Marriage Breakdown Can Be Taxing

In Canada, since 2000, there have been approximately 2.74 million divorces. If you haven't yet, at some point, you'll likely have to assist one or more clients navigate the financial ramifications of separation or divorce. Understanding the tax implications is a critical aspect of any marital breakdown.

What does marriage mean from a tax perspective?

A "spouse" is not explicitly defined in the *Income Tax Act* (ITA), although "common-law partner" is. Per S.248(1), the definition of a *common-law* partner is:

A person with whom you live in a conjugal relationship who is not your spouse, and he or she has been living with you at least 12 continuous months; or is the parent of your child by birth or adoption; or has custody of your child and your child is wholly dependent on that person for support.

There is no definition of "marriage" in the ITA : *This term only applies to a person you are legally married to.*[1] The Canada Revenue Agency (CRA) includes a definition of *"married"* in their administrative policies. CRA's website says, *Married means that you have a spouse.*

From a tax standpoint, what constitutes a separation?

We must look to the CRA's administrative policies for the relevant definition.

Separated means that you have been living apart from your spouse or common-law partner because of a breakdown in the relationship for a period of ***at least 90 days****. Once you have been separated for 90 days because of relationship breakdown, the effective date of your separated status is the day you started living apart.*[2]

To inform CRA of a marital status change, the client can complete Form RC65, Marital Status Change, using the date at the beginning of the 90-day separation period.[3] **Reminder:** It is often best to reach out to a tax professional before a formal separation or divorce, if possible. The most tax-effective way to divide assets may require that they be separated, divorced, or still legally married to their partner.

What are the tax consequences if my client's marital status is now "divorced" or "separated"?

If the client's marital status has changed to either "divorced" or "separated", they are no longer eligible for spousal/common-law partner tax planning opportunities. The result can vary dependent on the particular facts of their situation. Perhaps the combined income of the client and their spouse previously reduced access to:

- GST/HST credits,
- Canada child benefits,
- Guaranteed Income Supplement,
- Canada Workers Benefit, amongst other income-tested benefits and credits.

Other tax credits may have been claimable by either spouse or previously apportioned such as:

- the Canada caregiver credit,
- the home buyers' amount,
- medical expenses,
- qualifying childcare expenses, and
- donation tax credits, to name a few.

[1] https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-address-information/marital-status.html
[2] https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/t4114/canada-child-benefit.html
[3] https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-address-information/marital-status.html

As an advisor, it's important to understand how the new realities of the client's situation will impact their tax obligations, and in turn their future financial plan. It's also critical to know how their assets are divided upon divorce or separation, not to mention the timing of certain asset transfers.

Which matrimonial properties are typically subject to division upon marital breakdown?

Matrimonial or "family property" is commonly divided in accordance with the applicable provincial or territorial 'family law' legislation. The definition of 'matrimonial property' can vary significantly from one province to the other. Each jurisdiction's legislation details which assets may, or may not, be subject to division upon separation or divorce.

In certain provinces, such as B.C., common-law partners are treated the same as married spouses. In some provinces, like Ontario, that is not the case. Some provinces apply their own framework for who qualifies, such as *Adult Interdependent Partners* in Alberta. Common assets subject to division **may** include:

- the matrimonial home,
- registered assets and pension plans,
- movable assets such vehicles, business assets,
- non-registered accounts, comingled assets, and
- the growth of the value of properties and investments held since the commencement of the 'conjugal relationship.'

It's critical to review the relevant family law legislation in the client's jurisdiction. It's also important to note that CRA's definitions are irrelevant when it comes to family law. CRA's definitions are relevant to ensure that assets subject to division or equalization are transferred to a former spouse or common-law partner on a tax-deferred basis.

Which assets are most commonly ***excluded*** *from property division or equalization?*

Planning to protect against a potential marital breakdown is not uncommon, especially when wealth disparity exists between two soon-to-be spouses, or their respective families. Another common scenario where protection can be top of mind is in a blended family situation. The best proactive mechanism is a marriage or prenuptial agreement. However, according to a 2017 Ipsos poll, only about 8% of married Canadians have prenuptial agreements.[4]

With that in mind, it's important to understand what assets may be exposed to division upon separation or divorce. Again, every jurisdiction has very different rules as it pertains to assets that may be exempt from division or equalization. Generally speaking, some common excluded items **may** include:

- Property acquired before the relationship
  - Although growth is typically not exempt
- Third-party gifts received
- Inheritances received
- Life insurance policy proceeds
- Settlement as compensation for injury or loss
- Certain discretionary trusts, and
- Assets denoted in a binding domestic contract

[4] https://www.theglobeandmail.com/investing/globe-wealth/article-prenup-romance-killer-or-wealth-protector-or-even-bankruptcy/#:~:text=Not%20many%20people%20agree%3B%20an,of%20property%20and%20spousal%20support

Without excluded status, property may be considered "matrimonial" or "family property" and thus shareable, or subject to equalization, with an ex-spouse on the separation or divorce date. Excluded (or exempt) status may also be tarnished to the degree that the asset is subsequently comingled or used to otherwise purchase family property for example. That could be as simple as taking an otherwise excluded inheritance and depositing it into a joint bank account with a spouse.

As with the definition of matrimonial property across jurisdictions, exemptions can differ, as well. For example, according to the *Family Property Act* in Manitoba, the *growth* of the inheritance itself is exempt from equalization. Whereas in B.C., that same growth is not exempt from property division upon marital breakdown, as per B.C.'s *Family Law Act*. Meanwhile in Saskatchewan, an inheritance received subsequent to the start of the relationship is not considered excluded property, per Saskatchewan's *Family Property Act*. As I'm sure you can appreciate, it's imperative to analyze each asset within the jurisdictional legislation.

Key Consideration: Each jurisdictions family law also defines a spouse and outlines who may or may not be eligible for equalization or division of family property or equivalent.

How is the division of matrimonial property treated for tax purposes?

When it comes to any separation or divorce, division of property is typically the centerpiece of the financial discussion. Matrimonial property is commonly divided in accordance with the jurisdiction's division of property rules. There are varying degrees of outcomes as it pertains to property division, with room for negotiation depending on the circumstances and nature of the assets. Typically, property division occurs on a tax-deferred basis.

Paragraph 73(1.01) (b) of the ITA allows capital property to be transferred between living persons on a tax-deferred rollover basis to: *the former spouse of a taxpayer,* ***in settlement of rights arising*** *out of their marriage or common-law partnership.* This tax-deferred rollover only applies when both individuals are resident in Canada at the time of transfer.

It is best practice to obtain a legal agreement or equivalent (e.g., court order) to outline the property division terms. This is often a requirement for certain tax-deferred asset transfers upon divorce or separation e.g., the majority of registered investments. In addition to rights of property division, a separation agreement will typically cover:

- critical provisions including spousal support,
- child support,
- custody,
- parenting arrangements,
- debt obligations,
- decision-making framework,
- etc.

Who pays the tax subsequent to a rollover?

In the case of a tax-deferred rollover of capital property to a spouse or common-law partner, the attribution rules will kick in.[5] For example, if non-registered portfolio investments were gifted from one spouse to another, the gift itself is automatically tax-deferred. But any income or capital gains subsequently realized on the portfolio are attributed back to the transferor spouse. When a tax-deferred rollover occurs between separated or divorced spouses or common-law partners, attribution rules typically don't apply. However, depending on the nature of the asset, there are some unique considerations.

*What is a potential **pitfall** when it comes to capital property transfers upon separation?*

For spouses or common-law partners that have separated, but have not legally divorced, an election may be required to ensure that the capital gain is realized in the transferee's hands – if that is in fact the intention. In other words, the attribution rules may still apply.

For example, say a vacation property with an unrealized gain was transferred from Separated Spouse A to Separated Spouse B on a tax-deferred basis. For purposes of the example, assume that the spouses have yet to finalize a divorce, or they were never married to begin with. If the intent is for the future capital gain to be realized in the hands of the Separated Spouse B, the parties must jointly sign an election under paragraph 74.5(3)(b) of the ITA.[6] No prescribed form is required to do this. If the property is sold prior to the election, capital gains would be realized in the hands of the transferor, which more often than not, wouldn't be the intention. Please note that if the ex-spouses had finalized a divorce prior to the transfer, there would be no need to file the election. Also, this potential attribution pitfall is only relevant when it comes to capital gains income. In the case of interest, dividends, rents, etc. the attribution rules cease to apply upon relationship breakdown. It works as long as it is pursuant to a written agreement/court order, and both parties stay separated throughout the year.

What are some notable planning considerations for assets typically subject to division?

Registered Retirement Savings Plans (RRSPs)/ Registered Retirements Income Funds (RRIFs)

RRSPs or RRIFs can be transferred on a tax-deferred basis to a former spouse if the following criteria are met:

- The parties are living separated and apart (either separated or divorced) at the time of the transfer;
- The transfer is made in accordance with the terms of a **court order or a written agreement**, as settlement of rights arising from the breakdown of the relationship; and
- The transfer is an amount made directly to another RRSP, or RRIF, of which the former spouse or common-law partner is the annuitant, authorized by a signed Form T2220.

A T4RSP/T4RIF will be issued to the transferor. It would be indicated as a 'transfer' on schedule 7 of their T1 tax return. It would ensure the transferred amount is not taxable. This type of transfer does not require contribution room.

[5] https://www.taxtips.ca/personaltax/attribution-rules-re-gifts-transfers-loans-to-spouse-or-related-minor-child.htm

[6] Income Tax Act (R.S.C., 1985, c. 1 (5th Supp.))

Registered Pension Plans (RPPs)

Same transfer requirements, as with RRSPs, exist in the case of RPPs. However, Form T2151 (including authorization) is required to move the funds to a locked-in account in the transferee's name. When considering RPPs, whether defined contribution or defined benefit in nature, key considerations are:

- valuation,
- distribution, and
- timing of separation, i.e., before or after retirement.

Pension legislation varies by jurisdiction. It can influence how a pension is handled on separation or divorce. But generally, a former spouse may be entitled to an equal share of the pension plan that was earned during the period that the spouses were in a qualifying relationship. If the plan is a defined benefit plan by nature, access to the commuted value may be restricted based on the parameters of the plan, or the pension rules in the jurisdiction itself. If the plan member has already retired, the division of a defined benefit pension plan may also be restricted to splitting future pension payments. Each scenario is unique and will have to be examined as such.

Another element to consider is **preferential spousal rights**. Unlike RRSPs, for example, an RPP (or a LIRA/LRSP) typically provides for an automatic death benefit in favor of the surviving spouse, or potentially a common law partner. This might create a problem in a blended family setting, with a new spouse or common-law partner benefiting over a child (or children) of the previous union. This may not align with the wishes of the participant. The new spouse or common-law partner benefiting from this preference can waive his/her right to this priority, with the specific mechanics dependent on the applicable legislation. In certain cases, this priority can be avoided by unlocking the plan (based on relevant unlocking provisions) to optimize flexibility. A tax-deferred **annuity transfer** may also be an option in certain instances.

Matrimonial home

Typically, the matrimonial home is not considered exempt property under provincial law. It can be transferred on a tax-deferred basis upon marital breakdown. In fact, there are two options:

1. The entire interest in the property is transferred to one spouse on a tax-deferred basis as capital property under Paragraph 73 (1.01) (b) of the ITA, or
2. It can be transferred on a taxable basis. Provided the principal residence exemption requirements are satisfied, there would be no income tax owing in connection with the transfer.

If multiple residences potentially qualify for the exemption during the marriage, it may be worthwhile to designate a property as the principal residence. This gives the spouses the opportunity to agree on optimal use of the exemption, which should be corroborated in the separation agreement. Remember that during the union, both spouses or common-law partners must designate the same property for the purpose of the principal residence exemption. An agreement is particularly important to ensure a reset in the availability of a principal residence exemption (PRE) for each spouse subsequent to the separation or divorce.

Consider: If there are a couple of family properties that qualify for the PRE (e.g., a cottage and a home) and each spouse/common-law partner retains one of those properties in the course of a marital breakdown, it is imperative that the allocation of the PRE is addressed in a separation/divorce agreement. If the PRE is not addressed in an agreement, it will be available on a 'first-come, first-served' basis from the date of sale retroactive to, and including, the period of the conjugal relationship. This could lead to a significant taxable capital gain for the spouse/common-law partner who does not realize the initial property sale subsequent to the marital breakdown. In the case of a separation, also consider the attribution rules (as discussed above) and whether or not a Paragraph 74.5(3)(b) election may be required.

TFSAs

The criteria that must be met to transfer a TFSA to a former spouse or common-law partner are the same as for the TFSA (as outlined above), although Form T2220 is not required. When the criteria are met upon separation or divorce, the TFSA transfer will be considered a qualifying transfer and will not be considered a withdrawal. No TFSA contribution room will be required by the transferee. Also, the transferred amount will not be added back to the transferor's contribution room at the start of the following year. While a direct transfer is certainly preferred from the transferee's standpoint, depending on the situation, a withdrawal, followed by a transfer of cash, could also be an option to satisfy equalization or division of property requirements.

Similar to transfers of registered accounts from one financial institution to another, the financial institution will handle the transfer using their internal form. Information will be required from both parties and both parties will be required to sign the form.

RESPs

A former spouse/common-law partner can replace the original subscriber as a consequence of the settlement of rights arising out of the breakdown of a marriage or common-law partnership. This would occur on a tax-deferred basis. The assets are typically not considered family property, so former spouses can continue to be joint subscribers and continue to contribute accordingly. However, they cannot open a joint subscriber account once divorced.

A potential alternative may be to transfer a portion of a RESP to a former spouse or common-law partner. Assuming the receiving plan would have the same beneficiary(ies), this can occur on a tax-deferred basis. A transfer cannot be undertaken if an accumulated income payment has already been made. There are three separate government forms required to complete the transfer 'to be completed by the subscriber, the receiver promoter and the transferring promoter.'

Non-registered Investments

Non-registered investments are fairly straight forward. They can be otherwise transferred to a former spouse or common-law partner, on a tax-deferred basis. Assuming the divorce has been finalized, or a 74.5 (3)(b) election has been filed, there will be no attribution of income to the transferee.

Consider that the superficial loss rules may apply unless the divorce is finalized within 30 days of transfer.

There may be reasons to elect out of the tax-deferred spousal rollover such as:

- Unused capital losses
- Lifetime capital gains exemption on transferred shares of a qualifying business
- Access to lower marginal tax rates (transferor)
- An inherent loss position

Life Insurance

Life insurance is often purchased to ensure obligations, such as spousal support, continues to be met in the case of an untimely passing. However, in certain cases a separation or divorce may negotiate a transfer of a policy from one former spouse to another. Although life insurance is not considered capital property[7], it can transfer to an ex-spouse on a tax-deferred basis[8] when the transfer is in settlement of rights arising out of the marriage or common-law partnership. Both transferor and transferee must be residents of Canada at time of the transfer. The transferor's adjusted cost base (ACB) at time of transfer becomes the ACB of the transferee.

[7]For the purposes of Section 73 of the ITA.

[8]Under subsection 148 (8.1) of the ITA

Conclusion

Clearly there are no shortage of elements to navigate in a marriage/common-law relationship breakdown, tax-based or otherwise. It's important to understand how the transition can be completed in a tax-efficient manner, while being cognizant of potential tax pitfalls - which can further alter the client's financial plan.

Understanding applicable division of property rules is especially critical when a couple is married/common-law and there is no prenuptial agreement in place. Consider each unique situation and encourage clients to work with a qualified tax specialist and a lawyer to facilitate a written agreement that works for both parties. This should not be construed as tax or legal advice. Please consult a qualified professional as needed.

Important information

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