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Divorce and tax matters 411

Clients navigating separation or divorce often seek guidance from their trusted advisors to mitigate impact on their wealth. Advisors may face complicated issues and emerging conflicts of interest in advising these clients. This article highlights the tax impacts of division of assets and support matters of separation and divorce.

Division of assets

On relationship breakdown, certain assets may be exempt from property division, although growth of "exempt" assets during the relationship is typically shared. Division dates for valuation purposes differ across provinces. Most jurisdictions, including Ontario, use the separation date. Alberta uses the settlement date or trial date. The parties may agree to a different date.

Keep good records. Paper trails are key. Proving exemptions means proving property value on both the date acquired and the division date, proving it is not divisible family property. Where assets are bought and sold over time, tracing may be required to uncover original capital amounts subject to exemption. Treat your relationship like a business. Keep statements, purchase and sale agreements, receipts, separation agreements, tax returns and notices of assessment close at hand.

Once separated more than 90 consecutive days *Notify the CRA* of your status change. This proves the timing of the separation to the CRA and triggers them to process changes to credits and payments. For tax purposes, the *separation date* is the date you *started* living separate and apart. You may be still considered separated if living under the same roof but do not share a bedroom, meals or activities.

The Income Tax Act ("ITA") affords common-law partners ("CLP") the same rights as married partners for tax purposes. The ITA defines common-law partners as living together in a conjugal relationship for 12 continuous months or less if the relationship is of some permanence and the parties share a child.

On relationship breakdown, property and support rights for CLPs vary by provincial family law. Depending on the province, CLPs may have more limited rights than married spouses. The definition of CLP for family law purposes also varies by province. For example, Saskatchewan and British Columbia require co-habitation of at least two years for CLP status. Alberta, Manitoba and Ontario require three years.

Support matters

Where not specified, payments between former spouses/CLPs are presumed to be for child support. It is a child's right to have support from both parents. The federal Divorce Act publishes guidelines for appropriate support in a variety of circumstances. Support payments can be determined by agreement or court order, but the guidelines should be considered. Separation and divorce matters are governed by provincial law and interpreted by provincial courts. Though the federal government has no jurisdiction to impose Divorce Act guidelines, most provinces have either adopted the federal guidelines or ones similar. Support agreements/court orders must be registered with the CRA.

Support Payments – Since May 1, 1997, spousal support payments are treated differently for tax purposes than child support payments. *Child support payments* for arrangements struck after this date are neither taxable to the recipient nor deductible to the payor. *Spousal support payments* are generally taxable to the recipient and deductible by the payer. Lump-sum payments are generally not considered support payments as they are not paid on a periodic basis. *Parenting time* is the amount of time a child spends with each parent. In a primary parenting situation, the non-primary parent pays child support based on guideline income tables. The paying parent can neither deduct child care expenses, nor claim tax credits for their child. The primary parent claims the tax credits for their child, including the eligible dependant, GST/HST and disability tax credit. In shared parenting, both parents typically pay child support. Benefits

and credits are shared if certain conditions are met. For support purposes and certain tax purposes, parenting is considered shared where each parent has at least 40% of parenting time.

The Canada Child Benefit ("CCB") is a tax-free monthly benefit paid to eligible families raising children under age 18. The primary parent typically collects the CCB. In shared parenting arrangements, each parent can apply. If they qualify based on their own income (or family income where re-partnered), the benefit will be shared and paid to each parent at the rate of 50% of what each would otherwise receive. In shared parenting, there is no option for parents to agree or for the court to order the lower income parent to receive the full benefit. The definition of shared arrangements for CCB purposes is different than for support purposes. In a 2018 tax court decision, the judge concluded that equal or near equal parenting of 44.4% and 55.5% is required to share the CCB. If you only have between 40% and 44.4% of parenting time, then the CRA may award the CCB entirely to the other parent. You *must* file a tax return annually to receive the CCB.

The GST/HST Credit and related provincial credits. In shared parenting arrangements, each eligible parent may receive half of the GST/HST for each child under age 19.

The Eligible Dependant Credit is available where you are supporting an eligible dependant and not living with a spouse[1]. The claim saves between $2,000 and $3,000 in tax annually depending on the province/territory. If you are the primary parent and you receive child support, you may claim the credit for one child. The contributing parent may not claim the credit for any child he or she pays support for. The credit becomes zero where the dependant's income exceeds a certain amount. In shared parenting where both parents are legally required to support the child, both parents are eligible to claim the credit. However, if the parties cannot agree who will claim the amount, neither parent may claim the credit, unless there is more than one child and each parent can claim for one of the children[2].

Legal fees to establish or increase taxable/deductible support payments are generally deductible for tax purposes. The same is true for fees paid to enforce child support orders or defend applications to reduce support amounts.

Child care expenses. The lower income parent of an intact family generally deducts child care expenses. After separation, a parent paying child support cannot deduct child care expenses in respect to that child. Child care expenses are deductible by the primary parent in non-shared arrangements. In shared parenting, each parent may deduct expenses to the extent each parent paid. Be careful! If a parent re-partners and the new partner is the lower income earner in that household, they claim the child care expense the parent otherwise would.

Tax impacts of property settlement Common law partners and married partners generally have equal rights to support on relationship breakdown. The same is not always true with regard to property division. Assets acquired and debts incurred during a *marriage* are typically considered *family* property and therefore distributed equally when the marriage ends. Rules for CLPs with respect to property division differ across the country.

Property transfers in settlement of property rights are typically without tax consequences. *Equalization of family property* typically results in an equalization payment from the higher net worth spouse to the lower net worth spouse so both leave the relationship in a similar position. *Exempt property* is either acquired by third party gift or inheritance, acquired before the relationship or received as an award for damages. The original value of exempt property held at the time of the marriage or on the date acquired is exempt from a distribution. The spouse claiming a property exemption must prove both the qualification for exemption and the value of the exemption. Growth of exempt property during the relationship is typically divisible.

From a tax perspective, both during the relationship and upon settlement of property rights on relationship breakdown, assets can transfer between spouses/CLPs on a rollover basis. This is called a *spousal rollover*. Rollovers are not available for post settlement transfers. If you roll property to your spouse/CLP during the relationship, any related income attributes back to you for tax purposes. This is called *spousal attribution.* Attribution of income such as dividends, rent and interest cease upon relationship breakdown. However, where a married couple is separated but not yet divorced, or a common-law couple separates, the parties must file a joint election[3] in their tax returns to ensure attribution will not apply to capital gains.

The matrimonial home. Whether you can stay in your home depends on whether you are married or common-law and what jurisdiction you live in. You can have more than one matrimonial home. Unlike other property, if you owned the matrimonial home at the date of the relationship, you do not receive credit for it in the property division calculation when you separate. Regardless of title, both have equal right to remain in the home.

[1] Income Tax Act Section 118(5) and 118(5.1). [2] In shared parenting where there is more than one child, for each parent to be eligible to claim the eligible dependent credit in respect of one child, the separation agreement must state that each parent pays the other their required portion of child support. If the separation agreement states that one parent pays a set-of amount to the other, the paying parent will not be able to claim the credit. [3] ITA ss. 74.5(3)(b).

Pensions. Ontario and Saskatchewan tend to favour equalization of assets. Other provinces treat equalization as one of several alternatives. Fair valuation for equalization purposes considers pre-retirement inflation indexing, age of retirement, duration applicable (from later of relationship or employment date to date of valuation), severance and other benefits, if any, and a tax adjustment. A key advantage of equalization of family assets is that *pensions* are dealt with at separation. Other pension treatments tie couples together financially for years in the future.

Pension income splitting and CPP. Spouses are no longer eligible for pension income splitting in the year of separation. However, Canada Pension Plan ("CPP") contributions you and your spouse/CLP made during your relationship can be divided equally upon divorce or separation. CPP credit splitting is undertaken even if only one partner contributed to CPP. Splitting requires you have lived with and separated from your spouse for at least 12 consecutive months respectively. In the case of CPP, once authorities are advised of the date of the marriage breakdown, they will automatically transfer part of the plan from one spouse to the other.

RRSP and RRIF transfers made directly by the issuer may occur without tax consequences. This includes no impact on either person's contribution room. Plan withdrawals to compensate a former spouse in cash are taxable to the transferring spouse in the year of withdrawal. A tax adjusted payment amount should be negotiated in such circumstances.

TFSA transfers completed directly by the issuer are also qualifying transfers and occur without affecting either person's contribution room. If one chooses to receive a settlement amount and subsequently contribute part or all of it to their own TFSA, the contribution becomes a regular contribution subject to available contribution room.

Preserving the tax attributes and contribution room of RRSP, RRIF and TFSA transfers requires the former spouses/CLPs lived apart due to the breakdown *at the time of transfer.* The transfer itself is to be ordered or agreed to in settlement of related property rights.

RESPs do not have to be divided upon separation or divorce. Spouses can remain as joint subscribers through post-separation and divorce, each contributing independently. Once separated or divorced, you cannot enter into a new RESP contract as joint subscribers, but you can individually create your own RESP for your children. Unlike RRSPs, RESPs are not creditor protected. If this is a concern, split the RESP into separate plans. Money can be transferred from one RESP to another without tax consequences provided certain conditions are met.

If a child is the beneficiary of more than one *RESP*, each qualifying contribution will attract grants in order of contribution until the beneficiary's lifetime maximum is met. The lifetime contribution limit is aggregated across all plans and monitored through the beneficiary's social insurance number (SIN). Separation agreements should spell out obligations to continue contributions as agreed to, confirm when the subscriber(s) may withdraw from the RESP, prevent withdrawal of funds except for post-secondary education of the beneficiary, instruct who bears the tax liability/penalties, if any, and outline who can be named a successor subscriber in the event of either parent's death.

Private company shares. Spouses are non-arms length parties for tax purposes, as are corporations controlled by each. Depending on the facts, individuals may still be considered non-arm's length after separation or divorce. Where a corporation controlled by one spouse acquires shares in a corporation controlled by the other during division of assets on relationship breakdown, timing is critical to avoid negative tax implication. This includes denial of capital gains treatment and lost opportunity to apply capital gains exemptions. Properly planned and timed transactions can split corporate assets into two corporations without tax consequences. Often, one party can receive passive assets and the other the active assets, but the transaction must be completed while the couple is still non-arm's length for tax purposes. If couples can't work together to accomplish the related butterfly, a divisive butterfly is available where parties are arm's length for tax purposes. It is more complicated and less flexible, typically requiring both parties to take a share of business and non-business assets.

Divorce impacts estate planning! In many provinces divorce no longer revokes a will. Provincial estate law may remove your former spouse/CLPs entitlement to inherit or act as your representative under your will or upon intestacy. This relief is not available for beneficiary designations. If you do not want your former partner as a beneficiary of your registered plan or insurance policy, you *must* remove their designation on your plan contract and/or under your will. CLPs have broader property rights on death of a partner than on relationship breakdown. Poorly-worded separation agreements can bind your estate to support payments not otherwise intended. Anyone undergoing separation or divorce must revisit their will, power of attorney documents, beneficiary designations and even shareholder agreements to ensure alignment with separation agreements. All legal documents should reflect the appropriate planning and agreements intended.

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