Facts and Fallacies of Conjugality: The Attribution Rules Revisited

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Introduction

Taking account of taxpayers’ conjugal relationships in determining their tax liability reduces the effectiveness of the tax system in achieving an appropriate distribution of society’s resources, misperceives the nature of tax law, leads to serious horizontal inequities, hinders the achievement of gender equity, complicates the tax system, intrudes into the privacy of intimate relationships, and furthers male dominance in the private realm.\(^1\)

Many torments are said to lie within the confines of a wedding ring. No doubt every marriage exacts its price. But of all the inequities that conspire to thwart marital bliss, few are as insidious as those imposed by the *Income Tax Act*.\(^2\) Although married Canadians could expect to shoulder a lighter tax burden by obtaining a divorce and signing a well-crafted support and equalization agreement,\(^3\) from a practical standpoint, few taxpayers will divorce or fail to marry solely to avoid the added tax bite. Ideally, the decision to remain tied by the marital knot should reflect a triumph of love over money and not the failure to obtain professional tax advice. Canadian income tax legislation, however, would have one speculate otherwise -- conditioned as it is in parts -- on a taxpayer’s conjugal status.\(^4\)

Federal tax policy has always reflected some ambivalence over whether it should be centred strictly on the individual tax unit, thereby rendering conjugal relationships irrelevant to the assessment of tax, or whether certain relationships in specified circumstances should be recognized.\(^5\) Granted that the ‘individual’ has been formally adopted as the tax unit for income tax purposes, legislators have consistently added on special ‘joint’ or marital provisions in income tax legislation. As such, the Act contains nearly 200 provisions that depend in some way on close adult relationships and includes over 400 references to the term, “spouse”.\(^6\) Suffice it to say, the Act recognizes, for various reasons, the interdependence of familial relationships and more specifically, spouses.
Although the definition of “spouse” has been expanded in recent years to include common-law heterosexual and same-sex partnerships, these reforms have stopped short of questioning why conjugality should be the relevant condition for adjusting taxes in the first place. In this way, although Canadian law has become “almost entirely sex, race and sexuality-neutral”, the ‘couple’ is still relied on as a basis for allocating the tax burden. The question arises, is it appropriate for income tax laws to be concerned with conjugal relationships? Should they be taken into account in defining an individual’s rights and obligations vis-à-vis the state? While it is beyond the scope of this paper to provide a definitive answer to this query, the ensuing analysis would be incomplete without reference to the surrounding debate.

In their analysis of the tax rules that relate to spouses and familial relationships, authors have traditionally classified the rules that relate to spouses into two broad categories: those which favour spouses by lowering their combined tax liability and rules that are unfavourable to spouses because they have the effect of increasing their overall tax liability. For present purposes, such an approach is arguably inappropriate. One cannot assess the impact of (or the need for) a particular measure solely by reference to criteria that consider whether the taxpayer has an increased or a reduced tax burden. Provisions that hinge on spousal status must be evaluated within the context of the distinct goals and features that characterize the Canadian tax regime. Moreover, the analysis must be situated in the social, political and economic environment in which the rules apply.

The purpose of this paper is to evaluate the operation and impact of two key tax provisions predicated on spousal relationships, namely, the spousal and common-law partner attribution rules (“spousal attribution rules”) in subsections 74.1(1) and 74.2 of the Act. Three general questions underlie this critique. First, are the objectives of the legislation and policy
underlying the provisions legitimate? Second, on the assumption that they can be justified, is the spousal-sharing relationship pertinent to these objectives or can the rights and responsibilities in question be individualized? Third, assuming that the relationship is relevant, can the provisions be better tailored to achieve their aims more coherently?

While much work has been done to determine the impact on taxpayers of the rules that relate to spousal relationships, the analysis has generally tended to occur in the context of considering the tax unit. The typical inquiry is one that has analyzed whether spouses should be treated as one unit for tax purposes and accordingly, should file a joint return. Only a select number of studies have focused on the underlying issue of whether it is appropriate to recognize a conjugal relationship for any purpose in the Act.

This paper proposes to explore the manner in which the current income tax system can compromise the integrity of the individual as the unit of taxation and demonstrate why this may be problematic. The underlying assumption is that the tax treatment of close adult relationships should depend less on whether they are conjugal in nature and more on their functional relevance to the policy objectives of the Canadian tax regime.

Drawing on tax policy literature, feminist analyses on tax law and policy, as well as general economic theories and data on Canadian households, this paper examines the nature of the state’s role and interest in designing tax instruments for the regulation of spousal relationships. It also canvasses the objectives of the tax system in respect of the attribution rules and considers whether these goals can be achieved without reference to the spousal unit.

The paper begins by tracing the evolution of subsections 74.1(1) and 74.2. It proceeds to examine these provisions in greater depth by taking into account the basic tenets of technical tax policy enquiry. It also discusses whether the policy rationales underlying these provisions are
valid given changing demographics and reviews the efficacy of the rules in achieving their purpose. The conclusion briefly reiterates the inconsistencies that have tended to plague the spousal attribution rules and summarizes options for reform.

**Legislative History of the Spousal Attribution Rules**

From its inception in 1917, the Canadian income tax system has accounted for various facets of spousal and familial relationships. While the precise nature of these relationships, and the rules applicable to ‘related’ persons, such as spouses, have changed over the last 90 years, the tax system has consistently treated married taxpayers differently. The *Income War Tax Act* (the predecessor of the ITA) provided a different tax threshold for spouses than it did for single taxpayers. In particular, it imposed a 4% tax on all income exceeding $1,500 for “unmarried persons and widows or widowers without dependent children.” For all other individuals (married persons and widows or widowers with dependent children) the 4% tax was only payable on income exceeding $3,000.

The Minister of Finance had initially proposed that all taxpayers be given the same personal exemptions without regard to marriage or family composition. However, in the ensuing debates, those who wanted marriage to be given special status prevailed over those who suggested that “household composition was so diverse that no special benefits should be given only to married taxpayers.”

Parliament’s intent was to ensure that all married persons received preferential tax treatment by way of an exemption from tax. The effect of the provision, however, was to leave married men with larger after-tax incomes than single men, married women and spinsters. At the time, the hope was expressed that all married men would “do their duty”. Nevertheless, it was acknowledged that not all who would qualify for the exemption would necessarily have or
support dependants. As noted by Kathleen Lahey, this policy effectively exempted working class men -- single and married -- from income taxation.\(^{12}\)

The first federal income tax statute also included an attribution rule that was designed to prevent income splitting between husband and wife. The rule recognized that there was an incentive to reduce the overall tax liability within relationships. As indicated above, this incentive arose at a time where only one spouse would pay tax. It was determined that the consequent tax advantage gained from transferring income to a spouse who did not pay tax was inappropriate. Subsection 4(4) of *The Income War Tax Act, 1917* was thus enacted. The rule embodied a test of application that considered not only the form of the particular transaction but also its purpose. It provided as follows:

A person who, after the first day of August, 1917, has reduced his income by the transfer or assignment of any real or personal, movable or immovable property, to such person’s wife or husband, as the case may be, or to any member of the family of such person, shall, nevertheless, be liable to be taxed as if such transfer or assignment had not been made, unless the Minister is satisfied that such transfer or assignment was not made for the purpose of evading the taxes imposed under this Act or any part thereof.

The 1917 provision was simple in its language and explicit in its intention. Moreover, the rule was not drafted to capture every offensive transaction, but rather left considerable leeway for judicial and administrative interpretation. The behaviour targeted by the provision was the reduction of tax through the shifting of income to spouses and other family members, where the purpose of the transaction could not otherwise be justified. The mechanism to dissuade this avoidance behaviour was to tax the errant taxpayer as if the transaction had not occurred.

It is significant to note that over the years, application of the government’s policy against income splitting was developed more by the judiciary than through statutory intervention.\(^{13}\) “Decisions in which the courts’ traditional adherence to strict construction ignored and frustrated
the rules’ manifest purpose to prevent tax avoidance” were, however, overruled by legislative amendment. In *M.N.R. v. MacInnes*, for example, the Minister sought to apply the attribution rule in subsection 32(2) of the *Income War Tax Act* to dividend income from shares purchased by the taxpayer’s wife with proceeds from the sale of certain other securities. She had acquired these securities with funds that had been gifted to her by the taxpayer.

The Court held that the rule, which applied to “income derived from [transferred] property or from property substituted therefor,” did not apply to income from property substituted for property, substituted for transferred property. Although the words “substituted property” might reasonably have been interpreted to include subsequent substitutions *ad infinitum*, the Court emphasized that “a tax liability cannot be fastened upon a person unless his case comes within the express terms of the enactment by which it is imposed.” It concluded as follows:

[I]f Parliament has intended that a husband should be liable to tax in respect of income derived not only from property transferred by him to his wife and property substituted therefor but also from property substituted for such substituted property, it should have expressed its intention in clear terms.

The fact that the Act was amended after the years at issue (but before the hearing of the case) to deem property substituted for substituted property, to be substituted property, merely confirmed the Court’s conclusion that the taxpayer was not liable “under the law as it stood in 1948.”

Employing a similar interpretative approach, the Exchequer Court held in *Robins v. M.N.R* that the rule in subsection 21(1) of the 1952 *Income Tax Act*, which applied to “income for a taxation year from the property or from property substituted therefor,” did not apply to business income from the sale of real estate acquired by the taxpayer’s spouse with capital supplied by the taxpayer. Notwithstanding the fact that this interpretation disregarded the
express purpose of the rules to prevent income splitting, the decision was not subsequently reversed by legislation.

By the time of the 1972 tax reform, the attribution rules had evolved into a more detailed series of provisions that applied not only to transfers of all income-producing property, but also to earnings from family businesses of all types, including sole proprietorships, partnerships of which the spouse was an employee, partnerships of which both spouses were members, and spousal employees of incorporated family businesses. As Kathleen Lahey has suggested, a particularly adverse consequence of these rules, especially as they related to family businesses, was that they effectively “appropriated what would have been a wife’s paid labour and turned it into her husband’s property by disallowing salary deductions and denying the existence of family business partnerships for tax purposes.”

As the rules were gradually refined through the court process, planning techniques aimed at exploiting perceived loopholes in the law were created. For instance, in Denkelman v. M.N.R., the Exchequer Court ruled that a loan did not constitute a transfer of property. Consequently, the attribution rules could not be applied to “genuine loans” to an individual’s spouse. In a subsequent decision rendered by the same Court, the rules were even held to be inapplicable to non-interest-bearing demand loans whose primary purpose could reasonably be regarded as being the avoidance of the attribution rules.

Another method of income splitting that was effectively popularized by the decision of the Supreme Court in Army & Navy Dept. Stores was founded on the principle that a shareholder has no ownership interest, either direct or indirect, in the property of a corporation. Accordingly, in this method income splitting was achieved by transferring property to a corporation owned by the taxpayer’s spouse. Income earned on the property was then paid by the
corporation to the spouse, either directly or by means of a trust, in the form of dividends or salaries.

The ability to circumvent attribution by simply executing a loan agreement inspired several Canadian brokerage houses to market pre-packaged “family trusts” as an income-splitting vehicle. In an effort to suppress the proliferation of these schemes, the Department of Finance pursued a “zero-tolerance approach” in 1985 by drafting detailed anti-avoidance legislation. David Dodge, then senior assistant deputy Minister of Finance, justified the new approach by stating:

It is true; we do have a zero tolerance level in this area. But the reason for this degree of intolerance is precisely what we are accused of lacking -- equity. It is not a money-grabbing, revenue-raising initiative. It is quite necessary in the interests of fairness. It is true that there are relatively few Canadian taxpayers who have sufficient liquid assets at their disposal to enable them to divert substantial amounts of income to members of their families. It is true that only the most wealthy Canadian taxpayers can benefit substantially from income splitting. But these few are precisely the ones for whom the attribution rules have been designed -- in order to ensure that they bear their fair share of the tax burden, in accordance with our rules of progressive income taxation. And let us not be naive; clearly this group is not so small as to be insignificant.

Consequently, for the first time since 1972, substantial statutory amendments were effected to the attribution rules. Then Finance Minister Michael Wilson’s first budget introduced a detailed and more extensive regime of rules than the more general provisions contained in subsection 74(1). These provisions applied to attribute income where property was either loaned or transferred to or for the benefit of a spouse. Certain loans and transfers were, however, exempted from the application of these rules by virtue of the provisions contained in section 74.5. The most notable of these were the exemptions available for loans and transfers which were conducted on an arm’s length, commercial basis.
The introduction of sections 74.1 to 74.5 represented a dramatic change in the legislative approach to income splitting. In an attempt to specifically address each anticipated method of income splitting, rules that formerly occupied one page of the Act now filled eight pages. Although the loopholes in the previous rules were eliminated, this new approach had its own inherent problems. These included the application of the attribution rules in inappropriate situations and gaps in the legislation that created new opportunities to split income. As suggested by Claire Young, the latter stemmed directly from the specificity of the legislation.34

Amended sections 74.1 to 74.5 remained unchanged until significant jurisprudential developments in 1998 provided a renewed impetus for legislative review. In Neuman v. The Queen,35 the Supreme Court of Canada challenged the federal government to draft legislation that would effectively and unequivocally combat income-splitting arrangements. It stated:36

Taxpayers are entitled to arrange their affairs for the sole purpose of achieving a favourable position regarding taxation and no distinction is to be made in the application of this principle between arm’s-length and non arm’s length transactions. The Income Tax Act has many specific anti-avoidance provisions and rules governing the treatment of non arm’s length transactions. We should not be quick to embellish the provision at issue here when it is open for the legislator to be precise and specific with respect to any mischief to be avoided.

This challenge was promptly assumed, when then Finance Minister Paul Martin introduced a “special tax” in his budget speech of February 16, 1999, under the heading of “Tax Fairness Measures”.37 Martin rationalized the need for this new tax by stating that “recent case law has provided support for income-splitting techniques contrary to policy intent.”38 This measure, later nicknamed the “kiddie tax”, incorporated a new dimension to the rules designed to prohibit income splitting.

Unlike the extensive measures introduced by the May 1985 budget, which adopted a “shotgun” approach to the problem of income-splitting schemes, the kiddie tax was a very
specifically targeted anti-avoidance measure. The new provision sought to tax minors at the top marginal rate on private corporation dividends and certain other forms of investment income, thereby removing much of the benefit to parents of splitting passive income with their children.⁴⁹

By restricting the application of this provision to minors, the government implicitly condoned this form of income splitting with spouses, causing observers to question the depth of its commitment to counter income splitting more generally. The omission was particularly significant in view of the fact that the tax had been proposed largely in response to cases involving spouses.

It has been suggested that the government’s decision to exclude spouses from the purview of the provision was reflective of the changing social and economic circumstances of married women:⁴⁰

The decline in the number of two-spouse, one-income families is changing the focus of the attribution rules. It has reduced the importance of the rules as they apply to spouses and increased the importance of the rules as they apply to minor children. This is because, where both spouses earn similar incomes, there is little scope for income-splitting between spouses and it is the diversion of income to minor children that becomes most attractive.

The current rules, while based on the same premise as the original attribution rules, are significantly more complex than their predecessors. In general, however, the existing anti-avoidance provisions dealing with income splitting are similar in approach to the 1917 provision. At present, section 74.1 provides that income or loss from property transferred or loaned by an individual, either directly or indirectly, to or for the benefit of that individual’s spouse is attributed to the individual and is not included in the income of the spouse.

By virtue of section 74.2, taxable capital gains and allowable capital losses realized on the disposition of property transferred or loaned by an individual to the individual’s spouse are also attributed to the individual, and not included in the computation of the spouse’s income. In
each case, attribution applies to income, gains or losses from the original property or substituted property.

There is no attribution once the transferor spouse or lender ceases to be a resident of Canada or is no longer alive. In the case of a transfer or loan to a spouse, there is no attribution of income or loss once the spouses are legally separated or divorced. There is also no attribution of capital gains or losses realized after the separation or divorce, if a joint election is made by the transferor or lender and the spouse or former spouse. For couples in a common-law partnership, separation for more than 90 days (by reason of a breakdown in the relationship) signifies an end to the conjugal relationship for tax purposes. As between the separated couple, the attribution rules are inapplicable thereafter.

There are three significant exceptions to the rules. The first is in respect of loans that bear a commercial rate of interest. If interest is charged at a rate prescribed by regulation or the rate to which arm’s length parties would have agreed and if that interest is paid within 30 days after the end of each year, the attribution rules do not apply to the income, gains or losses. The second exception is for transfers to a spouse which are made at fair market value, although in order for this exception to apply the spouses would have to elect out of the automatic rollover under section 73(1) so that the initial transfer would be taxable. The final exception to the spousal attribution rules results from the fact that the rules pertain only to income from property and not income from business. Accordingly, if income is generated by business assets which were transferred or loaned from one spouse to the other, such income would not be attributed back to the transferor spouse.

Insofar as acceptable income splitting schemes are concerned, the attribution rules do not apply to prevent the payment of a (reasonable) salary by one spouse to the other. Before 1980,
subsection 74(3) provided that remuneration paid to any employee by the spouse of that employee was not deductible in computing the spouse’s income and not included in the employee’s income. Although this rule did not attribute income, it had a similar effect. Since its repeal in 1980, there have been no restrictions on income splitting by way of salary payments, except for the restrictions in section 67 pertaining to the reasonableness of any deduction.

It should be noted that the rules described above are part of a comprehensive set of provisions that apply to income splitting and tax avoidance generally. As such, there are other more general attribution rules that are also relevant to spouses, although their application exceeds the parameters of the rules described above, since they apply to a broader range of persons.

Rules such as those contained in subsections 56(2) and (4) would apply to the diversion of income to a spouse, because they regulate the diversion of income to any person and to a non-arm’s length person respectively. In addition, subsection 56(4.1) applies to an interest-free or low interest loan made to a non-arm’s length person. Because these rules do not include a direct reference to the term, “spouse”, they will not be addressed herein.

**Technical Tax Criteria: A Brief Overview**

In evaluating the state’s reliance on conjugality as a criterion for legal regulation, the preliminary task is to ascertain the objectives of laws that take relationships into account and then assess their validity. Analyzing the objectives of laws contained in the Act is complicated by the fact that tax laws serve a myriad of functions. Possibly, the most significant of these purposes is to raise a sufficient amount of revenue to finance government expenditures, such as transfer payments and the purchase of public goods and services. In this context, tax provisions are structured to impose the cost of government services fairly across Canadian resident
individuals. This objective is premised on the concept of “equality of sacrifice” and requires that taxes be allocated among tax units in proportion to their “ability to pay”.

The ability-to-pay approach postulates that taxes should be levied on individuals in accordance with their discretionary economic power.\(^{46}\) Referred to as technical tax measures, provisions of this nature are concerned primarily, although not exclusively, with fulfilling the principal function of the tax system as outlined above. Provisions such as the spousal attribution rules are expressly targeted at preventing specific “offensive” tax avoidance (income-splitting) strategies. The general intent of such measures is to protect the revenue base against erosion. On this account, the attribution rules can be regarded as pursuing technical tax objectives and accordingly, should be analyzed as such.

In his now classic statement of tax maxims, Adam Smith wrote in 1775 that taxes should be “equitable, simple, convenient, cheap to administer, and difficult to evade.”\(^{47}\) Subsequent restatements of these criteria have never quite deviated from this list, although tax policy analysis has traditionally judged the effect of technical tax measures and, to a certain degree, their fairness by reference to three particular factors -- horizontal and vertical equity, neutrality and simplicity. Underpinning these criteria are the “normative values of income taxation and the use of the income tax as a tool for income redistribution.”\(^{48}\)

Equity essentially means “fairness”. Equity considerations are therefore prescriptive in nature and cannot be resolved by an appeal to facts. There are, however, several principles that describe varying types of equity considerations. In particular, the ability-to-pay principle maintains that taxes should be assigned in accordance with an individual’s ability to shoulder the tax burden. The rationale of the ability-to-pay approach is that the payment of taxes requires from the individual, a loss of utility -- a sacrifice.\(^{49}\) A fair system of taxation based on the ability-
to-pay approach might accordingly be defined, following John Stuart Mill, as one in which the sacrifices of utility by all taxpayers are equal.

As a practical matter, it is very difficult to secure agreement on what counts as equality of sacrifice. The difficulty is not just that taxpayers differ greatly in wealth, but that many other features of social and economic life affect the extent of the sacrifice that may be expected of the tax-paying populace. As a starting point, however, an individual’s ability to pay is measured by his or her discretionary economic earnings (as reflected in income).

The ability-to-pay principle has two derivative objectives: horizontal and vertical equity. Horizontal equity asserts that similarly situated individuals should be treated equally. In theory, this would require persons in comparable circumstances to shoulder a similar tax burden. In practice, however, the concept is particularly difficult to pin down. Given that this evaluative criterion is closely tied to individual circumstance, the challenge lies in identifying which taxpayers are “similarly situated”. Even if one believes that the fairest manner of raising revenue is to require taxpayers to make an equal sacrifice, it is unrealistic to assume that equal incomes are always reflective of equal ability.

Vertical equity posits that “differently situated individuals should be taxed appropriately differently.” Ceteris paribus, there is general agreement that individuals with higher incomes should pay more in tax than individuals with lower incomes and in effect, should pay a larger portion of the cost of government services. Vertical equity therefore encompasses the notion that persons with an enhanced ability to pay should pay proportionately more in taxes than those with a reduced ability to pay. Although intuitively appealing, this principle is not easily translated into reality. Determining when taxpayers are in ‘different’ circumstances, and how much more taxpayers with a greater ability to pay -- should pay, are inherently political choices.
The Royal Commission on Taxation (known as the Carter Commission after its chair) took the view in 1966 that the criterion of ability to pay required that taxes be levied at progressive rates on a comprehensive tax base; that the unit of taxation be the family as opposed to the individual; and lastly, that corporate and personal income tax on corporate profits be integrated to avoid double taxation. Family unit taxation was rejected by the federal government as a “tax on marriage” that was “unfair and unreasonable”. However, the Carter Commission’s recommended progressive rate structure was implemented as part of the 1972 tax reform.

Simply stated, a progressive system is one that imposes graduated rates of tax with the result that those with higher incomes pay tax at a higher rate on that higher amount of income. As usual, however, the devil is in the details. Although the ability-to-pay principle insists that rates be progressive, it offers no aid beyond this. As Louis Eisenstein questions, where should the progression begin? How rapidly should it proceed and where should it end? If the rates are to mitigate inequalities of wealth, how drastic should they be in pursuit of this objective?

The ability-to-pay approach is necessarily reticent in the face of such concerns. On the one hand, a premium is placed on private initiative and on the pursuit of gain, particularly in the context of a market economy. On the other hand, progressive taxation presupposes that as taxpayers accumulate more wealth, they should keep less.

One might assume that in the absence of progressive rates, there would be little interest in the technicalities of the ability-to-pay approach. Nevertheless, an income tax qualifies as a levy of equity and fairness if it corresponds with ‘ability’ as so conceived. Conceptually, the principle treats all taxpayers equally and as such, is a “sturdy neutral” among contending interests.

The ‘ideology’ of ability to pay is attractive to academics essentially because it articulates the importance of equity before the law. It is important to note, however, that in practical terms,
this principle proceeds on the basis of distinctions. When distinctions are drawn, certain groups of taxpayers are inevitably recognized and differently treated. Accordingly, in the context of evaluating technical tax provisions, the more meaningful question is whether a particular distinction was properly made.

Principles of equity are undoubtedly an important foundation of the tax system. However, some authors have suggested that traditional tax policy analysis has, in the past, omitted an essential element, and that is -- equality among particular groups in society. Maureen Maloney, for instance, has pointed out that “[w]hile current interpretations of equity, both vertical and horizontal, may catch class biases, they do not go far enough because the need for equity is generally recognized with respect only to the distribution of income.”

In assessing the equal application of income tax provisions, it is important to acknowledge that “equality” does not merely mean formal equality, but that it also encompasses the notion of substantive equality. An approach founded on formal equality treats all individuals in a neutral fashion, regardless of the differences between them. However, such an approach is arguably “inadequate to the task of creating real equality because it does not encompass or even acknowledge inequality of condition. Substantive equality recognizes that in order to achieve equality, different groups in society may require different treatment.”

In addition to equity, an essential ingredient of a fair tax system is neutrality. The tax system should be neutral in the sense that, aside from specified exceptions, it should be designed to bring about a minimum change in the allocation of resources within the private sector of the economy, relative to the allocation that would take place in the absence of taxes.

Underlying the concept of neutrality is a concern that the distortion of economic choices may result in a misallocation of resources because taxpayers may choose to direct their funds
only to those activities that receive preferential tax treatment. However, it is not only economic choices that should be protected against distortion by the tax system. Social choices, such as the choice to marry, to cohabit with a common-law partner or to remain single, should not be made as a consequence of any preferential tax treatment that would ensue from choosing one lifestyle over another.

An effective tax system not only prioritizes neutrality but also strives to be efficient in its administration. The criterion of efficiency demands that compliance costs for taxpayers and administrative costs for the tax authorities be minimized as far as possible. Increased complexity diminishes equity where “the relative accessibility of tax law is differentiated by taxpayer training, experience or income, or where taxpayer capacity to exploit the opportunities created by an increasingly complex code is similarly differentiated.” Consequently, this policy objective often requires some sacrifice of equity and neutrality concerns.

Although the capacity of a taxing authority to administer the system becomes increasingly difficult as it becomes more complex, simplicity is another standard against which the effectiveness of technical tax measures may be evaluated. The criterion of simplicity highlights the importance of ensuring that taxpayers understand and appreciate the impact of various tax rules in relation to their choices, both social and economic.

Legislative acknowledgement of the above-described criteria is essential, not only to achieve Parliament’s objectives but also to foster a basic respect for the tax system from which a high degree of voluntary compliance derives. In reviewing the legislative concerns that prompted the enactment of the spousal attribution rules as well as the justifications for their continued existence, these provisions will be analyzed in the following sections with reference to these criteria.
An Assessment of the Spousal Attribution Rules by Reference to Technical Tax Criteria

The ideology of ability to pay assumes that all gains should be treated alike. If it is desirable, however, for policy reasons to impose a diverse burden on equal incomes, the question is no longer whether there has been a departure from the concept of ‘ability’ but rather whether the departure was nevertheless appropriate. With respect to the attribution rules, the policy concerns are fairly straightforward. As long as income is subject to progressive tax rates, there is an incentive to income split. This is because a taxpayer can minimize tax liability by assigning income or transferring income-producing property to a family member who pays tax at a lower marginal rate. Furthermore, because the individual is the unit of taxation and there is no aggregation of (spousal) income for computational purposes, the assignment or transfer of income or the loaning of income-producing property within the spousal unit is an appealing income-splitting strategy. For the most part, this is because control over the income generated by that property is retained within the family.

In theory, the spousal attribution rules are designed to prevent this splitting of unearned (or investment) income by a taxpayer with a spouse or common-law partner. As indicated earlier, however, the detailed nature of the rules can result in gaps in the application of the legislation. One of the difficulties of a detailed legislative approach is that if a transaction is not specifically included in the legislation, there is a good argument that the transaction is thereby excluded from its ambit. As observed by Claire Young, the application of the attribution rules to the forgiveness of a loan is provides one such example.

Assume that a wife makes a loan to her husband at the prescribed rate of interest and that interest is paid on the loan within the required period. The loan is used to acquire property that generates income. What if, in a subsequent year, the wife forgives that loan? Does either
subsection 74.1(1) or subsection 74.1(3) apply to attribute income from the property acquired
with the loaned funds after the loan is forgiven? Although it is not explicitly addressed by the
legislation, can it be said that this transaction falls squarely “within the spirit” of the rules? Is the
forgiveness of the loan a “transfer” given that the lender has divested herself of any right to
receive repayment, and the right to funds is vested in the debtor? While there is no clear answer
to these queries, if the forgiveness of a loan is not a transfer, strategies to circumvent the rules
can be devised with relative ease.

There are other examples of loopholes in the legislation. Subsection 74.5(7) prevents
avoidance of the attribution rules as they apply to loans through the use of loan guarantees given
by individuals. However, the provision does not apply to corporate guarantees. Consequently, if
an individual wishes to guarantee a loan made by a third party to her spouse, the application of
the rules to that guarantee can be avoided if the guarantee is provided by a corporation of which
the individual is a shareholder.63

The problems with the spousal attribution rules involve more than ambiguities in the
legislation. For instance, why are the rules limited to income from property and not applicable to
business income? Claire Young has offered the following response: “One reason may be the
administrative difficulty of tracing the income back to the transferred or loaned property.”64 Of
course, a similar tracing problem would not preclude the attribution of capital gains arising on
the disposition of the property. Assume, for instance, that a wife establishes a business which she
finances with her own savings and third party loans. If she conducts the business in a building
gifted to her by her husband, how should the income derived from the property be disaggregated
from her efforts in running the business? Moreover, what portion of the business income should
be considered to have arisen a result of the loans and savings?
As the attribution rules have become increasingly watertight in their application, their importance in preventing income splitting has diminished. There is no question that as anti-avoidance measures, these rules contribute to the efficient functioning of the revenue collection process. Moreover, when the individual is the tax unit, as is the case in Canada, it is necessary that boundaries be maintained around the individual to prevent collusive tax planning. From a practical perspective, however, it is questionable whether the rules operate in a fair and equitable manner. To this end, the policy debate surrounding the provisions has traditionally centred on whether “the increase in fairness and prevention of revenue loss achieved by the rules justifies the concomitant increase in complexity and the resulting compliance cost burden on taxpayers.”

Interestingly enough, the very principles of equity in favour of which the attribution rules are routinely defended, form the primary basis upon which these provisions have been criticized. In particular, David Duff has advocated repealing the spousal attribution rules on the grounds that “adult spouses obtain effective control over the income to which they are legally entitled.” He has also recommended that “some” splitting of employment or other income be permitted with a spouse who provides unpaid child care (as a means of acknowledging the economic value of this labour). Neil Brooks has alleged that attribution “fails to recognize the autonomy of the spouse receiving the property (usually the wife). It also has the effect of discouraging husbands from transferring family property to their wives during marriage and thus achieving a more equitable distribution of wealth.” Kathleen Lahey has criticized “the tendency to view women as being mere puppets” in income-splitting transactions. And Claire Young has suggested that empirical data be accumulated to determine whether male taxpayers would transfer more property to their female partners in the absence of the attribution rules.
Claire Young’s recommendation for reliable data on the distribution of wealth between members of conjugal couples, and between men and women generally, merits further consideration. Ideally, the question of who controls income within a conjugal partnership should be susceptible to empirical inquiry. However, studies pertaining to control over marital income are unlikely to ever yield definitive results.

Research on pooling and resource-sharing between couples is notoriously difficult because it is a sensitive issue for many spouses. A few studies have been conducted, and they have offered some common sense observations. They suggest, for example, that the patterns of control within a marital partnership are extremely complex, and that control is exercised through many different mechanisms; that some pooling of marital income is common but that full pooling is not. They also indicate that control over marital income -- the power to decide how the income shall be used -- is shared to a lesser extent than the consumption of the income. The spouse who earns the income tends to retain control over the manner in which the funds are spent, even if that spouse’s decision results in shared consumption.

In order to identify the spouse who commands a greater measure of control over income within a marriage, it is also necessary to specify the meaning of ‘control’ with some precision. As any estate planner and family lawyer would attest, informal power dynamics are at least as important as legal rights in determining who truly controls a family business or other income-producing assets. Does ‘control’ imply control over production of income or control over its disposition? When a husband supports a non-income earning wife, is he exercising control over his income, or is he responding to social and legal pressures that prevent him from leaving his wife destitute? Does the husband or the wife control the income that is spent to purchase a family vehicle if the husband chooses the make and model after his wife has decided that the time is
right to buy a new car? Does the wife control the amount spent to renovate the marital home if she has to persuade her husband for months on end before he agrees to the expenditure? Who is in control when one spouse has veto power and declines to exercise it?

Because ‘control’ is such a nebulous concept, the control principle comes very close to being incoherent. To lend some specificity to the meaning of control, supporters of the control theory might indulge the assumption that marital partners are likely to utilize their control over income to obtain its benefits for themselves.73 Accordingly, the key issue is who controls the savings and accumulated capital of the couple.74 If there is true and equal control of these amounts, only then can an argument be made to treat spouses differently from single taxpayers.

Alternatively, it has been argued that where an individual has a sharing relationship with another, the value of the economic resources from which the individual benefits through the sharing should be included in his income. This theory is premised on the notion that individuals should be taxed on the income from which they benefit. When this theory is transposed to spousal relationships, the conclusion is that because spouses share equally in the material gains of their partnership (a significant assumption), their incomes should be aggregated (and then divided between them) to compute their individual tax liability.75

Such a measure would, for practical purposes, result in the joint taxation of spouses. While spouses are not jointly taxed in Canada, the rules that hinge on conjugal status are based on an underlying theory that spouses share economic resources or that there is an economic mutuality to their relationship. It follows that the weakness of the benefit theory is that it assumes that there is pooling within the spousal unit of income and wealth. Needless to say, this assumption is highly flawed.
Feminist tax theorist, Marjorie Kornhauser corroborates this position by stating that the existence of pooling in spousal relationships is “largely unsupported by empirical evidence”. She contends that most analysts have only a vague presumption of the existence and importance of marital sharing, underscored by long-standing tradition and conventional expectation. Reality, she believes, is something else entirely. Kornhauser bases her initial argument against marital pooling on the available data -- a universe which she concedes is quite small.

Given the insufficiency of this data, Kornhauser’s premise is interesting, not because she argues against the existence of pooling, but because she asserts that it exists. Her contention is that pooling occurs across the entire spectrum of human communal living arrangements: roommates, single parents, homosexual partnerships, adult children with dependent elderly parents, and communes. She regards pooling as being far too common, in general, to characterize it as a unique aspect of the spousal relationship, and too uncommon, specifically in marriage, to accept it as a basis for taxation.

Noting the prevalence of domestic violence in many households, Neil Brooks follows in Kornhauser’s suit by confirming that “there is not anywhere near full sharing in many households, let alone sharing of control that would indicate both spouses value family assets.” The Women and Taxation Working Group of the Ontario Fair Tax Commission has also acknowledged this point by stating that it is men who tend to control income and capital, a statement that was reiterated by the Fair Tax Commission in a report released in 1993.

Louise Dulude engages in a more nuanced analysis of this issue by accounting for the impact of being in a particular income class. She states that “with the single exception of the very poor, the earnings and assets of couples are generally controlled and managed by the spouse who has legal title to them.” She also indicates that couples with relatively low and equal incomes
tend to share more than other couples. Given that men are wealthier and own more capital than
women,\textsuperscript{81} it is likely that the control generally remains with them. In reality therefore, pooling
and the resultant redistribution of wealth does not occur in the majority of relationships.\textsuperscript{82}

The question arises, is it possible to devise a rule that goes beyond the use of conjugality
(or any other relational attribute) as a proxy for household economies? What if every individual
who shared living space and expenses with another adult received a different tax treatment than
persons living alone? In theory, such a rule could do a better job of identifying relationships that
give rise to household economies than the current rule based on conjugality. However, the
enforcement of such a rule would either be highly arbitrary or would have to vest unacceptably
broad powers of discretion in administrative officials. It is therefore impossible, for practical
purposes, to conceive of a new rule that would be reasonably objective and at the same time, not
generate incongruous results.

The fact remains that while there may be reason to question empirically, the extent to
which assumptions on marital pooling hold true, the phenomenon does exist in shared
households. No doubt, conjugal cohabitation has become an increasingly poor proxy for the
identification of such economies. It is difficult, however, to argue against the \textit{status quo} in the
absence of a superior alternative.

\textbf{Interaction of the Spousal Attribution Rules & the Spousal Rollover Provisions}\textsuperscript{83}

There are distinct inconsistencies in the application of the spousal attribution rules when
viewed in the context of the Act as a whole. Indeed, they support the concept of the individual as
the tax unit. Nevertheless, in their application to inter-spousal transfers of capital property, the
attribution rules appear to be in conflict with the policy underlying the spousal rollover
provisions. Transfers of capital property (either by way of a gift or bequest) between spouses are
deemed to take place at the transferor’s adjusted cost base for tax purposes, and therefore neither a capital gain nor loss results at the time of transfer. The term “rollover” is used to describe these transfers to reflect the fact that the transferee of the property is put in the same position as the transferor, i.e. the tax status of the property rolls over to the transferee and the tax consequences of any gain or loss with respect to the property are deferred until the transferor spouse, former spouse or spousal trust ultimately disposes of the property.

Spousal rollovers are not strictly benefit-conferring provisions as such, but are designed to insulate from income taxation, certain transfers of family property that would otherwise trigger tax liability. The policy underlying the inter vivos rollover rule is multi-faceted. First, this provision serves an administrative purpose. If transfers between spouses were taxable events, the Canada Revenue Agency (“CRA”) would have to trace all such transactions in order to ensure that any tax owing was paid. Enforcement of this kind would be practically impossible given the context in which these transfers routinely occur.

The rollover rules also encourage the redistribution of property within the spousal relationship. While property rules affect the redistribution of property within the family unit or between two individuals in a relationship, they do not change the net wealth of the couple as such. To the extent that the transferred property is non-income producing and has appreciated in value since it was acquired, the rollover removes any disincentive to the transfer that would otherwise arise by reason of the tax liability that could ensue as a result of the disposition.

The rule in subsection 73(1) ostensibly treats spouses as one tax unit with respect to property transfers between them. Yet, if on a subsequent disposition of that property by the transferee, a capital gain or loss arises, it is not taxed jointly to both spouses as would be consistent with a policy that regards spouses as a single unit. Rather, as indicated above, the gain
or loss is attributed to the transferor on the basis that the individual is the tax unit and is precluded from rearranging his or her affairs within the spousal unit to reduce his or her tax burden.

In order for the attribution rules not to apply to income generated by capital property transferred to a spouse or a capital gain on disposition of such property, the property would have to be transferred at fair market value. Such a rule requires that the transferor elect out of subsection 73(1) and thereby lose the advantage of the rollover. On this account, the rule in section 73 and the attribution rules appear to deliver inconsistent messages. Section 73 encourages the transfer of capital property to a spouse by permitting the transfer to take place on a tax-free basis while the attribution rules discourage the transfer unless it is made at fair market value. This implies the spouse acquiring the property would have to secure the required funds to pay for the property being transferred.

A recent judgment delivered by the Tax Court of Canada highlights the incongruity that can result from the interplay of these two provisions. The ruling in *Overs v. Queen* is also the latest in a series of GAAR (“General Anti-Avoidance Rule”) cases decided by the Tax Court. The facts of this case are relatively straightforward. The taxpayer had an outstanding shareholder loan owing to a private corporation and he wished to circumvent the application of subsection 15(2). He sold shares of this corporation to his spouse at fair market value and repaid his indebtedness with the proceeds. His spouse borrowed the funds required to pay for the shares from a bank. The bank loan was guaranteed by taxpayer’s company and the spouse paid a guarantee fee to the company. The spouse incurred losses from property (the shares) due to the interest expense and fees relating to the bank loan.
The intended tax results were as follows: the shareholder loan was not included in the taxpayer’s income under subsection 15(2), there was a deferral of capital gain realized by the taxpayer on sale of the shares to his spouse since he did not elect to opt out of subsection 73(1) and lastly, the spouse’s loss from property was attributed to the taxpayer. The CRA reassessed Mr. Overs by applying the GAAR to deny the attributed losses he claimed.

The Crown objected to the “economic substance” of the transactions on the basis that the taxpayer had used the original shareholder loan to pay for personal living expenses. Conversely, the taxpayer argued that legally effective transactions must be respected. The taxpayer’s spouse had borrowed money from the bank, not the taxpayer. In addition, the spouse had an income-earning purpose (to earn dividend income from the shares) and therefore, the interest on the loan was deductible.

With respect to the application of the GAAR, the taxpayer argued that the transaction was not an “avoidance transaction” as its primary purpose was to repay a shareholder loan. Furthermore, there was no “abusive tax avoidance” as the transactions did not frustrate or defeat the purpose of the provisions of the Act as a whole. In a very brief decision, the Tax Court agreed with the taxpayer that the GAAR did not apply. Although the Court found that there was a tax benefit, there was no avoidance transaction and therefore, no “abusive tax avoidance”.

As illustrated by the *Overs* decision, the attribution rules can produce unusual (or as some would suggest, perverse) results in their application to inter-spousal transfers. Fortunately for Mr. *Overs*, the otherwise “clear and unambiguous” policies underlying the spousal rollover and attribution provisions were not found to be offended by his tax minimization plan.
Beyond the Spousal Attribution Rules: Broader Policy Concerns

A paradoxical aspect of the attribution rules relates to the inconsistent treatment of income splitting within the family unit. Under the current legislation, the splitting of property income with an adult child or indeed, a related adult (other than one’s spouse) is acceptable. What is regarded as unacceptable, albeit from a policy standpoint, is the splitting of property income within the family unit with a spouse or minor child. If one assumes that the rules have been enacted to preserve the individual as the tax unit and to eliminate any advantage from the diversion of income, then the attribution rules cannot be justified on these grounds alone. Moreover, as they presently apply, it is difficult to rationalize the existence of the rules by reference to tax policy criteria such as equity and neutrality.

By discouraging high-income earning spouses from transferring their property or after-tax income to their low-income earning spouses, the attribution rules also hinder the redistribution of wealth and income between the sexes. There is a gender aspect to this issue given that men tend to own more property and have higher incomes than women.87

The question of whether, in the absence of the attribution rules, men would transfer more property to their spouses is an empirical one on which there is no data. Maureen Maloney has speculated that repealing rules might have the effect of encouraging transfers of property between spouses. She advances this position by pointing out that before the rules were amended in 1981 to “restrict the principal residence capital gains exemption to one house per family, many second homes were transferred to the sole ownership of the wife.”88

It is debatable whether the potential revenue loss that would result from a repeal of the attribution rules is, on its own, a valid justification for their retention. Indeed, when the rules were the subject of a comprehensive review in 1985 that extended their application to loans,
among other transactions, the government did not suggest loss of revenue as the reason for their extension. Rather, the change was justified on the basis that income splitting by way of a loan compromises “the integrity of a tax system that discourages the diversion of income from one taxpayer to another in order to reduce taxes.” The question is nevertheless an important one: what would be the cost, both in dollar terms and in terms of the damage to the integrity of the tax system, of repealing the attribution rules (i.e. permitting income splitting between spouses)?

In 1986 it was estimated that the maximum savings achieved by a top marginal rate taxpayer from transferring income-producing property to a spouse with no other income was approximately $9,500 per year. This figure included both federal and provincial taxes and was based on the transfer or loan of property, generating income of $68,000 per year. Over the last decade, changes to the federal personal tax rates and brackets have generally increased the system’s progressiveness as well as the tax savings that can be achieved from income splitting. For instance, it was projected in 2005 that the current tax savings from income splitting for Ontario residents (assumed to be taxed at the top marginal tax rate) would be roughly $14,367 per year.

Granted that the maximum potential tax savings for a taxpayer can be estimated, the number of taxpayers who, in the absence of the attribution rules, would organize their affairs to take advantage of these savings is difficult to estimate. One cannot assume, for instance, that all married couples in a financial position to benefit from income splitting would actually do so. As noted by Claire Young, “[n]on-tax factors, such as legal and other costs of transferring property or lending funds, the stability of the relationship, and any anticipated changes in the relative income of the spouses” may well deter many taxpayers from income splitting.
One can also speculate that given women’s increased participation in the paid labour force and the increase in the number of two-family earners, there is less opportunity for taxpayers to benefit from income splitting with their spouses. Even in circumstances where one spouse has a slightly higher income than the other and there is, in theory, an advantage to be gained from transferring income-producing property to that spouse, the transfer could place the recipient spouse in a higher tax bracket, thereby defeating the purpose of the transaction.

It would appear that the most persuasive case for retaining the attribution rules is that they restore a degree of vertical equity to the tax system. However, this theory begins to crumble when the selective application of the rules is considered. Although income splitting may reduce the tax burden of one taxpayer, it also increases the tax burden of another. It is for this, and other reasons, that income splitting tends to occur between non-arm’s length parties. Arguably, the real impediment to the repeal of the spousal attribution rules is not based on tax policy principles but rather, political considerations. Removal of the rules would be perceived by many as yet another tax break that would benefit only high-income individuals.

Interestingly enough, the issue of whether the attribution rules should be retained is not one that has received much discussion in recent times. There seems to be a perception that because these provisions have been a part of the tax system since its inception, they should be retained. For example, the Ontario Fair Tax Commission in its epic report titled “Fair Taxation in a Changing World” did not analyze the attribution rules and neither did the Women and Tax Working Group of that Commission. Given the issues discussed above and, in particular, the negative implications for female taxpayers, it is ironical that this is the case.

In a relatively recent report titled *Beyond Conjugality*, the Law Commission of Canada examined the regulation of close personal adult relationships. Employing a method of analysis
that integrated conventional tax policy concepts with broader public policy questions, it evaluated a wide array of ITA provisions that give special treatment to conjugal couples.\footnote{97} Strangely enough, the report offered no commentary on the spousal attribution rules. This was a peculiar omission given that two background studies prepared for the Commission called for a review of these rules.\footnote{98} As suggested by Lisa Philipps in her review on the report,\footnote{99} the lack of commentary was even more curious in light of the importance the report attached to “promoting individual autonomy, encouraging the redistribution of property within relationships, taxing individuals only on income they earn or control, and valuing care work.” These are, after all, the most oft-cited principles in favour of abolishing the spousal attribution rules.

**The Future of the Spousal Attribution Rules: A Case for Reform versus Repeal\footnote{100}**

Debates over personal income tax policy often tend to focus on comparing the tax treatment of different types of familial units, paying little attention (if any) to the disparate positions and sometimes incompatible interests of the individuals who constitute these households. It appears, however, that the “time is ripe for a thorough debate on whether the spousal attribution rules have become outdated in view of changes in the economic status of women and in social norms surrounding gender equality.”\footnote{101} A more principled and inclusive approach is needed to consider not just the situation of spouses and common-law partners, but to examine the legitimacy of assumptions about the perceived economics of being a couple.

The traditional approach of the Canadian tax system has been to use the attribution rules to attack schemes and structures that have been considered inappropriate. There are alternative approaches. The U.S. tax system permits spouses to file a joint return, subjecting the combined income to a lower rate of taxation than if the returns are filed separately. However, the use of combined income in the determination of tax liability has been criticized as imposing a financial
penalty on the formation of conjugal relationships. In its report on tax simplification released on June 19, 1986, the House of Commons Standing Committee on Finance and Economic Affairs recommended that “the Minister of Finance consider the advisability of amending the Income Tax Act to allow spouses the opportunity of filing joint income tax returns.”\(^{102}\) No indication was given, however, as to whether this recommendation resulted from concerns about spousal income splitting.

Another alternative, as noted by David Stevens, is to ensure that the ‘illegitimate’ recipient pays tax on the ‘offensive’ income at the appropriate high rate.\(^{103}\) This has been the American approach since 1987 when Congress implemented a split-income tax on the unearned income of children under 14. This approach has the merit of simplicity - it is simple to state, enforce and explain, as well as difficult to avoid. The split-income (kiddie) tax proposed in the February 16, 1999 budget and since enacted, effective for 2000 and later taxation years, was the first attempt in Canada to implement this approach. As previously indicated, however, this scheme was not extended to the spousal attribution rules.

Recognition of the family, or at least the couple, as the tax unit would give a nod to equity by obviating the need for attribution rules respecting spouses as well as reducing tax complexity. However, the viability of this alternative has been a question solely of academic interest, and with good reason. Given the political ramifications of effecting such a change, the prospect of implementing the couple as the tax unit is remote. Moreover, from a practical perspective, to make such a sweeping change solely on the basis that the spousal attribution rules can thereby be removed from the Act is, as Claire Young describes, “akin to taking a sledge hammer to crack a nut.”\(^{104}\)
Any argument in favour of sustaining the ‘individual’ as the unit of taxation reduces the relevance of conjugality in the tax system and lends support to the case against spousal attribution. Yet any proposal to abolish (or even merely liberalize) the anti-income splitting rules must still contend with the objection that only the country’s wealthiest taxpayers would stand to benefit from a change that weakens the progressivity of the rate structure. No doubt, some may be prepared to make peace with this regressive impact if it results in a more equal allocation of wealth and income between men and women. This point is emphasized by Neil Brooks when he suggests that recognizing the autonomy of women for tax purposes is essential, irrespective of the distributive consequences that this recognition may have across income classes.\(^{105}\)

To date, a persuasive case has not been advanced that granting taxpayers carte blanche to income split would, in fact, enhance women’s equality in a substantive, as opposed to formal sense. While an outright repeal of the attribution rules would possibly result in women holding legal title to more property, Lisa Philipps observes that this change would be inconsequential if it is not understood by the couple, as well as by third parties, to denote an actual change in beneficial ownership and \textit{de facto} control over the property. On this account, simply abolishing the attribution rules as they relate to spouses would be a particularly ineffective approach.

An alternative proposed by Lisa Philipps is that the rules should be amended to differentiate between transfers of effective control over income or property, and ‘paper’ transactions that are intended to primarily reduce the transferor’s tax burden.\(^{106}\) As discussed above, however, it is not an easy task to determine who exercises effective control over income and property within a spousal relationship or, for that matter, other conjugal partnerships. Notwithstanding the overall improvements in their legal and social status, in many families, women continue to lack equal decision-making power, even where they are formally entitled to
the same. As such, it is empirically inaccurate to assume that in every instance, the transfer of legal title between spouses implies that the transferee has control over future decisions about the use or disposition of the property, or the expenditure of income generated by the same.

Neil Brooks alludes to this issue when he suggests that “if the transaction has substantial economic effect, it should be respected despite the motivation of the transferor,”107 but he does not expand on the manner in which “substantial economic effect” can be differentiated from the formal control obtained through a transfer of title. Kathleen Lahey also acknowledges this point when she voices her concern that “in adjudicating property claims between spouses, courts may well decide to disregard transfers to spouses as being mere arrangements to avoid tax liability.”108 That is, a legal transfer may be effective for tax purposes but denied and defeated for other purposes. In passing, Lahey opines that there is a need for “tests designed to identify genuine economic autonomy”109 but does not offer any guidance on the “design” of these tests.

To entirely abolish the spousal attributions rules would give free rein to transactions that “reduce tax liability for the primary wealth-holder but do not effect meaningful transfers of control over economic resources.”110 The alternative approach would be to retain the current rules in subsection 74.1(1) and section 74.2 but also create a new exception, so that attribution does not apply where the transferor relinquishes all use of and control over the property and any income therefrom, including de facto as well as de jure control.

As recommended by Lisa Philipps, such a provision might be patterned on the language of subsection 256(5.1), which describes de facto control as “any direct or indirect influence that, if exercised, would result in control in fact.” It is imperative to include de facto control of substituted property or the income from substituted property, to address cases where inter-spousal gifts of property or money are returned to the transferor through loan arrangements,
share purchases, or other “superficially commercial transactions”. With regard to the attribution of capital gains, it may be worthwhile to incorporate a minimum holding period before the property can be disposed of by the transferee without any consequent attribution of gain or loss. In other words, to reduce the likelihood of “spouses being used as way stations”\textsuperscript{111} in the sale of property to a pre-identified third party.

According to Lisa Philipps, the provision might also stipulate that the exception would not be available, and attribution would apply retroactive to the time of transfer, if the transferor later “denies or attempts to rescind the transferee’s ownership of the property for some other purpose.”\textsuperscript{112} This restriction would alleviate the concern that income splitting transactions may be disregarded when the need arises, for other reasons, to identify the “true” owner of the property.

Insofar as the appropriate penalty is concerned, options other than merely attributing the income back to the transferor (or lender) may be considered. For instance, the application of a rate of tax that equals or is higher than the top marginal rate might function as a more effective deterrent. The existing penalty does not effectively curb income splitting because, even if the impugned transfer was not made, the income would be taxed at that higher rate. As the penalty currently stands, adventurous taxpayers may well wish to take the risk of a reassessment.

**Conclusion**

The percentage of Canadians who are married or cohabitating in common-law relationships is declining.\textsuperscript{113} Within those relationships, the role of spouses is changing. Other non-spousal relationships share many characteristics with spousal relationships and yet, it is mainly the ‘spousal’ and spouse-like relationship that the tax system treats differently.
With the unparalleled expansion of spousal treatment (if not spousal status), the attribution rules potentially apply to a greater number of taxpayers than ever before in Canada’s history. However, many taxpayers in a conjugal relationship who now receive spousal treatment are, in economic terms, functionally more self-dependent than married couples in the past and therefore are unlikely to benefit from income splitting by any great measure. What is more, sophisticated taxpayers who are inclined to pursue income-splitting techniques are generally able to avoid their application with strategic tax planning.

The operation of the rules in relation to common-law and unmarried same-sex couples is also troubling. If the tax treatment of transfers between two unmarried individuals depends, in effect, on whether they share an accommodation, how is their status to be verified by the CRA without an intolerable intrusion into their private lives? While it may be possible for the CRA to ascertain the common-law status of a heterosexual couple if they file their tax returns with the same address year after year, it is unreasonable to make a similar assumption for persons of the same sex. Enforcement thus remains a difficult, if not insurmountable, task.

With regard to the majority of tax provisions relating to “spouses”, common-law and same-sex couples would benefit the most by checking the box only in the taxation year that one of them dies so that the surviving partner can benefit from pension related provisions. Some may even benefit by choosing never to check the box. A married couple does not, however, have the “choice” that a common-law couple has, particularly with regard to legislation that has been enacted after their marriage. Granted that attribution rules play an important role in the legislative attack against income splitting, administering these rules can be problematic in practice. Unless joint penalty provisions of this kind can be effectively enforced, and it is questionable that they can be, the issue of equality under the law must be considered.
It is evident that reform in this area must “somehow navigate the dilemma, familiar from many other contexts, of how to encourage the development of more egalitarian relationships while addressing the reality that many conjugal relationships are not yet equal.”\textsuperscript{115} Achieving equality in the treatment of adults living together in close personal relationships is not just a matter of redefining who is entitled to marry or who qualifies as a spouse for the purpose of preparing a tax return. To overcome discriminatory assumptions and ensure equality in its policies, Parliament must also be cognizant of the practical consequences of its statutes.

As for the spousal attribution rules, the ideal solution remains an elusive one. Although amendments can be made to improve their operation and effectiveness, any additional modifications may result in increased complexity for taxpayers. Previous amendments have also illustrated, in no small measure, the difficulties with a piecemeal approach. The alternative solution of an outright repeal is difficult to assess in the absence of empirical data on both the cost of administering the rules and the potential revenue loss from their repeal. It would appear, however, that notwithstanding the exclusive appeal of this proposal to single-income couples, and particularly to those with high incomes, the overall equity of the tax system would be much improved by their removal.

The spousal attribution rules provide an excellent prism through which to examine the state’s reliance on conjugality in its efforts to combat income splitting. An assessment of the rules as they are currently structured provides an insight into the inequities and difficulties that arise in respect of their application. There are, however, systemic obstacles to reform that must be addressed if we are to look beyond the ‘black box’ of the conjugal couple and structure taxes on the basis of individual circumstance as opposed to conjugal status.
ENDNOTES


2 R.S.C. 1985, c.1 (5th Supp.), as amended (herein referred to as “the ITA” or “the Act”). Unless otherwise stated, statutory references in this paper are to the Act.

3 Statistics Canada documented the fiscal impact of spousal treatment in a micro-simulation that explored the effects of treating married-couple families as unmarried-couple families. The results for the 1989 taxation year demonstrated that spousal treatment reduced the disposable income of 58% of those families. Less than 2% were unaffected by the change, and only 29% enjoyed higher disposable incomes because they were married. The revenue gain to the government flowing from spousal treatment was $3.5 billion, at the rate of $1,560 in additional taxes per family. Kathleen A. Lahey, The Benefit/Penalty Unit in Income Tax Policy: Diversity and Reform (Ottawa: Law Commission of Canada, September 2000) at 6 [hereinafter Lahey].

4 Under current legislation, a couple would be better off getting married, divorcing soon after (to income split in the form of alimony, own two principle residences, and maximize other benefits such as GST Refunds and the Child Tax Benefit), and re-marrying the day before one of them dies (to collect the pension benefits and to inherit).

5 This ambivalence is clearly reflected in early debates over whether the first income tax statute enacted in Canada -- the Income War Tax Act, 1917 passed to finance Canada’s involvement in World War I -- should treat all individual taxpayers alike, or whether those with families should be given special benefits. Lahey, supra note 3 at 1.

6 Claire Young, What's Sex Got to Do With It? Tax and the “Family” (Ottawa: Law Commission of Canada, 2000) at 1[hereinafter Young].

7 See the definition of “common law partner” in subsection 248(1), added by SC 2000, c. 12, section 139(2).

8 Lahey, supra note 3 at iv. This is especially troubling in view of changing demographics in relation to the Canadian nuclear family and labour force.

9 Income War Tax Act, 1917, 7-8 Geo. V, c. 28.

10 Ibid. at paragraph 4(1)(a). It should be noted that in 1919, the provision was amended to change the amount of the exemption and the range of persons to whom it applied. The tax was imposed on income exceeding $1,000 but less than $6,000 for unmarried persons, widows and widowers without dependent children, and persons not supporting dependent brothers or sisters or sisters under the age of 18 or a dependent parent or grandparent. For all other persons, the tax was imposed on income over $2,000 but not exceeding $6,000. See An Act to Amend the Income War Tax Act, S.C. 1919, c.55, section 3.

11 Lahey, supra note 3 at 2. The corresponding footnote reads as follows: “The government had originally decided that instead of trying to calibrate exemptions to marital status, family size, or number and type of dependents, it would be better to offer all taxpayers generous individual exemptions on the assumption that most adults have some support obligations. See Canada, House of Commons, Debates and Proceedings, 7th Session, 12th Parliament, IV: 4102, 4103 (August 3, 1917), Thomas White. This approach was vigorously attacked on the grounds that this would unfairly benefit single men, who would escape ‘too lightly,’ ‘spinsters,’ who were assumed to have no dependents, and married women, who were ‘free’ to work for wages or ‘save a lot of disbursements’ by working in the home. Ibid., IV: 4103, Mr. Verville; 4105, Mr. Knowles. There was a definite animosity toward men who remained unmarried even though ‘it was not their fault.’ Ibid., IV: 4104, Mr. Graham.”

12 Lahey, supra note 3 at 78.
See, for example, *Estate of David Fasken v. M.N.R.* 49 DTC 491 (Ex. Ct.) which held that a divestiture of property by the transferor and a vesting of the property in a transferee was a transfer and *Sachs v. The Queen* 80 DTC 629 (F.C.A.) which held that property includes a contingent interest in a trust.


54 DTC 1031 (Ex. Ct.) [hereinafter *MacInnes*].

*Duff*, supra note 14 at 472.

*MacInnes*, supra note 15 at 1033.

See subsection 22(3) of the 1948 *Income Tax Act*, as amended by S.C. 1952, section 6. According to this provision, “where a person who did own or hold property has disposed of it and acquired other property in substitution therefor and subsequently, by one or more further transactions, has effected one or more further substitutions, the property acquired by any such transaction shall be deemed to have been substituted for the property originally owned or held.” A similar rule is now found in paragraph 248(5)(a).

*MacInnes*, supra note 15 at 1033.

63 DTC 1012 (Ex. Ct.).

For a brief commentary on this case, see G. McGregor, “Interpretation of Taxing Statutes: Whither Canada?” (1968) 16:2 *Canadian Tax Journal* 122-36 at 132, commenting that “[t]he intention of Parliament in enacting this provision is crystal clear; but that did not prevent the Exchequer Court … from … interpreting the section literally and strictly … with the result of frustrating that intention.”

ITA former section 74(1), repealed by S.C. 1986, c. 6, section 37, applicable to transfers of property after May 22, 1985, but functionally replaced by section 73.

ITA former section 74(3)-(4), repealed by S.C. 1980-81-82-83, c. 48, subsection 40(1), applicable with respect to remuneration paid after 1979 for services rendered as an employee after 1979.

ITA former section 74(5), repealed by S.C. 1980-81-82-83, c. 48, subsection 40(1), applicable to fiscal periods ending after December 11, 1979.

This was achieved through discretionary challenges to the ‘reasonableness’ of deductions for spousal salaries under ITA section 69, which is still in effect.

*Lahey*, supra note 3 at 97.


See *Oelbaum* at 5178; per Jackett P. (as he then was), applying the court’s prior decision in *Dunkelman*, notwithstanding the Minister’s argument that the rule in that case should apply only to a “more businesslike transaction than … in the case at bar,” in which the taxpayer had loaned $150,000 to his wife in consideration for which she had executed three $50,000 non-interest-bearing promissory notes payable on demand, each of which remained outstanding at the time of the court’s decision five years later. See also former Interpretation Bulletin IT-258R2, “Transfer of Property to a Spouse” (May 11, 1982) paragraph 8, which stated, “A transfer does not include a genuine loan made by a person to his spouse”. For a case examining the “genuineness” of a loan for these purposes, see *Harvey v. The Queen*, 94 DTC 1911 (T.C.C.), concluding that the taxpayer had not effected a genuine loan to a trust whose intended beneficiaries were his minor children and whose intended trustee was his spouse.


32 Canada, Department of Finance, 1985 Budget, Budget Speech, May 23, 1985, 15.


35 Neuman v. The Queen, 98 DTC 6297 at 6305 (S.C.C.) [hereinafter Neuman].

36 Iacobucci J., interpreting the application of subsection 56(2) to the payment of discretionary dividends in Neuman, ibid. at 6305.

37 Canada, Department of Finance, 1999 Budget, Budget Plan, annex 7, February 16, 1999.

38 Ibid. at 193. In addition, the budget speech referred to the proliferation of “tax planning techniques … developed over time to avoid the application of the attribution rules or to take undue advantage of exceptions provided in those rules.”

39 Section 120.4 of the Act added by S.C. 2000, c. 19, section 30. For a thorough discussion of these developments, see Donnelly, supra note 31 at 1008.


41 There is also no attribution of contributions to a spouse’s RRSP, a spouse’s provincial pension plan (prescribed for the purposes of paragraph 60(v)) and support payments to a designated person. Note that there is attribution of contribution to a spousal RRSP if the contribution is withdrawn within three years (subsection 146(8.3)).

42 It would appear that the availability of relief from the application of the attribution is inconsistent in this respect.

43 Subsection 74.5(3) provides that attribution of income under section 74.1 is suspended for as long as the separation continues; attribution of capital gains under section 74.2 is not suspended automatically, but will be suspended if both spouses jointly elect to suspend the attribution of capital gains. If the separation is ended by reconciliation, the attribution rules return to force.

44 In order to maintain this exemption, it is important to ensure adequate documentation is kept on file to establish compliance.

45 See Interpretation Bulletin IT-511R, “Inter-spousal and Certain Other Transfers and Loans of Property” (February 21, 1994) paragraph 5, in which the CRA expresses its administrative position that subsection 74.1(1) does not apply “to attribute business income or losses even if the business operates with some or all of the property obtained originally from the transferor.” See also Interpretation Bulletin IT-434R “Rental of Real Property by an Individual” (April 30, 1982, as amended by special release, dated July 7, 1989) paragraph 11, which states, “Subsections
74.1(1) and (2) apply only where the transferred property produces income from property. Neither of these subsections applies where the loaned or transferred property produces business income.”


50 Carter Report, supra note 46, vol. 1 at 4-5.

51 Hogg, supra note 40 at 29.

52 Carter Report, supra note 46, vol. 3 at 32-36.

53 E.J. Benson, Proposals for Tax Reform (Ottawa: Department of Finance, 1969) at 15.

54 Ibid. at 12.

55 Ibid. at 22.

56 Eisenstein, supra note 49 at 27.


60 Hogg, supra note 40 at 31.

61 Ibid. at 56.

62 Obviously, the attribution rules would not be needed at all in a flat-rate system, where all income (high and low) would bear tax at the same rate. The flattening of rates compared to the pre-1988 situation has reduced the value of income splitting, but the availability of personal credits to each individual taxpayer, the four-bracket rate schedule and the various surtaxes have left the system sufficiently progressive that taxpayers continue to pursue savings from splitting.

63 As discussed more fully below, this strategy was successfully employed in Overs v. The Queen 2006 TCC 26 (T.C.C.) [hereinafter Overs].

64 The Attribution Rules, supra note 34 at 294.


68 Brooks, supra note 1 at 74. For similar views, see Hogg, supra note 40 at 405 and Donnelly, supra note 31 at 1008.

69 Lahey, supra note 3 at 119. See also Lahey’s earlier comments in favour of repealing the spousal attribution rules, in Kathleen A. Lahey, “The Tax Unit in Income Tax Theory” in E. Diane Pask, Kathleen E. Mahoney, and Catherine A. Brown, eds., Women, the Law and the Economy (Toronto: Butterworths, 1985) 277-310 at 300 [hereinafter The Tax Unit].

70 Young, supra note 6 at 45 and 48-49.

71 Brooks, supra note 1 at 62-63.


73 Ibid.

74 Young, supra note 6 at 78.

75 Ibid. at 25.

76 “[M]y study and the others discussed in this Article clearly establishes [sic] several facts: (1) not all couples pool assets; (2) pooling is not confined to married couples, and separation of assets is not confined to unmarried couples; (3) financial arrangements sometimes change during the course of the relationship; and (4) even among those couples who say they pool, in reality the non-earner spouse often does not have equal access to assets; instead the earner controls the money.” M. Kornhauser, “Love, Money, and the IRS: Family, Income-Sharing, and the Joint Income Tax Return” (1993-94) 45:1 Hastings Law Journal 63-111 at 105 [hereinafter Kornhauser].

77 Brooks, supra note 1 at 63.


82 Brooks, supra note 1 at 63. See also, Kornhauser, supra note 76.
The material in the following section is referenced, in part, from *The Attribution Rules*, *supra* note 34. It is ironic that almost 20 years have come to pass since this article was published, and the spousal attribution rules have remained unchanged. Perhaps their future was not as “uncertain” as the author suggested it would be!

Section 73 and subsection 70(6). These rollovers apply to *inter vivos* transfers and transfers at death.

Capital property transfers between separating spouses pursuant to a written agreement or court order will automatically receive rollover treatment. No election is required for the rollover to take place.

*Overs*, *supra* note 63.

The average earnings of employed women are still substantially lower than those of men, even when they are employed on a full-time basis. In 2003, women working on a full-time, full-year basis had average earnings of only $36,500, or 71% what their male counterparts made. Statistics Canada, online: The Daily <http://www.statcan.ca/Daily/English/060307/d060307a.htm> (date accessed: April 24, 2006).

Maureen Maloney, *Women and Tax Reform: Background Paper* (Ottawa: Canadian Advisory Council on the Status of Women, 1987) at 16. Note, however, that no statistics about the increase in these transfers are included to support Maloney’s assertion.

*The Attribution Rules, supra* note 34 at 298.

Canada, Department of Finance, *Budget Papers, Supplementary Information*, 59. See also *Young, supra* note 6 at 47.


The issue of the potential likelihood of persons to income split was addressed in *MacNaughton, supra* note 65. In this article the authors evaluated the potential impact of the kiddie tax. They concluded at 1179 that “[I]ncome splitting behaviour seems to be confined to a small segment of the population. In 1996, only 0.49 percent of all individuals under age 20 reported dividend income and only 0.19 percent reported net business income.”

*The Attribution Rules, supra* note 34 at 297.


See *Lahey, supra* note 3 at 117-20 and *Young, supra* note 6 at 40-49.


The material in the following section is referenced, in part, from Philipps, *ibid.* In this article, the author concludes that the spousal attribution rules should be revised to account for “genuine transfers of de facto control over property, without condoning the use of more formalistic transactions that aim principally to reduce the primary wealthholder’s tax burden.” See the introductory comments provided by the author at 1031.
101 Ibid. at 1035.


104 The Attribution Rules, supra note 34 at 306.

105 Brooks, supra note 1 at 74. See also The Tax Unit, supra note 69 at 300.

106 Philipps, supra note 99 at 1037.

107 Brooks, supra note 1 at 74 (emphasis added).

108 The Tax Unit, supra note 69 at 300.

109 Lahey, supra note 3 at 119.

110 Philipps, supra note 99 at 1037.

111 Ibid.

112 Ibid.

113 From 1981 to 2001, the proportion of men aged 20 to 24 in unions (either marriage or common-law) dropped from 27% to 14%; for women in the same age group, the proportion dropped from 46% to 26%. Statistics Canada, online: <http://www12.statcan.ca/english/census01/products/analytic/companion/fam/canada.cfm> (date accessed: April 24, 2006).

114 Lahey, supra note 3 at 74.

115 Philipps, supra note 99 at 1037.
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