

## Separation and Divorce Can be Taxing in More Ways Than One

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On the breakdown of a relationship, the various tax aspects of support payments, legal costs and division of assets are not usually a main priority, however tax should not be ignored.

### Support Payments

Child support is not taxable in the hands of the recipient nor is it tax deductible to the payer; however, this treatment differs from that of qualifying spousal support payments. For income tax purposes, an amount is considered spousal support if meets certain conditions. It must be received by a spouse or former spouse in the year either as alimony or other allowance for the maintenance of the taxpayer. It must be received pursuant to an order of a competent tribunal or by written agreement between the parties which is signed and dated by both parties. It must be payable on a periodic basis. And lastly, the parties must be living separate and apart because of a breakdown of the marriage at the time the payments were received and through the remaining year. Certain payments to a third party, while not periodic or at the discretion of the beneficiary of the payments, may be deductible to the payer if the payments are made pursuant to an order or written agreement. It is important to note that payments made prior to an order or agreement are tax deductible if they would otherwise qualify as support payments, they are made in the same year or the previous year and the order or agreement refers to those payments.

Voluntary payments are not deductible.

Support payments not specifically defined as solely for spousal support will be considered child support for tax purposes. If the full amount of child and spousal support payments are not paid, payments are first treated as child support and any remaining amount is treated as spousal support.

Lump sum spousal support payments are generally not tax deductible unless paid by a former spouse or common law partner with respect to qualifying periodic support payments for one or more previous years as set out in a written agreement or court order. If the amount is more than \$3,000, it may qualify as a "qualifying retroactive lump-sum payment" and income averaging may be available thereby taxing the amount in the taxation year it was originally owed as opposed to the year it was actually received.



### Legal Fees

The Canada Revenue Agency has indicated that legal fees to establish, seek an adjustment to, or enforce payment of support payments are deductible, however legal fees related to establishing parental rights and obtaining a divorce are not deductible.

### Tax Credits and Canada Child Benefit Payments

A taxpayer may be able to claim an eligible dependent amount with respect to a child if the person is not claiming the married or common law spouse amount, and lives with and supports a child under the age of 18. The taxpayer must not be making any support payments for the child and no one else can claim the credit for that child. If more than one child, each parent may be able to claim the eligible dependent amount in respect of one child if they do not pay support in respect of that child.

A disability tax credit can be claimed by a parent of a child if the tests for the eligible dependent amount are met.

Medical expenses paid by the taxpayer for the child can be claimed, however they cannot be claimed if combined with child support payments.

While the transfer of unused tuition tax credits from a child is sometimes covered in separation and divorce agreements, it is the child who ultimately designates the transfer.

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The Canada Child Benefit is generally paid to the individual who is “primarily responsible” for the care of a child who is under the age of 18 and who lives with that individual. The benefit amount is based on the family’s net income, adjusted for certain items. In the case of separated or divorced couples, the benefit amount is calculated based on the adjusted income of the individual who has primary custody of the child. In a shared custody situation where a child lives with two different individuals in separate residences on a “more or less equal basis”, each individual will receive 50% of the payment they would have received if the child lived with them all of the time.

### Tax-Effective Division of Matrimonial Assets

A balanced after-tax segregation of matrimonial assets may be difficult to achieve as not all assets are being liquidated and it may be that the

assets which one spouse may want to liquidate, such as private company shares, may have an unrealized tax liability associated with them that must be considered.

The Income Tax Act provides that assets can be transferred between spouses on a tax-deferred basis such that no capital gain is triggered on the transfer where assets are being moved as part of a settlement of rights arising out of a marriage or common law partnership. As part of the negotiation of the division of assets it should be kept in mind that the recipient spouse will pay tax on any accrued gain or capital cost allowance recapture when they ultimately dispose of the property.

Common examples of these types of assets would be the family cottage, investments with unrealized gains and rental properties.

Certain assets, such as cash, a principal residence, and investments and personal assets with no unrealized gains, can be transferred at fair

market value because no taxable gain will result. In the case of a principal residence, the parties will need to designate a property as a principal residence for specific years and if there is more than one residence, they will need to decide which to designate. If they cannot agree on designation, income tax may be applicable.

No tax is triggered on a transfer directly between RRSPs and RRIFs provided both parties sign the necessary forms, the transfer is made while the parties are living separate and apart and the transfer is pursuant to a court order or separation agreement. A transfer of Registered Pension Plan (RPP) benefits can also take place on a tax-deferred basis if the transfer is between RPPs or to an RRSP. Amounts can transfer directly between Tax-Free Savings Accounts without affecting either party’s contribution room.

Once Service Canada is notified of a divorce, CPP credits are combined and split between former spouses however Quebec, Saskatchewan, BC and Alberta allow parties to opt out of this equalization.

A division of other assets such as stock options, convertible securities, foreign assets and shares of private corporations may be more difficult to accomplish. Shares of private corporations may be particularly hard to deal with as the value of the shares may be such that equalization can only be partially achieved using

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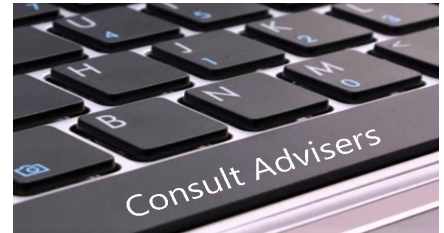
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other marital assets and financing is required to complete the equalization. Where both spouses are shareholders of the corporation, the parties must agree as to whether both will continue with the business, whether one spouse will buy the shares of the departing spouse or have the company redeem the shares, or whether the business will be split such that each spouse will continue to operate their own business.

The Income Tax Act contains a provision that allows for the splitting of

corporate assets held by one company into two companies, perhaps one owned by each of the former spouses. This can be accomplished on a tax-deferred basis while the individuals are still spouses and therefore must be completed before the divorce is finalized.

In finalizing your separation and divorce, tax is not always top of mind. Good advice from your accountant prior to, and during the separation process can result in significant tax savings and asset preservation.



Each provincial jurisdiction may be different when it comes to family law and pension law matters, therefore clients should consult advisors in their own province.

**Consult your nearest DFK tax professional for further advice**