



# Tax Issues on Separation and Divorce



**MATTHEWS  
CAMPBELL**

*A Partnership of Incorporated Professionals*

## TAX ISSUES ON SEPARATION AND DIVORCE

When a marriage ends, the number and variety of decisions to be made in what is already a time of emotional turmoil seem endless. The individuals involved are typically focused on making new living arrangements, settling on custody and access rights, and generally trying to fashion new lives for themselves and their children. At such a time, the need to make prudent tax and financial decisions often takes second place. However, the decisions and agreements made following the end of a marriage can affect the tax and financial well-being of both parties for years afterward. Adding to the confusion, the rules and administrative policies governing the taxation of separated and divorced spouses have undergone some significant changes in recent years. From a financial point of view, when a marriage ends, the parties involved are generally most concerned



about support arrangements and about the division of assets acquired during the marriage. This article summarizes the tax rules and administrative policies currently in effect with respect to those issues.

### When are support payments deductible?

The law lays down very specific rules as to what constitutes support payments (technically called “support amounts”) and when they are deductible to the payer (and therefore taxable to the recipient). Prior to 1997, the terms “alimony” and “maintenance” were used in place of support amounts, but the definitions are virtually the same. Minor differences are discussed in context below.

The rules continue to distinguish cases where a marriage or common-law marriage has broken down from the cases in which there never was a conjugal relationship but there is a child on behalf of whom support is ordered. The rules are discussed under separate headings below.

Where marriage breakdown occurs, including the breakdown of a common-law relationship or a common-law partnership, a payment constitutes a

support amount and is deductible if all the following criteria are met:

- the amount must be paid under an order of a competent tribunal or under a written agreement; however, please note that a court order or written agreement can validate earlier payments of the year and the preceding year;
- the amount must be payable or receivable as an allowance on a periodic basis (for 1996 and earlier years read “the payment must be in the nature of alimony or other allowance payable on a periodic basis”); however, please note that a subsequent court order or written agreement can validate as periodic specified expenses which may in fact be contingent or occasional;
- the amount must be for the maintenance of the recipient, the children of the recipient, or both;
- the taxpayer must be living apart from the recipient at the time of the payment because of the breakdown of their marriage;
- the recipient has discretion as to the use of the amount; in either form, the issue is whether payments made to a third party qualify as support amounts; in both cases, the answer is yes provided the governing order or agreement provides for such third-party payments for the benefit of the recipient or children in the recipient’s care; and
- the amount is not a “child support payment” covered by new system rules effective May 1, 1997.

An order of a competent tribunal is a decree, order, or judgment made by a court or other competent tribunal. Nothing less than a concrete pronouncement, decree, or direction of a tribunal empowered to make an order will constitute the required order. An agreement deemed by a provincial court to be a court order for purposes of provincial maintenance enforcement legislation, will not, in and of itself, result in the agreement being considered an order made by a competent tribunal for the purposes of the Act.

If the spouses or common-law partners have only a written separation agreement, the alimony or other allowance will be deductible if the other requirements are met. Generally speaking, a written agreement should be a written document under which a person agrees to make regular payments to maintain his or her current or former spouse or common-law partner, children of his or her current or former spouse or common-law partner, or both. The agreement should normally be duly signed and dated by both parties. The courts have held that cancelled cheques, correspondence, and agreements which do not mention agreement to live separate and apart do not constitute a “written separation agreement”.

However, the Canada Revenue Agency (CRA) is prepared to accept that an exchange of written correspondence between the parties or their respective solicitors may be considered to be a written agreement if:

- there was the intention to create a binding and enforceable contractual relation;
- the exchange of written correspondence outlines all of the essential terms and conditions of the agreement in a clear and unambiguous manner; and
- there is a clear and unequivocal acceptance in writing by both parties of all those terms and conditions.



## Child support payments

Effective May 1, 1997, a new system of taxation has been implemented under which separate treatment is prescribed for payments made on account of child support (“child support payments”) and payments made on account of support of the recipient (usually but not always a former spouse or common-law partner; in any event these payments are referred to for convenience as “spousal payments”). Child support payments are not taxable to the recipient nor deductible to the payer, whereas support payments for the benefit of the recipient will continue to be taxable to the recipient and deductible to the payer so long as they meet the criteria set out above. There is a general presumption that payments are child support payments unless otherwise identified, and new system agreements which provide for taxable/deductible (as opposed to child support) payments must be registered with the CRA.

## What is a child support payment?

A child support payment is any support payment which would be deductible under the rules set out above that is not identified in the agreement or order under which it is made as being solely for the support of a spouse or common-law partner or former spouse or common-law partner or the parent of the taxpayer’s child. In short, unless the written agreement or court order which provides for periodic payments specifies that an amount is

for the benefit of the recipient and not the child, it is presumed to be child support. Therefore, if a written agreement, for example, provides for a global amount of support to be paid in respect of a spouse and child, the whole amount is considered child support for tax purposes. The same treatment will apply to amounts that are required to be paid directly to third parties but are nevertheless potentially deductible. Such third-party payments will be treated as child support amounts unless the order or agreement under which they are made clearly identifies the payments as being solely for the support of a spouse or common-law partner, former spouse or common-law partner, or parent of the payer’s child, as the case may be.

## How are child support payments determined?

The amount of a child support payment is determined by agreement of the parties or by a court, as the case may be. Part and parcel of the new child support system, however, are guidelines published under the federal *Divorce Act* as to appropriate amounts of child support in various circumstances. The federal government has no authority to impose these guidelines, since separation and divorce settlements are governed by provincial law interpreted and applied by provincial courts. However, most provinces either adopt or recommend to their courts either the federal scale or a similar one of their own devising. Even in these circumstances, the guidelines may not be binding, especially where amicable agreements are made outside the ambit of court review. Determination of these amounts is beyond the scope of this article, which is merely concerned with the taxability/deductibility of amounts determined.

The federal Department of Justice publishes the federal child support amount guidelines. Call 1-888-373-2222 for more information. It is also available on the Department of Justice Canada Web site, located at [www.justice.gc.ca](http://www.justice.gc.ca).

## Taxation of third-party payments

The general rule is that for an amount to qualify as a support amount it must be paid directly to the recipient, and the recipient must have control over how the funds are spent. However, following a separation, it often happens that the person who was, during the marriage, responsible for the payment of certain expenditures, such as property taxes on the family home, will continue to pay those amounts directly to a third party. Such amounts can be treated for tax purposes as support amounts; however, it’s important to structure such payments carefully, as seemingly insignificant differences in the way the payments are made can have unintended and unwelcome tax consequences. The general rule in this area is that payments made directly to third







parties may be deducted by the payor and included in the income of the recipient where the following criteria are met:

- the payments are made, under an order or agreement, for the benefit and maintenance of the recipient spouse;
- the payments are made at a time when the payor and the recipient were living separate and apart; and
- the court order or written agreement specifies that the recipient will include the amounts in income and that the payor can deduct them.

For example, where a former spouse continues to make property tax or insurance premium payments on the family home in which his former spouse and their children continue to live, he would be able to deduct such payments from income, and his former spouse would include them in her income, assuming that the three criteria listed above are satisfied.

### Division of property on marriage breakdown

Our tax system generally imposes tax consequences where property is transferred between persons related to one another (referred to in tax terminology as non-arm's length parties) for any amount other than the fair market value of that property. However, different rules apply where property transfers take place as a result of marriage breakdown. Generally, there are no immediate tax consequences where property is transferred from one spouse to another, as long as the parties are separated as a result of the breakdown of their marriage and the transfer is in settlement of property rights arising out of that marriage.

### RRSP and pension assets

Most taxpayers are aware that where monies are taken out of a registered retirement savings plan (RRSP) or a registered retirement income fund (RRIF), tax must be paid on those withdrawals. However, our tax system provides for an exception to this rule in the case of a marriage breakdown. Where former spouses are no longer living together, and there is either a court order or a written separation agreement outlining the division of property between them, amounts in an RRSP or an RRIF may be transferred directly from one spouse's plan to the other's in accordance with that order or agreement, without any tax consequences.

Similarly, when a couple divorces, the question of entitlement to credits accrued under the Canada Pension Plan by both spouses during the marriage often arises. Here again, the law allows for the splitting of CPP benefits between a taxpayer and a former spouse. Formerly legally married spouses (as well as common-law spouses who have lived together

for at least one year) can make an application to have the credits earned by both spouses during the marriage totalled and split equally between the parties.

### Deductibility of legal fees

In even the most amicable of divorces, it is almost inevitable that both parties involved will incur some legal fees. Where matters become contentious, and particularly where litigation is required, the amount of such fees can be substantial. The CRA's current rules and administrative policies on whether such legal fees are deductible have evolved over the past several years through a series of technical opinions, court cases, and technical newsletters, making it difficult to determine what is or isn't deductible at any given point in time. However, it is possible to outline the general rules which apply to payors and recipients of support, with the caution that the question of deductibility should be confirmed with a professional who is familiar with both these rules and the individual's circumstances.

Generally, after October 10, 2002, legal fees paid to obtain spousal support or an increase in spousal support amounts, to make child support non-taxable, or to collect late support payments may be deducted by the person who paid the fees. Similarly, legal fees paid to enforce child support orders are deductible. Finally, where a person receiving support pays legal fees to defend against an action brought to reduce those support amounts, those fees may be deducted.

From the point of view of the payor of support, the CRA takes the position that legal fees paid to defend against claims for support or increased support are not deductible.

### After the separation—who claims what?

#### Tax deductions for children—the “equivalent to spouse” deduction

Following a divorce, a single parent who lives with and supports his or her child may claim what is known as an “amount for an eligible dependant”, or AED, sometimes referred to as the single parent exemption. The tax credit that may be obtained is a significant one, allowing the parent to reduce his or her federal taxes by about \$1,670, and provincial or territorial taxes by anywhere from about \$400 to \$1,700, depending on the province of residence. The rules respecting eligibility for the credit can be confusing and sometimes even arbitrary; it is important to ensure your eligibility before making the claim and to respond promptly to any request from the tax authorities for documentation establishing your right to claim the credit. As well, different rules apply with respect to who may claim the credit in the year of separation and in subsequent years.



## Year of separation

Generally, a person who pays child support is not allowed to claim an eligible dependant amount in respect of that child. However, in the year the parents separate, the parent who pays support has an option. He or she may claim the credit (assuming that no other person is claiming the AED for that child), or may claim a deduction for spousal support paid, assuming that all other eligibility criteria for an AED credit or a support payment deduction have been satisfied.

## Years after the year of separation

In years following the year of separation (i.e., where the parties live separate and apart for the entire year), the parent with whom a child lives may claim the AED. Where an AED claim is made, especially for the first time, the tax authorities may well request some documentation to show that the person claiming the credit does actually have custody of the child. A separation agreement or court order outlining the custody and living arrangements is ideal; failing that, a copy of school records verifying that the child's address is the same as that of the parent claiming the credit should suffice.

More and more frequently, divorcing parents are able to agree on and implement joint custody arrangements, where the children may move back and forth between each parent's home. In such situations, it's important to remember that the AED cannot be split—it must be claimed by one parent or the other. Co-operation in this regard is essential—if the parents cannot come to an agreement, and both

attempt to claim the credit in respect of the same child, neither will be allowed to claim it and the credit will be lost. However, where there are two children in the family, and the parents share custody, it is perfectly possible for one parent to make the AED claim in respect of the first child and the other parent to make the claim for the second child.

## Conclusion

Obtaining professional advice is usually a good idea when dealing with tax matters. When those tax matters involve the end of a marriage, such advice is essential. The tax rules in this area, particularly those governing the taxation of support payments are, unfortunately, among the more complex in the *Income Tax Act*. The rules are replete with exceptions, limitations, elections, and changes in the both the law and the administrative policies of the CRA. In addition, this is an area in which strict compliance (or lack of compliance) with the sometimes arcane and confusing rules and regulations can make all the difference. Numerous court decisions have held that, even where the parties are in agreement and their intent is clear, a failure to get the paperwork right means that the parties' intent is thwarted, to everyone's cost. Spending some time and money to ensure that all foreseeable financial and tax issues are thoroughly discussed and that all the formalities are complied with will minimize future conflicts and provide a reasonable degree of certainty for both parties with respect to their financial futures.

