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Highlights

AN OVERVIEW OF THE RESEARCH PROGRAM TO DEVELOP A CANADIAN CHILD SUPPORT FORMULA

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CHILD SUPPORT PROGRAM

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Highlights of the Program of Research to Develop
a Canadian Child Support Formula

HIGHLIGHTS

**AN OVERVIEW OF THE RESEARCH
PROGRAM TO DEVELOP A
CANADIAN CHILD SUPPORT FORMULA**

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Highlights of the Program of Research to Develop a Canadian Child Support Formula

In 1990, the Federal/Provincial/Territorial Family Law Committee embarked on a study to address widespread dissatisfaction concerning the determination of child support. On behalf of the Committee, the Department of Justice Canada undertook a four-year program of research to develop a formula that could be used to determine child support awards in cases of family breakdown. The research program was carried out in three phases and is described in detail in the 1995 report *An Overview of the Research Program to Develop a Canadian Child Support Formula* by Ross Finnie, Carolina Giliberti and Daniel Stripinis. This summary highlights the methodology and key findings described in that report.

Canadian Data on Child Support Awards

Over a three-month period in 1991, information on child support awards was collected in selected sites across Canada. Court reporters in 15 court districts completed a questionnaire, using the information contained in court files, on all cases involving the determination of child support. The final database contained information on the level of income, the number and ages of children, and the size of the child support award for 869 families.

Standards of Living

A key part of the analysis was to compare the standards of living of custodial and non-custodial households before and after separation or divorce. "Income-to-needs" ratios (defined as the ratio of a family's total income to its needs) were developed, in which "need" was defined as the income required to match Statistics Canada's low income measures. An income-to-needs ratio of less than one indicated that a family was "poor," while values greater than one represented proportionally higher levels of well-being.

Analysis of the cases in the database indicated that custodial parents had an average annual income of \$19,572, while the average income of non-custodial parents was \$31,101. Without taking account of the payment and receipt of a child-support award, the standard of living of both households tended to fall after the separation. The analysis below uses income-to-needs ratios to compare the standards of living of the custodial and non-custodial households at various income levels.

Average Child Support Awards

The average level of child support awards in the database was not high enough to lift many custodial families out of poverty. The average monthly child support award in the database was \$242 per child, ranging from a low of \$195 in New Brunswick to a high of \$294 in British Columbia. The average award per family was \$368, ranging from \$280 in New Brunswick to \$451 in British Columbia. Provincial average awards tended to rise with average provincial income.

Low income families

The financial situation of the separated family was particularly strained when both parents earned \$15,000 or less per year. When the family was together, they had a standard of living that was, on average, about 17 percent higher than Statistics Canada's low income cut-off. However, upon family breakdown, the loss of economies of scale resulted in a dramatic fall in the standards of living of both households, and both custodial and non-custodial households tended to find themselves in poverty. It should be noted that for the many families that are living in or close to poverty, a child support formula on its own will not eliminate child poverty.

Non-custodial parents earning \$15,000 or less a year have a standard of living slightly below that of the custodial parent and their children. Non-custodial parents earning more than \$30,000 a year have a substantially higher standard of living than the custodial parent and their children.

The results showed that non-custodial parents with a low income – \$15,000 a year or less – tended to have a lower standard of living than custodial parents and children because the custodial household benefits from government subsidies.

Higher income families

Analysis of the data indicated that a non-custodial parent earning a medium income – from \$15,000 to \$30,000 per year – tended to have, on average, a higher standard of living than the custodial household, especially in situations where the custodial parent earned \$15,000 or less. The medium income non-custodial parent had a slightly lower standard of living than the custodial household when the custodial parent earned an income of more than \$30,000 a year.

Non-custodial parents with high incomes tended to live at a much higher standard of living than the parent and children in the custodial household. Where the custodial parent earned a low income, the gap was substantial. In some cases, high income non-custodial parents had a standard of living that was twice as high as that of the custodial parent and children.

Child Support Formulas

The development of child support formulas represents an effort to prescribe award levels that increase the standard of living of custodial families and introduce greater equity in sharing the costs of children. All child support formulas follow certain procedures to

- estimate the costs of children, and
- decide how to apportion those costs between the custodial and non-custodial parents.

To estimate child costs, formulas typically use equivalence scales to assess how much income a family with children needs to be as well off as a single person. Following a thorough review of various

equivalence scales, the Family Law Committee determined that the "40/30" equivalence scale developed by Statistics Canada to construct their low income measures and to calculate adjusted family incomes represented the best estimate of the costs of children in Canada. This decision was supported by econometric evidence and consultations with social policy advocacy groups.

The 40/30 equivalence scale assumes that, on average, a two-person household needs 40 percent more income to be as well off as a single person: for example, a two-person household needs \$14,000 to be as well off as a single person with \$10,000 – the second person in the family is considered to "cost" \$4,000. Each additional household member adds another 30 percent to the income needs so that, in the example, a three-person household would need \$17,000 to be as well off as the single person with \$10,000.

The 40/30 scale can be applied to households of various sizes living in different financial circumstances. It must be noted, however, that the scale is expressed in terms of gross income needs and does not represent actual spending on a child. Although the 40/30 scale is used to estimate low income measures, applying it in a child support formula does not lead to award amounts that reflect some minimum subsistence level. The scale presumes that higher income families spend proportionally more on their children, and this is reflected in the resulting child support formulas.

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The Child Support Formulas under Review

Following a thorough evaluation of various mechanisms for sharing child costs between the parents, the Family Law Committee selected four formulas to which they would apply the 40/30 scale to determine child costs in each case. The four formulas were

- Income Shares with Reserve
- Flat Percentage
- Surplus Shares
- Revised Fixed Percentage

Income Shares with Reserve

The general approach underlying the Income Shares with Reserve formula is to maintain the financial contribution of the non-custodial parent at the level it would have been were the family still living together.

In the present analysis, child costs were determined using the 40/30 scale, and then split between the parents in proportion to their incomes. Because the formula does not incorporate the tax consequences of a child support payment directly, the resulting award was adjusted in one of two ways:

- 1) the base award was "grossed up" to leave the custodial parent with the correct net amount after she or he has paid taxes; or
- 2) the tax benefit accruing to the non-custodial parent from being able to deduct the award from taxable income was "passed on" to the custodial parent.¹

As the non-custodial parent's income rises, the amount of the award also rises because both the total family income and the proportional share earned by the non-custodial parent increases. As the *custodial* parent's income rises, however, the award may increase or decrease: while the higher family income increases the estimated cost of the child, the custodial parent's increased share of the total income decreases the award.

The Income Shares with Reserve formula provides for a "reserve" or basic amount of income below which the non-custodial parent is not required to pay child support. The Family Law Committee decided to set the basic personal amount at \$6,744, the income level below which Canadians are not required to pay income tax.

Flat Percentage

The general approach underlying the Flat Percentage formula is to apply a flat rate – representing a share of the estimated costs of a child – to the income of the non-custodial parent.

The flat rate was derived using the 40/30 scale to determine the child costs and calculating the non-custodial parent's share of these costs. These amounts were then calculated as a percentage of the non-custodial parent's income and averaged over the entire database by number of children. The

¹ See page 6 for a fuller discussion of the current deduction/inclusion tax treatment.

calculations yielded the following average percentages of the non-custodial parent's gross income, which apply to all income levels:

One child	8.5 percent of gross income
Two children	14.2 percent of gross income
Three children	18.3 percent of gross income
Four children	22.0 percent of gross income

As was done with the calculations for the Income Shares formula, the base award was adjusted to reflect the tax consequences, using both the grossing-up and passing-on-the-benefit methods.

Surplus Shares

The general approach underlying the Surplus Shares formula is first to meet the basic needs of the parents and child and then to ensure that the child shares in any remaining income.

The Surplus Shares formula starts with a basic personal amount for both parents, which was set at \$6,744. Non-custodial parents earning this amount or less would not be required to pay child support. After the basic needs of the parents were met, the basic needs of the child were determined using the 40/30 scale. These minimum needs were shared between the parents in proportion to their incomes. Any remaining disposable income (that is, after deduction of taxes, the non-custodial parent's basic reserve, and his or her share of the child's minimum needs) was shared with the child at a flat rate corresponding to the child's share of the total expenditures of the two family units.

The base award was then adjusted to take into consideration the tax consequences of the award to the custodial parent. Again, both adjustment methods were applied.

Revised Fixed Percentage

The Revised Fixed Percentage formula is unique to this project and was originally developed by researchers Daniel Stripinis and Ross Finnie under contract with the Department of Justice Canada. The Revised Fixed Percentage formula has the principal characteristics of the Flat Percentage formula but uses a specific set of underlying principles to arrive at the percentages, which vary depending on income level.

The general approach underlying this formula is to calculate the share of post-divorce costs of the child when the incomes of the non-custodial and custodial parents are equal, and to use these amounts as the basis of a fixed percentage approach. The formula is guided by the principles that both parents have a responsibility to meet the financial needs of the children according to their incomes,

The Revised Fixed Percentage formula is easy to administer because it requires information on the income of the non-custodial parent only - although the formula assumes that the custodial parent will have to contribute in proportion to his or her income in order to meet all the needs of the child. It also has the advantage of taking all tax considerations into account.

and by the reality that all non-custodial parents who earn the same income have the capacity to pay the same award, regardless of the custodial parent's income.

The first step in the development of the formula was to calculate the award that would result in an equal sharing of the post-divorce costs of the child between the two parents in situations where the custodial parent and the non-custodial parent have the same income. Most individuals would probably regard such an award value as fair: if incomes are equal, the shares of the costs of the child should also be equal. Awards that equalize contributions toward the child in this situation of equal incomes also equalize the standards of living of the two households.

The next step was to determine what should happen to the award when the custodial parent does not have the same income as the non-custodial parent. It should be noted that there is considerable disagreement over how awards should change with the custodial parent's income - with some formulas, the award rises as the income of the custodial parent falls, with others the award falls or remains the same. The Revised Fixed Percentage formula retains the principle common to all flat percentage systems: the award does not vary with the income of the custodial parent.

Calculating the award solely on the basis of the non-custodial parent's income does not imply that the custodial parent does not contribute to the needs of the child. On the contrary (and in keeping with current practice), the custodial parent is assumed to contribute to the needs of the child in proportion to her or his means.

Under this formula, the award rises as the income of the non-custodial parent rises: the child-centred principle here is that the child benefits from the standard of living of the non-custodial parent before the separation or divorce and he or she should retain this benefit afterwards.

Tax consequences are an integral part of the Revised Fixed Percentage formula and consequently the tax treatment had to be integrated into the calculations. When the parents are earning the same income, their post-tax contributions to the costs of raising the children are equalized. The tax consequences are considered to determine a pre-tax award amount. It therefore represents the pre-tax amount that must be transferred to equalize standards of living when both parents earn the same income.

Because the awards are independent of the non-custodial parent's income, the implicit tax gross-ups come into play in an interesting fashion when the parents are in different marginal tax brackets. If the custodial parent is in a higher marginal tax bracket than the non-custodial parent, the award will not completely cover the tax consequences. This occurs because the custodial parent has a higher income than the non-custodial parent, and is therefore above the equal income situation that is presumed in the construction of the award. In these cases, the custodial parent will be penalized by the current tax treatment.

This treatment of taxes works in favour of the custodial parent in cases where his or her income is lower than that of the non-custodial parent. In such cases, the taxes are more than covered in the award, leaving extra money for the custodial family. Generally speaking, this formula will work to the advantage of the majority of low income custodial parents and their children, thus benefitting those most at risk of being in poverty.

The current deduction/inclusion tax treatment works in favour of the custodial parent who is in a lower income tax bracket than the non-custodial parent.

The final step was to transform the awards into equivalent percentages of the non-custodial parent's income and smooth the resulting table of income percentages into a schedule of payment amounts.

This formula also includes a basic personal amount of \$6,744. As with the other formulas, non-custodial parents earning this amount or less than this amount would not be required to pay child support.

While the Revised Fixed Percentage formula is conceptually fairly straightforward, the resulting set of awards is based upon an iterative calculation:

The child costs depend on the award – because the custodial family will spend more on the child if there is more income available to the household – while the award in turn depends on the costs of the child.

These feedback loops lead to an award that represents the appropriate share of the child costs to be borne by the non-custodial parent.

Analysis of the Four Formulas

In general, the formulas were found to generate higher average awards than those in the current award database. The greatest increase in awards occurred when the non-custodial parent earned a higher income, defined in this research as over \$30,000. When the non-custodial parent had low earnings – \$15,000 or less – all the formulas generated awards that were lower than current levels. Results for the four formulas varied when both parents earned more than \$15,000 and less than \$30,000; however, all of the formulas generated awards that were substantially higher than current awards.

Analysis of the post-tax, post-award living standards of the custodial and non-custodial households showed that the formulas generally reduced the disparity between the living standards of the two households compared to the situation under current award levels.

Analysis of the post-tax, post-award living standards of the custodial and non-custodial households, as measured by the income-to-needs ratios, showed that the formulas generally reduced the disparity between the living standards of the two households compared to the situation under current award levels. The formulas

also reduced poverty levels among households, children and individuals earning an income. It should be noted that no formula of conventional design can even come close to eliminating child poverty for divorced families. This is partly because many families are already close to or in poverty before the divorce, and partly because any attempt to eliminate child poverty completely would result in awards so high as to be unworkable in a practical sense.

Selection of the Revised Fixed Percentage Formula

As described, the Revised Fixed Percentage formula is a child-centred formula that is based on the simple principle of an equal sharing of child costs when the two parents have the same income and then basing the awards on the non-custodial parent's income regardless of the income of the custodial parent. Empirical analysis showed the Revised Fixed Percentage formula to be the best overall performer of the four formulas:

- it generated awards that were 32 percent higher, on average, than current awards;
- it reduced the gap between the living standards of the non-custodial and custodial households more than any of the other formulas;
- it reduced poverty levels, cutting the number of children, individuals earning an income and households in poverty by an average of 16 percent;
- it lowered awards for low income non-custodial parents, for whom current child support awards represent a relatively high percentage of income and who have low living standards relative to custodial parents;
- it produced higher awards than any of the other formulas for high income non-custodial parents, whose child support payments currently represent a relatively small percentage of their incomes; and
- it is based on ability to pay and like all flat percentage models, the award only rises or falls as the non-custodial parent's income rises or falls respectively. This eliminates the inherent uncertainty in models based on proportions of income where it is unpredictable whether the award will rise or fall when the **custodial parent's** income rises or falls
- it would be the simplest formula to calculate and update over time because it depends only on the non-custodial parent's income and the number of children, and does *not* depend on the custodial parent's income.

Adjusting the Formula for Low Income Situations

When non-custodial parents have incomes under \$20,000, the Revised Fixed Percentage formula generated awards that were generally lower than current awards. This prompted the Family Law

Committee to initiate a modification to the original formula to raise the awards paid by these low income non-custodial parents.

This modification presented certain practical and conceptual difficulties relating to

- the validity of the income-award relationships in the current award database;
- the need to change or compromise on certain underlying principles of the original formula; and
- uncertainty as to how such an adjusted guideline could be updated over time.

Nevertheless, the modification was performed and consisted of increasing awards in all cases where the non-custodial parent had an income of less than \$20,000.

The low income adjusted formula generated awards that were substantially higher than those of the original Revised Fixed Percentage formula, but not as high as current levels of child support according to the database, in the cases where both parents earn \$15,000 or less.

Changing the Tax Treatment of Child Support

Under the current deduction/inclusion system, child support is included as taxable income for the custodial parent and deducted from the taxable income of the non-custodial parent. As a result of the recent *Thibodeau* case, both the original and adjusted Revised Fixed Percentage formulas were examined to assess the impact of a potential change in the taxation of child support.

Under a reversed, or no-deduction/no-inclusion/no-credit tax system, average base awards generated by the Revised Fixed Percentage formula – that is, the amounts actually going to custodial parents – were found to be *lower* than with the current tax treatment. This is because such a change in the tax system would result in a loss in the tax advantages that exist for the majority of families under the current system, tax advantages that the formula ensures are passed on to the custodial family. Furthermore, it is low income custodial households (i.e., those with incomes of \$15,000 or less) that benefit the most from the current tax system, and thus it is these low income custodial families that would suffer the greatest income drops with a reversal of the current tax treatment. Conversely, when the custodial parent has a higher income than the non-custodial parent, the net value of the award increases under the reversed tax treatment. Furthermore, moving from the deduction/inclusion rule to a no-deduction/no-inclusion rule would generally result in more poverty among households, children and individuals.

Similar results hold for the low income adjusted version of the formula: awards and standards of living would generally be lower with the elimination of the deduction/inclusion rule for the reasons cited above. Interestingly, when the custodial parent has a low income, net awards would actually be lower with the low income adjusted formula than under the original Revised Fixed Percentage with the current tax treatment.

Conclusion

The development of a child support formula is an exercise in balancing the interests of all parties involved and searching for a solution that is not only fair and equitable, but that will also work well in practice. It must be recognized that a child support formula cannot resolve all the problems that families encounter relating to the determination of child support. However, the application of a carefully constructed formula can ameliorate some of the difficulties and will go some of the way toward making the process fairer and less adversarial.