

## **MORE THAN JUST DNA – TAX, WELFARE AND THE FAMILY**

### **An examination of the concept of family in the Tax Transfer system, with particular reference to family benefits.**

Helen Hodgson<sup>1</sup>  
Senior Lecturer, Atax

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#### Abstract:

The relationship between tax credits and welfare benefits is said to be based on the concept of equity: One of the core issues that is addressed in most taxation systems is the requirement that the family circumstances of a particular taxpayer are taken into account. In some jurisdictions, such as the US and France, this is addressed through the definition of the tax unit. In other jurisdictions, such as the UK, a tax credit system is used.

In Australia the current system is a system of tax credits, delivered through the welfare system. It is designed to take account of the details of the children within a family, with an additional component that takes into account the income earned by the primary carer within that family.

However, the fundamental requirement is that there is a family, maintaining children. The concept of what is a family is a social rather than a legal construct. While marriage and spouse have legal definitions, family structures evolve and change over time.

In this paper I explore the concept of family as it is used in the income tax and welfare legislation. While this is primarily in the context of family tax credits and similar schemes, I consider the consistency of the definition within the legislation. I also consider the impact of the legislative construct of family on the entitlements to tax credits, and whether the definition of family is appropriate to ensure that the benefits improve the equity of the taxation system, and properly reflect the structure of the contemporary family unit.

Recently it was suggested that a Bill may be introduced into the Federal Parliament to allow parents to undertake secret DNA testing to prove or disprove parentage. While this may prove a genetic relationship, it will not assist in determining who is a member of your family.

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Recognition of the family is a contentious issue in Australian public policy. While the tax unit in this country has always been the individual, families have been recognised both for granting tax concessions, and in anti-avoidance rules. Simultaneously, we have a welfare system that is based on family income. The current system of family tax benefits is a hybrid of the two views: a benefit that is considered to be a part of the tax system, but is based on family income.

This raises a number of issues relating to the recognition of families in the tax and welfare systems, and whether the two can be aligned.

### **Horizontal v Vertical Equity:**

The principle of tax equity is based on fairness in the tax system. Equity is generally measured against two criteria: vertical equity requires that a person who is capable of paying more tax should pay more tax; while horizontal equity requires that a person who is in same circumstances as another person should pay the same amount of tax as that other person. While these concepts are relatively easy to apply in the context of two people in similar personal circumstances, so that the criteria are only based on financial considerations, they are more difficult to apply when personal factors, such as family issues, are taken into account.

The equity considerations are, therefore, based on notions of fairness, which may vary between individuals and from time to time. For example, as a member of a dual income couple with no children, should my taxes be used to provide benefits to a colleague, who is on the same base salary but is supporting a spouse and three children? After all, the choice to have children or not have children is essentially a personal choice that should be made on the basis of what the parents can afford.

Should family benefits be means tested? If the benefit is recognition of the additional cost that the family incurs by reason of having the children, then it could be argued that higher income families in fact incur higher costs, so horizontal equity would suggest that the benefit should not be reduced according to family income. However, the principle of vertical equity would dictate that as the family has a higher income, it is in less need, and is less entitled to government assistance.

It is in this context that the traditional analysis of horizontal and vertical equity can provide conflicting outcomes<sup>2</sup>. In this paper I shall consider the evolution of the family tax transfer system, examining it against the criteria of horizontal and vertical equity. In particular, I shall consider, within the Australian context:

1. the relationships that form a family, and the effect that family structures has on tax and welfare entitlements, with particular reference to de facto and same sex relationships;

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<sup>2</sup> Discussed in Brooks, N. (1996). "The Irrelevance of Conjugal Relationships in Assessing Tax Liability." Tax Units and the Tax Rate Scale; Ed: Head J & R Kreyer: 35.

2. universal benefits, which acknowledge that all families with children incur additional costs thus applying horizontal equity; and
3. the application of vertical equity to benefits through means testing.

### **What is a Family?**

The evolution of the family benefit system needs to be considered in the context of the social construct of the family. Not surprisingly, it is very difficult to define a family. It is not just a matter of genetics. Even referring to the dictionary gives a broad range of meanings:

- “1. parents and their children, whether living together or not.
2. one’s children as distinguished from one’s husband or wife.
3. any social group of persons closely related by blood, as parents, children, uncles, aunts and cousins; group descended from common ancestor.”<sup>3</sup>

Official statistics are recorded on the basis of households, which comprise a number of people living together. The relationships between these people may, or may not, be described as family relationships, and households may be asked to self describe whether they are in a family relationship or not.

Census data show a dramatic change in the composition of families and households over the past century. In 1911 the average household size was 4.53 people, but by 2001 it had shrunk to 2.6 people. In 2001 nearly ¼ (24.8%) of people were living alone, and 68.8% of the population lived as a family. About 1/3 (33.8%) of the population were living in 2 person households. Of those identifying as living as a family, 35.7% were couples with no children, almost the same proportion as couples with dependant children at 38.6%. It is predicted that by 2016 these proportions will be equal. A further 10.7% are sole parent families, and 8.4% are families with non dependant children. The remaining 6.5% do not fit these classifications. When compared with data from 1976, the trend shows that the number of couples without children has increased (from 28%), as has the number of sole parent families (from 6.5%) at the expense of couples with children (dependant 48.4%, non-dependant 11.1%)<sup>4</sup>.

The formality of lawful marriage is less relevant than it was in determining the shape of the modern family. The percentage of couples that cohabit across all age groups has doubled between 1986 and 2001, from 5.7% to 12.4%, although younger men and women are more likely to cohabit than older couples. The majority of couples that married in 2001 had cohabited prior to marriage (72%), which is a substantial increase from 1984 (38.4%). However the most dramatic increase in this statistic occurred in the nine year period between 1975 and 1984, when the rate more than doubled from 16% to 38.4%<sup>5</sup>.

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<sup>3</sup> The Pocket Macquarie Dictionary (1982) Jacaranda Press at p 322

<sup>4</sup> Family Facts and Figures, Australian Institute of Family Studies, <http://www.aifs.gov.au/institute/info/charts/ftype.html> at 29/11/2006.

<sup>5</sup> Above n 4

Data on same sex relationships is difficult to come by, as none of the formal government data collection agencies record same sex relationships. However it is clear that there are an increasing number of families where two adults in a same sex relationship are caring for children, either the natural or adopted child of one or the other adults; whether from a previous relationship or born into the relationship. It is currently estimated that around 20% of lesbians and 10% of gay men have children<sup>6</sup>.

Therefore it can be seen that while family structures are diverse, the trend is towards households having fewer children, with the significance of legal marriage declining as more couples cohabit, and more parents raise children without the assistance of a partner.

## **Horizontal Equity**

### **Treatment of Family Type:**

Within tax and welfare legislation “families” are not generally recognised as such, but are defined in terms of two key relationships, being the spousal relationship and the child relationship. While there are also limited provisions that apply to extended family members who are dependant<sup>7</sup>, discussion of those forms of support are not within the scope of this paper.

Social attitudes towards marriage and families have always been a major component in developing family policy that is politically acceptable. In welfare law this can be seen in the separate development of benefit and pension systems. Pensions were originally seen as being for the deserving, for example age pensions or blind pensions; while benefits were seen as a safety net measure for those who need temporary assistance, such as unemployment benefits. This distinction has broken down over the past two decades as means and assets tests have been progressively applied to both types of income support, work tests have been applied to benefits, and the criteria to qualify for pensions have become more restrictive.

To review access to the Widow’s Pension as a case study, the federally funded Widow’s Pension was introduced in 1942<sup>8</sup> following a review by the Joint Parliamentary Committee on Social Security of the Federal Parliament. It was found that due to a lack of income support available from the states, many widows were forced to seek work, which was not considered to be in the best interests of the family. Widows pensions were available in three categories: Class A applied to widows with children under 16; Class B applied to widows who were over 50 years of age; and Class C pensions were temporary pensions available to widows in necessitous circumstances within 26 weeks of their husband’s death. Means and assets test applied at different periods to the various classes of benefits.

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<sup>6</sup> Millbank, J. (2006) Areas of Federal Law that Exclude Same Sex Couples and their Children HREOC. p 7

<sup>7</sup> Note in particular the tax rebates that are available in respect of invalid relatives and aged parents, which are largely irrelevant as welfare benefits are included in applying dependency income tests

<sup>8</sup> Widows Pensions Act 1942, No 19 of 1942

However, an interesting feature of the Widows Pension was that from its first introduction it was available to the “widow” of a de facto marriage. The requirements for a de facto marriage were rather stricter than they are in modern legislation, as it required the de facto relationship to have lasted for at least three years before the widow was eligible for the pension. There were restrictions on the circumstances under which the pension was payable. A deserted wife would qualify for the pension, but a woman who was deserted by a de facto husband, or who left her lawful or de facto husband would not qualify. A woman whose husband was in an institution for the insane qualified but a woman whose husband was in jail did not qualify. Even with these restrictions there was opposition from some of the more conservative women’s groups on the grounds that granting the pension to de facto widows was undermining the institution of marriage, and the year after the legislation was passed the legislation was amended to exclude the definition of de facto and replace it with the term “dependant female” which was defined in substantially the same terms<sup>9</sup>.

It was not until 1972 that the Supporting Mothers Benefit<sup>10</sup> was introduced to provide income support to women that were excluded from the Widows’ pension. It was also the first income support available to single mothers as such. They would, however, have been entitled to Child Endowment, although the rates were minimal. Applying the criteria of horizontal equity to women in this situation, it was clearly not equitable to exclude certain women supporting families from benefits that were available to other women in substantially the same economic position. The sole reason for the exclusion was the marital status of the woman, which cannot be justified on either vertical or horizontal equity grounds.

### **The Family in Tax Legislation:**

Support available under the income tax law has been made available in respect of a spouse or, during certain periods, a child of the taxpayer. These terms are defined in the Income Tax Assessment Act 1997 (ITAA97) as follows:

“*Spouse* of a person includes a person who, although not legally married to the person, lives with the person on a genuine domestic basis as the person's husband or wife<sup>11</sup>.  
...  
“*Child* of a person includes the person's adopted child, step-child or ex-nuptial child.<sup>12</sup>”.

Note that both of these definitions are inclusive definitions: ie they were inserted into the legislation to expand on the usual legal meaning of spouse and child. While the inclusion of the extended definition of “child” is longstanding, the extended definition of “spouse”

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<sup>9</sup> Widows Pensions Act 1943, No 15 of 1943

<sup>10</sup> Social Services Act (No 3) 1973; No 48 of 1973

<sup>11</sup> Note that the 1997 definition is effectively the same as the definition in s.6(1) ITAA36, which referred to a bona fide domestic basis.

<sup>12</sup> s.995-1

is remarkably recent. Prior to 1990 there was no definition of spouse included in the income tax legislation for general purposes, although the existence of de facto relationships was recognised where necessary as an antiavoidance measure. The issue was being arbitrated as late as 1987. The following explanation of the circumstances was given by the Board of Taxation in 1982:

“Significantly, “spouse” is not defined. In the absence of any definition, it must be presumed to refer — and only refer — to a party to a lawful marriage (cf. sec. 46(1) of the *Marriage Act* 1961 (Com.), which defines the relationship created by the Act).

3. We find the conclusion inescapable that a common law wife is not a “spouse” for purposes of sec. 159J.....If further support were needed, one need only to have recourse to sec. 159K(4) which provides for a sole parent rebate where “a man and a woman have lived together as husband and wife on a *bona fide* domestic basis although they were not legally married to each other”. In other words, it must be presumed that the Legislature is aware of what has become known in common law parlance as “common law marriages” and has expressly chosen to limit the relief to be provided to cases involving dependant children and students.”<sup>13</sup>

The legislation was amended in 1990 to ensure that a general definition of spouse would be applied throughout the Income Tax Assessment Act 1936 (ITAA36), and that this definition would include de facto spouses. In the second reading speech the Minister assisting the Treasurer explained that the amendment was introduced as part of a package of amendments to ensure that the ITAA36 complied with the Equal Opportunity Act, which prohibits discrimination on the basis of marital status<sup>14</sup>. It is worth noting that the Asprey Committee did consider this issue in 1975, in the context of determining the tax unit. However it considered that determining whether a de facto marriage existed could be difficult, and intrusive, to determine<sup>15</sup>.

It may be overly cynical to note at this point that where a de facto couple had a child residing with them, the amended definition in fact restricted their entitlements. Prior to the changes, such a couple could claim that the de facto spouse was a housekeeper, in which case the income earned by the “housekeeper” was disregarded in calculating any income entitlement. This needs to be contrasted with the calculation of the spouse rebate, which was reduced if the spouse earned more than \$282 in the year, and consequently was not available in respect of most working spouses.

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<sup>13</sup> No 3 Board of Review, 82 ATC P24

<sup>14</sup> Income Tax Amendment Bill (No 5) 1990. 2<sup>nd</sup> reading speech, House of Representatives Hansard, 8 Nov 1990, p 3642,

<sup>15</sup> at para 10.29 Asprey, K. C. (1975). Taxation Review Committee Full Report. <http://setis.library.usyd.edu.au/oztexts/parsons.html> at 30/11/2006

In contrast, and as pointed out by the Board of Taxation in Case P24<sup>16</sup> the sole parent rebate, which was introduced in 1975 as part of the reforms of concessional deductions, explicitly recognised the possibility of de facto marriages from its inception. This was a prohibition on access to the rebate if the person was in a de facto relationship, rather than a provision to facilitate access. In other words, from 1975 it was recognised that the growing number of de facto marriages impacted on family structures, and the assistance that the State should offer, but prior to 1990 they were only recognised to the detriment of the taxpayer.

However it is important to note the form of the definition, which ensures that a legally married spouse, or a current de facto relationship is recognised. This does still raise some problems in dealing with the family structures that in fact exist, as the definition of spouse becomes an integral part of defining the family. Where family relationships are relevant they are determined by reference to the relationship between the taxpayer and the person, particularly a spouse or child, and there is no generic definition of “family”. The definition of “relative” is probably the closest:

“*relative* of a person means:

- (a) the person's spouse; or
- (b) the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or adopted child of that person, or of that person's spouse; or
- (c) the spouse of a person referred to in paragraph (b).<sup>17</sup>”

However, the classification of a person as a “relative” is usually applied for the purposes of a restrictive, or anti-avoidance provision. For example, s.26-30 ITAA97 limits deductibility for the travel expenses of a relative; or s.26-35 ITAA97 limits non arms-length payments to relatives.

The only definition of “family” in the ITAA is in relation to family trusts, which are trusts set up for and controlled by a particular family. Once the trustee elects to be classified as a family trust, it does benefit the trust in relation to the trust loss measures and the anti-dividend imputation trading measures: in other words it limits the application of those anti-avoidance measures.

An examination of the problems with this definition of “family” highlights the problems found generally with the definitions of “spouse” and “child” in the tax legislation. The definition of “family” for the purposes of the family trust measures is found in s.272-95:

“The *family* of an individual (the *test individual*) consists of all of the following (if applicable):

- a) any parent, grandparent, brother, sister, nephew, niece, child, or child of a child, of:
  - i) the test individual; or
  - ii) the test individual's spouse;

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<sup>16</sup> above n 13

<sup>17</sup> ITAA97, s.995-1

- b) the spouse of the test individual or of anyone who is a member of the test individual's family because of paragraph (a).”

This current definition of the family allows the trust deed to provide for two lineal generations up and down from the test individual. However when taking into account non-lineal family relationships, it only takes into account the siblings of the test individual, and their children. It is broader than the basic family unit of parents and children, but it is more restrictive than the definition of relatives applied elsewhere in the legislation.

This definition needs to be taken into account when nominating the test individual for the family. If it is intended that the beneficiaries include more than one generation on the side branches of the family, it may be appropriate to nominate a test individual from another generation to broaden the scope of the family. For example, if it is intended that an uncle benefit, it may be appropriate to nominate a parent, who is the sibling of the uncle, as the test individual. However this will also have the effect of limiting the lineal generations to the parent’s grandchildren, ie reducing the line by a generation.

Note that the definition of spouse for the purposes of the family trust election, as for the definition of a relative, is still based on either legal marriage or a current de facto relationship, as can be seen in the following examples:

- **Divorce:** Clearly a divorce results in the dissolution of the marriage, and the divorced person can no longer be considered the “spouse” of the family member. If a family trust election has been made it is immaterial whether a person **does** receive a distribution under the terms of the trust, as the family control test requires that **only** persons in the group can obtain beneficial enjoyment of the income or the capital of the trust (s.272-87(3)). Currently the only way to resolve this problem is to remove the divorced person from the group of potential beneficiaries, which will impact on the conduct of the divorce and the property settlements.
- **Death of the Test Individual:** There are potential consequences for the trust where the test individual dies, and the surviving widow(er) is a potential beneficiary under the family trust. The Commissioner has considered the question in ATO ID 2001/742 which considers the status of the widow(er) as a member of the family. It takes the view that the spouse of the deceased "test individual" will continue to be a family member under section 272-95 of the ITAA 1936 provided they were the spouse at the time of death. They will cease to be a spouse if they remarry or enter into a de facto relationship as entering a new spousal arrangement will terminate the previous relationship.
- **Death of the Spouse:** If the spouse dies, they may still be a member of the family group, however a problem arises in relation to any children of that person who are not also children of the test individual. The ATO has released ATO ID 2005/175 considering the standing of stepchildren, ie where formal adoption has

not taken place, within the family group. It takes the view that the relationship of a stepchild depends on the relationship between the natural parent and the step-parent, therefore the stepchild cannot be regarded as a child of the test individual. This may result in unjust outcomes where a child has been absorbed into a family without legal adoption.

- **Same Sex Couples:** As a same sex relationship is not considered to confer the status of a spouse on the partners to that relationship, if a member of the family is in a same-sex relationship that partner cannot be included in the family group.

These issues are being addressed by the government, which stated in the 2006/07 budget that it is proposing to extend the scope of the family to include lineal descendants, and to ensure that distributions to a former spouse, or the widow(er) of a family member, do not attract penalties<sup>18</sup>. These changes will only apply to the issues in relation to the definition of family for the purpose of family trust elections, and will not change the general definition of spouse. However the issues raised also arise in the context of other provisions that rely on the definition of spouse.

More problematic is the situation in respect of same sex couples. The Human Rights and Equal Opportunities Commission (HREOC) is currently undertaking a National Inquiry into Discrimination against People in Same-Sex Relationships: Financial and Work-Related Entitlements and Benefits.

For the purposes of both tax and social security legislation, spouse is not extended to include a same-sex partner. The justification in the tax laws is that the definition of spouse requires the partners to be living together as husband and wife. The Commissioner of Taxation has issued two ATOIDs that discuss the rights of same sex couples. In both documents, the ATO relies on the case of Gregory Brown v Commissioner for Superannuation<sup>19</sup>, in which it was held that two men in a longterm homosexual relationship could not be described as living together as man and wife:

“We are compelled to find that section 8A extends only to husbands and wives, and not to other persons in similar or analogous situations. And as a "husband" and a "wife" are, according to our earlier findings, a man and a woman who are married to each other, with or without a marriage ceremony, this cannot encompass partners in a homosexual relationship.<sup>20</sup>”

Accordingly, although a couple in a same sex relationship may be regarded as in the same factual circumstances as a de facto couple, the relationship is not regarded as a spousal relationship under the income tax law.

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<sup>18</sup> At the date of writing, the details of these changes are not available

<sup>19</sup> (1995) 38 ALD 344; (1995) 21 AAR 378

<sup>20</sup> at para 59

## The Family in Welfare Legislation

For the purposes of the Social Security Act 1991 (SSA), the term that is used is to define a spousal relationship is “member of a couple”. This is defined extensively in s.4 SSA and includes legally married couples that are not separated, and couples of the opposite sex who are over the age of consent and living in a “marriage-like relationship”. In determining what is a “marriage-like relationship” there are a series of criteria that the Secretary must have regard to, including:

- The financial aspects of the relationship;
- The nature of the household;
- The social aspects of the household;
- Any sexual relationship; and
- The nature of the people’s commitment to each other.

The Guide to Social Security Law<sup>21</sup> indicates that while all five factors must be considered, they need not all be present; and no one factor will be determinative. In addition to evidence from the two parties involved, the guide stresses the need for the case officer to obtain evidence from external sources, such as other government agencies or third parties. The decision is based on Centrelink forming a view on the facts of the particular arrangements of the case. In practice, where Centrelink believes that a claimant is living in a marriage-like relationship, that person is asked to complete an assessment. Proposals to give Centrelink officers the right to search the premises of claimants to obtain evidence were recently withdrawn<sup>22</sup>.

These factors are set out in far more detail in the Social Security legislation than in tax legislation, although the same criteria would clearly be relevant in determining whether a couple was living “as husband and wife” for tax purposes, or as a “member of a couple” for Social Security purposes.

For the purposes of the A New Tax System (Family Assistance) Act 1999 (FAA), the core relationship is the parenting relationship. The benefit is payable to a person who has an FTB child, defined in s.22 as follows:

- The child is under 18 (or a student under 25)
- The adult is legally responsible, or has contact under a family court order or parenting plan, or has the care for the child; and
- The child is a resident or living in Australia with the adult.

The definition specifically contemplates shared care arrangements, in which case the benefit must be shared between the carers.

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<sup>21</sup> [http://www.facsia.gov.au/guides\\_acts/ssg/ssguide-2/ssguide-2.2/ssguide-2.2.5/ssguide-2.2.5.10.html](http://www.facsia.gov.au/guides_acts/ssg/ssguide-2/ssguide-2.2/ssguide-2.2.5/ssguide-2.2.5.10.html) at 2.2.5.10, current at 29/11/2006. The Guide is produced by FaCSIA to assist in understanding social security law and its application.

<sup>22</sup> The Age, 11/11/2006, in relation to proposals in the Community Services and Indigenous Affairs and Veterans' Affairs Legislation Amendment (2006 Budget Measures) Bill 2006

However, once it has been established that the parent has an FTB child, the FTBA benefit payable is based on income calculated on the social security concept of “member of a couple”, or family income.

While there is no effective difference in entitlements between de facto couples and married couples in the entitlement to FTB, the anomalies remain in relation to same sex couples. As the definition of “member of a couple” specifically requires the adults to be of the opposite sex, the income of the adults is not aggregated in applying the income test; and further, by being treated as single, the parent will be entitled to FTB on the same basis as a single parent. However, the child will only be recognised as the FTB child of the person who is legally the parent – whether adopted or by birth, which may result in anomalies in the case of shared care arrangements.

### **Universal Benefits:**

#### **The Origins of FTB Part B - Personal Tax Deductions**

However the FTBB is not assessed on the same basis. The history of the FTBB can be traced through the tax concessions that applied where a taxpayer was supporting a dependant spouse. Unlike the history of payments for children, the payments for dependant spouses, being based on the income of that spouse, have been more horizontally equitable than vertically equitable. Regardless of the income of the family, or the “breadwinner”, the element measured to determine equity has been the income of the spouse. This aspect has been carried into the FTBB. In fact, during the 2004 election campaign, the ALP proposed means testing the FTBB for families earning more than \$250,000 pa as part of an overhaul of the family benefits package. The government rejected the need for this, stating that the tax saving would be minimal as there are very few families in that income bracket that receive the benefit.

Therefore within the same payment there is a component based on family income, and another component based on spousal income – the combination of which contributes to the extremely high effective marginal tax rates as the primary carer re-enters the workforce. This can also be segmented into a component that is based on the principle of vertical equity, as it is means tested; and a component that is universal as it applies to any family that is regarded as a single income family.

While the Australian system has always been based on the individual as the tax unit, historically since the introduction of the Federal Income Tax family support mechanisms have been built into the income tax system. These systems have been based on the traditional model of a single income breadwinner, usually male, as they have specifically relied on dependency of the spouse or child. The original Commonwealth Income Tax Act 1915 allowed an annual deduction from taxable income for each dependant child under 16, originally at the rate of £13<sup>23</sup>. Dependant spouse deductions were not introduced until 1936, when a deduction of £50 became allowable in addition to the dependant child rebates, which had by now been increased to £50. The amount that

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<sup>23</sup> Income Tax Assessment Act 1915 s.88 (1)(k)

could be claimed for a dependant spouse was reduced for income earned separately by the spouse. These concessional deductions, similar to the deductions available in the United Kingdom and other European countries, were still available when the Asprey Committee<sup>24</sup>, which handed down its interim report in June 1974, was established. One of the recommendations of the Committee was that income tax support for families be changed from a system of deductions to a system of rebates<sup>25</sup>. By the time that the final report of the committee was tabled in the following year, the government had announced that the system of concessional deductions would become a system of concessional rebates, with effect from the 1974-75 year of income. This was seen as a more equitable system of providing tax relief, as the amount made available to qualifying taxpayers was no longer affected by the marginal tax rate of the taxpayer:

“12.4. One view of the spouse deduction would be that at least a basic minimum which one spouse might be expected to spend on the other who is dependant on him should not be taxed. This points to a deduction approach to the concession. However, in lower income ranges, where the marginal rate of tax is less, the tax saving from a deduction is correspondingly smaller. It is questionable whether the effective assistance should be so unequally distributed, and should be least where it will be of most, if never great, real assistance. The Committee suggests that consideration be given to converting the present deduction to a tax rebate diminishing in relation to the income of the spouse.<sup>26</sup>”

The committee went on to discuss the problems associated with providing for children through the taxation system. At this time there was a universal child benefit available, known as Child Endowment. The Committee pointed out the inefficiency in having a universal payment available parallel to the tax deduction, and recommended combining the two.

### **The Origins of FTB Part A - The Child Endowment Scheme**

At this point it is worth digressing to discuss the basis of the universal Child Endowment benefit. This benefit had been debated in Australia and the UK for some years, and was first paid by the NSW State Government to families in NSW. In 1928 the Federal Government appointed a Royal Commission to enquire into the feasibility of a national Child Endowment scheme. At that time the proposal was rejected. The Commission was urged to consider the redistributive justice of such a scheme to:

“- those who have already finished child rearing – without any support – and are now to be taxed to support those who have not finished  
- to single men who are using their income ‘for some purpose no less admirable than the maintenance of other men’s children’

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<sup>24</sup> above n 15

<sup>25</sup> The Australian Committee of Enquiry into Poverty, chaired by Ronald F Henderson, enquiring into poverty concurrently, also recommended that the Child Endowment payment be increased and tax concessions be removed. It estimated that 25.9% of families with 4 or more children, and 7.2% of families with fewer than 4 children lived in poverty. Overall child poverty was estimated at 15.6%. Henderson RF, (1974) Interim Report

<sup>26</sup> Above n 2, Full Report at para 12.4

- to the infertile. 'I am not sure that bringing up children is entirely a cost'<sup>27</sup>.

The Commission recommended against the introduction of a universal child benefit, on the grounds that the arbitrated minimum wage levels were adequate to support a family<sup>28</sup>. John Curtin, later to become Prime Minister and one of the Commissioners appointed to that enquiry, signed a minority report recommending its introduction.

The universal Child Endowment payment was introduced in 1941, just before Curtin became Prime Minister. The Hansard debate refers to a decision of the Commonwealth Court (of Conciliation and Arbitration) in which Beeby J noted that by this time the arbitrated minimum wage would barely support a family of three<sup>29</sup>. Later in the same year Curtin abolished the child tax deductions that were at that time available, although by the time the Asprey Commission was appointed in 1972 these had been reintroduced as concessional deductions. Child endowment was a universal, fixed amount payable to a person maintaining children and dependant students. The amount was usually paid to the mother, although it could be paid to another person at the Commissioner of Pensions' discretion<sup>30</sup>. Initially, consistent with the minimum wage ruling, it only applied in respect of children after the first but by 1950 amendments had ensured that also applied to the first child. The amount payable increased in relation to each child, so that the amount paid for the third or fourth child in the family was substantially more than the first child payment. The effect of inflation and legislative change from 1941 to 1972 meant that by 1972 the value of the Child Endowment had eroded, with the tax deductions becoming more significant as a benefit delivery method.

Maternity benefits were also a (generally) universal benefit payable to new mothers between 1912 and 1978; and reintroduced in 1995. With one notable exception these were one off payments, and not paid through the taxation system. The exception was a tax offset, known as the Baby Bonus, available for a maximum of 5 years in relation to the birth of a first child between 1/7/2001 and 30/6/2004, however there was substantial criticism of this scheme, and the offset was replaced by a lump sum scheme from 1/7/2004. As these are one off payments, I have excluded the impact from the discussion in this paper.

In respect of Child Endowment, at least, the Government implemented the recommendations of the Henderson and Asprey Committees<sup>31</sup>. The 1974-75 budget modified the method of claiming family support from deductions to rebates; but there was a more substantial restructuring of the tax rate structure with effect from the 1975-76

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<sup>27</sup> Brigden as quoted in Royal Commission on Child Endowment or Family Allowances –Minutes of Evidence, p. 671 quoted in Giblin's Platoon The trials and triumphs of the economist in Australian public life; chapter 4 at [http://epress.anu.edu.au/gp/mobile\\_devices/index.html](http://epress.anu.edu.au/gp/mobile_devices/index.html) retrieved on 28/11/2006

<sup>28</sup> The role of the wage fixing system in regulating minimum income levels is discussed in Castles, F. G. (2001). "A farewell to Australia's Welfare State." *International Journal of Health Services* 31(3): 537 - 544.

<sup>29</sup> Holt, 2<sup>nd</sup> Reading Speech Child Endowment Act 1941, Hansard Commonwealth Parliament of Australia Vol 166 at 339, 27/3/1941

<sup>30</sup> Child Endowment Act 1941, s.18(1)

<sup>31</sup> Above n 2,3.

year. At that time the tax threshold was introduced, but many of the concessional deductions were abolished. The recommendations of the Asprey and Henderson Committees were adopted, with the dependant child deduction being abolished (although retained for the calculation of certain other rebates), but Child Endowment rates, to be renamed as Family Allowance, being substantially increased. Spouse deductions were converted to rebates with the amount payable being dependant on the income earned by the spouse. Sole parent rebates were available to persons with the sole care of their children.

The following table compares the amounts that could be claimed in respect of dependant spouses and children before and after the 1976 reforms:

	1st Child \$ pa	2nd Child \$ pa	Spouse	Sole parent
Child Endowment 1972	0.50 pw = \$26	\$1 pw = \$52		Per child
Tax Deduction 1972 value @ 20% tax rate	\$260 pa \$52	\$208 pa \$41.60	\$364 pa \$72.80	Nil
Child Endowment 1975	\$3.50 pw = \$182	\$5 pw = \$260		Per child
Tax Rebate 1975	Nil	Nil	\$400	\$200

This remained the framework of family assistance for the next 10 years. Payments to children were made outside the tax system, through direct transfers. Such payments were made to the primary carer of the children, usually the mother. However, the introduction of means testing of Family Allowance, introduced in 1986 (for students) and 1987 (for all children) represented a significant change in the underlying policy of family assistance.

A universal benefit focuses on horizontal equity: all families are entitled to recognition of the additional costs that are incurred by families with children. Introduction of a means test recognises that some families need assistance with the cost of raising children, but that some families do not require assistance – test of vertical equity. The means test as applied in Australia is not used to gain access to the benefit, thus restricting it to those in need; but it is an affluence test, applied to limit access by high income earners who are not perceived to need assistance. This is a much more politically acceptable message in Australia.

The justification of the dependant spouse rebate was as a recognition that sole income families were in a different position to families where both are working. However this is based only on the status of the spouse, as measured by her income. In that sense, the dependant spouse rebate was not a means tested benefit, as a single income family earning \$100,000 would qualify, while a family where both parties were earning \$50,000 would not qualify. However, the overall tax paid by the family is lower in the case of the dual income family, as the impact of the progressive tax rate scale ensures that the second income is taxed at lower rates than increases to the primary income.

## Needs Based Transfers – Vertical Equity

### Basic Income Support

Families reliant on income support welfare payments were supported through supplements to these payments. From 1943 pensioners received an additional payment equal to the Child Endowment for the first child that they supported. This was integrated with the Child Endowment, as at that time the Child Endowment was paid for all children after the first. This additional benefit was extended to unemployment recipients in 1945. In 1950, when Child Endowment became payable in respect of all children in the family, the additional allowance was maintained. This form of assistance for families in receipt of income support set the pattern. Generally, pensioners (eg widow's pension) were subject to less stringent income tests than beneficiaries (eg unemployment benefits). However the receipt of the additional family component was tied to eligibility for the basic income support.

In considering these income support payments it is worth noting that Australia never had a contributory insurance scheme to provide income support if a person fell out of work. Income support has always been funded through general revenue, unlike schemes in the UK or the US under which a person's entitlements are affected by their contributions to the scheme.

Until 1982 family income supplements, other than the universal Child Endowment/Family Allowance, were only payable to those families on income support. Prior to that time Australia had not implemented a system of income support for those in work. This can be attributed to the centralised wage fixing system, which was designed to ensure that the minimum wage entitlement was sufficient for a family to live on<sup>32</sup>. Safety nets were seen as being necessary to assist those without employment or unable to work, but the minimum wage regulated a base level of income for those in work.

However, following the recession of the early 1980's it became clear that there was an increasing problem in relation to the "working poor". The Family Income Supplement was the first supplement intended to be claimed by low income families in work, and matched the additional payments available to income support recipients. The take up rate of this benefit was low, and there was concern that families were slipping into poverty. Accordingly from 1987 it was abolished in favour of a Family Allowance Supplement that was available to all low income earners, whether in work or in receipt of benefits. This expansion of the benefit for low income earners was partly funded by reducing access for high income earners, though the introduction of assets tests as well as income testing, further strengthening the vertical equity of the scheme, while reducing the universality of the payment.

The reforms over the 1980s had also redirected the benefits away from the pay packet of the breadwinner into the hands of the primary carer. One of the issues associated with delivery of benefits through the tax system is that the benefits are delivered to the

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<sup>32</sup> Above n. 6

taxpayer, traditionally the male breadwinner. This assumes that there is an appropriate allocation of resources within the household, and that the additional resources will be pooled to support the family. It has, however, been shown that it is more effective to deliver funds into the hands of the primary carer to ensure that the funds are actually used on the welfare of children<sup>33</sup>.

In contrast, maternity payments and Child Endowment / Family Allowance were generally paid to the mother. However as the tax system was the primary means of delivering dependant spouse benefits, or where the family was on income support payments, these were paid into the hands of the breadwinner (father). The Family Income Supplement (from 1984) and the Family Allowance Supplement (Additional Family Payment from 1993) were payable to the primary carer.

This move was strengthened when the Home Child Care Allowance was introduced in 1994. This was effectively a means of “cashing out” the dependant spouse rebate and paying it directly into the hands of the primary carer. The maximum available was slightly more than the amount of the spouse rebate, and was reduced by reference to the principal carer’s income according to the same formula as the spouse rebate. Although the dependant spouse rebate remained in the legislation, eligibility was restricted if the HCCA had been claimed. This effectively gave the family a choice of claim methods, although most “traditional” families where the wife was not earning, and could accurately estimate her income, claimed the HCCA on an ongoing basis rather than through the tax system.

Therefore by 1996 when the Howard government was elected, family support was available as follows:

- Basic Family Payment available to all except high income earners (affluence tested);
- Additional Family Payment available to low income earners (means tested);
- Basic Income Support Payments were increased based on the number of dependants of the claimant;
- Dependant spouses received a Home Child Care Allowance which was an alternative to a spouse tax rebate payable to the principal earner;
- Most payments were made to the principal carer, with the exception of basic income support payments and the residual dependant spouse tax rebate.

While this system was undeniably complex, particularly when determining the entitlements of a particular claimant, it reflected principles of vertical equity in that families in need were entitled to more assistance; and it also attempted to ensure that benefits were delivered into the bank account of the principal carer, who makes the decisions about the use of those funds.

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<sup>33</sup> Joseph Rowntree Foundation: Distribution of Income Within Families Receiving Benefits: Findings April 1998

One of the notable features of the changes that Howard made to the family support system has been the return to the use of the tax system as a delivery method. The Family Tax Initiative<sup>34</sup> was a shortlived proposal, from 1997 to 2000, which allowed an increase in the income tax threshold to families earning less than \$70,000 (or \$65,000 for the dependant spouse component if there was a child under 5). However any system that relies on tax as a delivery method must be replicated in social security legislation to enable non tax paying families to obtain access to the same support through increased welfare benefits. Failure to include access for these families would severely impact on vertical equity. Accordingly the Family Tax Initiative was delivered through the tax system as Family Tax Allowance, and through the welfare system to low income earners as the Family Tax Payment. This therefore required systems and definitions to ensure that families were only able to claim under one or the other method.

A further problem with the Family Tax Initiative was that the income cutoffs were “sudden death” limits. As the benefit was primarily delivered via tax threshold adjustments, there were no tapering arrangements to allow partial access. The thresholds were adjusted to reflect the number of children being supported by the family (\$3,000 per child), and included an additional component where the primary carer was caring for a child under 5 and was not earning more than an amount pegged to the Basic Parenting Allowance (around \$4500 at the time). A NATSEM analysis at the time of introduction estimated that less than 30% of families would not be better off following the introduction of the benefit, with the biggest gains being among low income earners<sup>35</sup>.

The view of the traditional family was strengthened under this scheme. It was clearly designed to assist, if not encourage, families where one parent works and the other is the principal carer. This structure is reflected by the use of the term “breadwinner” in the legislation. While by this time gender specific references had been removed from the legislation, it would not be unreasonable to expect that most “breadwinners” would be the father in the family. Family allowances continued to be paid to the mother during this period.

### **The Current System: Welfare, Tax and Equity**

This unwieldy system was replaced in 2000 by the Family Tax Benefit (FTB)<sup>36</sup>. The framework of the Family Tax Benefit Scheme is similar to the Family Tax Initiative in that it comprises two parts. The first, the Part A benefit (FTBA) is based on family income, while the 2<sup>nd</sup>, Part B, (FTBB) is based on the income of the principal carer, and varies depending on whether there is a child under the age of 5. It is also available either as a tax offset or a direct payment, but unless the recipient is on income support payments, the client has the choice of the method of payment. It is significantly different in that the benefits are not withdrawn on a sudden death income test, but taper rates are

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<sup>34</sup> Family (Tax Initiative) Act 1996 No. 63 of 1996,

<sup>35</sup> Beer, G. (1996) An Examination of the Impact of the Family Tax Initiative. NATSEM Policy Paper No 3

<sup>36</sup> A New Tax System (Family Assistance) Act 1999. For a more detailed analysis see Hodgson H (2004): Mum It's Not Fair. An Analysis of Transfer Payments to Australian Families Applying the Criteria of Equity and Simplicity. (2004) 19 Australian Tax Forum 283

applied. There is, however, criticism of the Family Tax Benefit system in relation to the impact of these taper rates, which apply separately to the two components of the FTB at levels that discourage the secondary earner from rejoining the workforce<sup>37</sup>.

The problem in discussing the FTB in this context is that it is not clear whether it is in fact welfare legislation or tax legislation. While it is named as a tax benefit, and discussed by the Government as such, the method of delivery is more commonly through the welfare system on a periodic basis, and it is not administered by the Australian Taxation Office. It could be described as the illegitimate offspring of the two systems, and this is the primary reason for a number of the problems in the design of the FTB system.

Welfare payments are more concerned with delivering benefits to families in need. This is done through basic income support payments, and additional assistance to low income families. In the context of family payments, from the time that the universal Child Endowment became means tested, the means testing was based on family income. The justification for family payments was that the funds were to assist in the raising of children. This was explicitly stated in the early Child Endowment legislation, which required the funds to be spent on the maintenance and welfare of the child; and restated in the FTB proposals which reiterate that FTB Part A is to assist with the cost of raising children. As discussed previously, there is an inherent inconsistency in means testing such payments: the modern purpose could more appropriately be described as assisting low and middle income families with the cost of raising children.

However, the impact of the withdrawal rates of the FTB is not on the wealthiest families, due to the compounding effect of the withdrawal of FTBA and FTBB concurrently as the spouse income increases family income. While the current system has improved vertical equity, reducing effective marginal tax rates for most families, it is families in the 4<sup>th</sup>, 5<sup>th</sup> and 6<sup>th</sup> decile that currently face the highest effective marginal tax rates<sup>38</sup>.

The evolution of the universal Child Endowment payment into the current FTBA reflects the retreat from universality. However the steps and plateaus of the FTBA rates are intended to ensure that only wealthy families are excluded from assistance with the cost of raising children, although low income families that are in need of more assistance receive extra assistance.

The FTBA serves a different function to the FTBB, which is a horizontal equity measure that endeavours to compensate for the different tax structure of the single income family. During the 1996 federal election campaign the coalition which became the government, initiated a public debate in relation to whether families should be permitted to split income between working and non-working spouses<sup>39</sup>. In 1975 Asprey incorporated a

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<sup>37</sup> Harding, A., Q. N. Vu, et al. (2006). Trends in Effective Marginal Tax Rates 1996-97 to 2006-07. AMP NATSEM Income and Health Report Issue 14.

<sup>38</sup> See Figure 6, NATSEM Ibid.

<sup>39</sup> This theme was picked up by the academic community: see Head, J. and R. Krever, Eds. (1996). Tax Units and the Tax Rate Scale, ATRF.

personal reservation to the final report of the committee<sup>40</sup> that he chaired, in which he reconsidered the views that were published in the interim report. He comments that the construction of a joint taxation system would need careful attention to the rates. However, following a legal analysis of the property rights of women<sup>41</sup>, he concludes that:

“In my opinion, in the world of today a married woman should be treated both under the general law and in the taxation system as an individual in her own right and, in relation to the income which is both morally and legally her own, she should pay no more and no less tax than if she were a single person.<sup>42</sup>”

However, as FTBA means testing is applied to the income of the family, this requires a method of joint assessment of income, similar to the tests used in welfare legislation. As the tax unit is the individual, then the application of a joint income test is inconsistent with the existing individual tax base that has been applied in Australia. Historically, this appears to have first become necessary under the 1996 Family Tax Initiative, which applied an increased tax threshold based on family income. A taxpayer claiming the FTI was required to lodge a formal agreement signed by their spouse, nominating which of the parents was claiming the increased FTI threshold.

As the welfare system is designed to provide benefits to families in need, it is appropriate to measure the income and assets available to a household on a joint basis, whereas the income tax system is designed to tax the income of individuals, as individual economic units. Dependency relationships are relevant in the tax system to enhance the equity of the tax system either by acknowledging the effect of progressive tax rates on a single income, or to compensate for the cost of maintaining a spouse. In the welfare system they are designed to deny benefits to those not deserving of assistance, by taking household income into account. Therefore, generally it would be to a person’s advantage to acknowledge that they are in a spousal relationship for tax purposes, while it would be to their detriment to acknowledge the relationship for social security purposes, as it would reduce entitlements.

### **Conclusions:**

There are many anomalies in the operation of the child support system. These anomalies have largely arisen as a result of the evolution of the system. One of the fundamental problems with the Family Tax Benefit system is that it tries to combine elements of the taxation system with the welfare system, in the interests of integration.

If considered as part of the taxation system, one of the fundamental problems is that the base to determine entitlement is family income, which is contrary to the design principle that the tax unit is the individual. However, in the context of the welfare system it is appropriate for entitlements to be based on the family unit, yet FTBB payments are an exception to the rule that benefits are not available to families with high incomes.

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<sup>40</sup> See n 15

<sup>41</sup> N 15 at 10.5 – 10.13

<sup>42</sup> see n 15: Reservation to Chapter 11

It has also been argued that the spousal relationship should be disregarded for the purposes of determining family relationships, and the family relationship should be determined by the relationship to the child<sup>43</sup>. I would argue that the primary relationship for the purposes of the current family tax benefit system is now the child. The problem arises when determining the amount of income that the household has available to support the child, as household income includes spousal income.

In considering horizontal equity, the family type that is clearly not treated equally under either tax or welfare law is the same sex family. In most circumstances this works to the benefit of this family type, as a parent is treated as a sole parent, and any income from their partner is excluded in claiming welfare benefits, including FTB. However for many families in this situation the desire to have their relationship recognised outweighs any financial loss they may suffer<sup>44</sup>.

Members of the Howard government are adamant that the FTB is part of the tax system, as evidenced by comments of the Prime Minister in the 2004 Federal election, and the Treasurer when discussing the 2005 budget. This does not seem to be consistent with the way in which it is delivered, and regarded by most recipients, who take it as a regular payment to assist in meeting ongoing household expenditure. It would seem that the Government's reasons in calling it part of the tax system are more to do with the ability to take FTB into consideration when discussing the tax cuts that the government has provided to low income families.

In terms of the equity of the system, Australians have become accustomed to valuing vertical equity over horizontal equity. For the last 2 decades we have accepted that family benefits are to assist families in need, and as aspirational voters we support programs that improve vertical equity. However the tradeoff is that we then impose high effective marginal tax rates as recipients cease to qualify for the assistance. In contrast, a universal benefit would apply the principal of horizontal equity, and may resolve some of the issues of the high effective marginal tax rates – however to be revenue neutral, benefits overall would need to be reduced, and low income families would lose out.

Even the most conservative of governments would balk at that.

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<sup>43</sup> Stewart, M. (1999). "Domesticating Tax Reform: The Family in Australian Tax and Transfer Law." *Sydney Law Review* 21: 453.

<sup>44</sup> There are other areas of law where recognition of a same sex spouse would confer benefits, but these may not be financial benefits; eg the right to make medical decisions in respect of their partner.

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