range of income sources and taxpayers as suggested in the 2011 election campaign. Presumably the income qualified for splitting would include business and investment income that is not subject to withholding of tax at source, and which creates greater opportunities for aggressive tax avoidance or evasion by the recipient. Cases decided under existing joint and several liability provisions of s.160 of the ITA substantiate this concern and

³⁹ CRA Q&A Releases, 2007-07-18 -- *Pension Income Splitting*.

⁴⁰ CRA Form T1032 E (12), Step 5.

⁴¹ ITA s.60.03(4).

offer a glimpse into the potential for an unwitting spouse to be assessed for unpaid taxes, penalties and interest accruing over multiple years.

In essence, s.160 provides for joint and several liability where an individual transfers property to a spouse for less than fair market value consideration, at a time when the individual owes income tax. As with any tax debt, the normal reassessment period of three years may be indefinite if the primary earner has fraudulently misrepresented his (or her) income. Moreover, the Courts have held that the limitation period for assessing the joint debtor only starts to run 90 days after the first spouse is assessed for the unpaid tax, not on the earlier date when the property was transferred.⁴² In addition, s.160 has been held to impose absolute liability that does not require any knowledge of the primary debtor's unpaid tax.⁴³ The joint debt can be enforced against the spouse even after the primary debtor has gone bankrupt.⁴⁴ Further, where the primary debtor owes tax for some years that are subject to joint spousal liability and some that are not (for example because they post-date the transfer of assets to the spouse), CRA is under no obligation to apply any amounts that it recovers from the bankruptcy against the former. Rather, CRA can apply recoveries to the amounts for which the primary debtor is solely liable, preserving its ability to assess the spouse for joint debts.⁴⁵

The risk for spouses inherent in joint liability is nicely captured by Sharlow J.A.'s comments in the Court's decision against Mrs. Wannan:

While not every use of section 160 is unwarranted or unfair, there is always some potential for an unjust result. There is no due diligence defence to the application of section 160. It may apply to a transferee of property who has no intention to assist the primary debtor to avoid the payment of tax. Indeed, it may apply to a transferee who has no knowledge of the tax affairs of the primary debtor. However section 160 has been validly enacted as part of the law of Canada. If the Crown seeks to rely on section 160 in a particular case, it must be permitted to do so if the statutory conditions are met.⁴⁶

⁴² See *Madsen v. The Queen*, 2004 DTC 3058 (TCC).

⁴³ See *Wannan v. The Queen*, 2003 DTC 5715 (FCA); *No.605 v. MNR*, 59 DTC 159 (TAB).

⁴⁴ See *Clause v. The Queen*, 2010 DTC 1298 (TCC); *Wannan v. The Queen*, 2003 DTC 5715 (FCA); *Bergeron v. The Queen*, 2003 DTC 1491 (TCC); *The Queen v. Heavyside*, 97 DTC 5026 (FCA).

⁴⁵ *Ibid.*

⁴⁶ *Supra*, at paragraph 3.

It should be remembered that in s.160 cases the joint debtor has actually received a transfer of property that may be available to satisfy the tax debt, or which has in some way enriched the joint debtor. The spouse's situation may be much worse with notional income splitting as joint liability is imposed without any requirement for an actual transfer of income or property.

The US experience shows it is not a simple matter to design relieving provisions for innocent spouses that will effectively prevent injustice without imposing burdensome costs on taxpayers and tax authorities, and without opening up opportunities for not-so-innocent spouses to collude to defeat the tax authorities. At the very least, this issue needs to be thought through from the standpoint of gender equality, as well as administrative feasibility, before income splitting rules are broadened. The preferred approach would be to make tax advantages conditional upon a legal transfer of income or assets – that is to enact real income splitting rather than notional income splitting.

CONCLUSION

The so-called innocent spouse problem refers to unjust imposition of joint return liability on a lower income spouse, where the higher earner has become judgment proof or is harder to pursue for unpaid taxes. In relatively egalitarian relationships characterized by strong transparency and communication, spouses may well structure their affairs to ensure that taxes are covered by the higher income spouse and that there is shared benefit from the tax savings on split income, if not from the full amount of the underlying income. However, studies of household economic behaviour suggest this best case scenario does not apply in all cases. Rather, some spouses will sign a joint election form without full or accurate information about the implications for their own tax liability, and without gaining control over any additional household resources. The lower earning spouse (almost always a woman in the innocent spouse cases) may then become the target of enforcement actions to collect unpaid tax, perhaps after the relationship has ended, and whether or not she has access to the underlying income. The US experience is that this happens with alarming frequency, and their chosen remedy of granting special relief to spouses deemed “innocent” has created its own set of inequities and administrative burdens.

I highlight the innocent spouse problem in this comment as just the tip of an iceberg. It is one of the more visible, measurable ways in which notional income splitting regimes undermine

gender equality, and one that should dissuade governments from extending notional income splitting any further. But there is a larger and less visible part of the iceberg which should be at least as concerning to policy makers. Notional models of income splitting actually remove incentives for a wealthier spouse to place legal title to assets or income in the hands of a partner who does not have equal earning power, or who forgoes opportunities in the paid labour market in order to focus on parenting or other unpaid care roles. It also raises the marginal effective tax rate on any income earned independently by that partner, raising the fiscal barriers to women's equal participation in markets. These effects may attract less immediate attention but will be far more pervasive than the innocent spouse problem. Wrongheaded from the standpoint of economic efficiency, such a policy also would be a step back in the process of securing Canadian women's economic and social equality. Real income splitting models should be considered as an alternative that could be appropriately designed to have some gender equality promoting effects.