TAX IMPLICATIONS OF MARRIAGE BREAKDOWN*

The tax consequences of the breakdown of marriage can be divided into five principal areas:

1. Maintenance and alimony;
2. Capital gains;
3. Attribution rules;
4. The effect of liquidating assets to pay a matrimonial property settlement; and
5. The liability for taxes owing by a spouse.

I. MAINTENANCE AND ALIMONY

In certain circumstances, the Income Tax Act permits a taxpayer to deduct maintenance or alimony paid to a spouse or former spouse, which is taxable in the hands of the recipient. Paragraph 60(b) permits a taxpayer to deduct:

> An amount paid by the taxpayer in the year, pursuant to a decree, order or judgment of a competent tribunal or pursuant to a written agreement, as alimony or other allowance paid on a periodic basis for the maintenance of the recipient thereof, children of the marriage, or both the recipient and children of the marriage, if he was living apart from, and was separated pursuant to a divorce, judicial separation or written separation agreement from, his spouse or former spouse to whom he was required to make the payment at the time the payment was made and throughout the remainder of the year.

Similarly, paragraph 60(c) permits a taxpayer to deduct maintenance payments to the extent that they are made pursuant to an order of a competent tribunal. The entire provision reads as follows:

> There may be deducted in computing a taxpayer's income for a taxation year . . . (b) an amount paid by the taxpayer in the year, *pursuant to an order of a competent tribunal*, as an allowance payable on a periodic basis for the maintenance of the recipient thereof, children of the recipient, or both the recipient and children of the recipient if, at the time the payment was made and throughout the remainder of the year, he was living apart from the recipient, who was either his spouse or an individual described in paragraph 73(1)(d), to whom he was required to make the payment. [Emphasis added]

These two provisions contain certain requirements before alimony or maintenance payments are deductible by a taxpayer. First, the amount must actually be *paid*. Secondly, the amount must be paid by the taxpayer in the appropriate taxation year. Thirdly, alimony payments must be made pursuant to a decree, order or judgment of a competent tribunal, or pursuant to a written agreement (but note that maintenance awards require a court order to be deductible). Fourthly, the amount paid must be for alimony, maintenance or some other "allowance". The courts have generally insisted that the inclusion of the word "allowance" colours the nature of the payment, so that it will only be deductible if it is:[1]

> . . . a limited predetermined sum of money paid to enable the recipient to provide for certain kinds of expense; its amount is determined in advance and, once paid, it is at the complete disposition of the recipient who is not required to account for it. A payment in satisfaction of an obligation to indemnify or reimburse someone or to defray his or her actual expenses is not an allowance; it is not a sum allowed to the recipient to be applied in his or her discretion to certain kinds of expense.

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1. *The Queen* v. *Pascoe* 75 D.T.C. 5427 at 5428 (F.C.A.).

Or, as the court in *Veliotis* v. *The Queen*[2] said:

> ... [A]limony is a periodic allowance not only in the sense that the payer must make payments at regular intervals, but also in the sense that at regular intervals the payer must provide a sum adequate to maintain the payee until the next payment.

Fifthly, the payment must be made on a periodic basis. This necessarily excludes the deductibility of a lump sum payment. On the other hand, there is no requirement in the Act as to how many payments must be made, or what the period between each payment must be. Similarly, there is no requirement that the payments must continue throughout the recipient's lifetime (although the decision in *M.N.R.* v. *Trottier*[3] seems to indicate that the payments cannot continue beyond the recipient's lifetime). Sixthly, the payment must be made to the spouse or former spouse. It cannot be deducted if it is made to the children directly, even if it is for their maintenance. Finally, the taxpayer not only must be living apart from the spouse or former spouse, but must continue to do so throughout the remainder of the year. Subsequent cohabitation will nullify the deduction throughout the entire taxation year.

With respect to maintenance payments, they are deductible only if they are ordered by a competent tribunal; deductibility cannot be created by virtue of a written agreement. In principle, maintenance payments can be deducted for a "common law" spouse covered by such a court order, but only in quite restricted circumstances. In particular, a payment made to a "common law" spouse is deductible only if that "common law" spouse constitutes "an individual described in paragraph 73(1)(d)" of the Act, which in turn cross-references Regulation 6500(1). This Regulation only refers to the Ontario Family Law Reform Act.[4] Accordingly, in my view, only those common law spouses governed by this Ontario Act are cross-referenced by paragraph 60(c) of the Income Tax Act, and only maintenance payments made to such "common law" spouses are deductible for the purposes of calculating the payor's income for tax purposes. With respect, I do not think that one can read paragraph 60(c) to permit the deduction of a payment made to any "common law" spouse who has entered into a written separation agreement with the payor, but only those in *Ontario* who have done so. This is clearly unfair, but I think is the present law.

Section 60.1 of the Income Tax Act extends the deductibility of periodical alimony or maintenance made "to or for the benefit of" a person who is his spouse, former spouse, or a "common law" spouse (referred to above), or "for the benefit of" children in the custody of such a person. This permits payments to be deducted even though the payments have been made to a third party and not to the spouse or former spouse directly. Difficulties persist in determining precisely which payments to third parties are deductible, but the recent decision of the Federal Court in *The Queen* v. *Bryce*[5] appears to adopt a considerably broader view than that taken by Revenue Canada. (*Quaere:* Might payments made directly to children be deductible under this provision?)

Paragraph 56(1)(b) and (c) include the alimony and maintenance payments in the hands of the recipient spouse or former spouse (and sec-

2. 74 D.T.C. 6190 at 6192 (F.C.T.D.).
3. 67 D.T.C. 5029 (Ex. Ct.).
4. S.O. 1978, c. 2.
5. 80 D.T.C. 6304 (T.D.). Subsequently, however, reversed on appeal at [1982] C.T.C. 133. Leave has been granted for a further appeal to the Supreme Court of Canada.

tion 56.1 deems payments made to third parties to have been received in the hands of the spouse or former spouse for whose benefit they have been paid). Because of the symmetry between sections 60 and 56, the general rule is that an amount deductible by the payor will be taxable in the hands of the recipient. Conversely, if for some reason the amount is not deductible by the payor, it is not taxable in the hands of the recipient. Accordingly, considerable care should be taken to determine the income tax consequences of any agreement or court order relating to alimony or maintenance. In particular, because the payor will almost certainly pay tax at a higher marginal rate than the recipient, the overall tax burden may be minimized by structuring the payment to be deductible under the Income Tax Act, thereby increasing the amount of resources available to the parties involved.

The existence of continued litigation over the applicability of sections 56, 56.1, 60 and 60.1 indicates that some care is required in this area. A review of the recent litigation, therefore, might be helpful.

The most notable development in this field is the decision of the Federal Court in *The Queen* v. *Burgess*.[6] The issue there involved the deductibility of solicitor's fees incurred in the course of the taxpayer's action to gain maintenance for herself and children upon divorce. In an earlier decision,[7] the Tax Review Board had allowed the deduction as an expense incurred for the purpose of earning income from property; *viz.*, to enforce the right to maintenance. On appeal, however, Cattanach J. rejected the deduction. His Lordship held that the right to maintenance after divorce was not entailed in the marriage contract itself. On the contrary, the taxpayer here was seeking to create a new right to maintenance under the Divorce Act. Accordingly, the legal expenses were incurred for the purpose of bringing into existence a new legal right, were capital in nature, and accordingly were not deductible. This reasoning provides a serious limitation to the tax subsidies which usually speed up the exit from unhappy marriages. Wary practitioners, therefore, will in future have to take care to see that the periodical alimony payments are large enough to cover the recipient's legal fees (plus interest! plus tax!).

Nor is it any good trying to convert a non-deductible lump-sum payment into a deductible periodical payment simply by making it payable in instalments.[8] Unfortunately, the exact point at which instalments become periodical appears to be elusive.

Taxpayers are still having difficulty with the specific requirements for deductibility of periodic payments of alimony or maintenance. In *Renwick* v. *M.N.R.*,[9] the Tax Review Board did not permit the taxpayer to deduct additional amounts of maintenance paid to keep up with inflation: no written agreement or court order existed, so no deductibility resulted. The Board also held that the resumption of cohabitation terminates a written separation agreement, and thus it does not cover subsequent sums paid after the couple split up again.[10]

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6. [1981] C.T.C. 258 (T.D.).
7. *Burgess* v. *M.N.R.* [1979] C.T.C. 2374.
8. *See The Queen* v. *Dorion* [1981] C.T.C. 136 (F.C.T.D.), where $20,000.00 was payable in five equal instalments.
9. [1981] C.T.C. 2607.
10. *See Gauvin* v. *M.N.R.* [1981] C.T.C. 2035.

II. CAPITAL GAINS

In general, a capital gain arises whenever there is a disposition (real or deemed) of a capital asset, and the proceeds of disposition exceed the adjusted cost base of that asset for the taxpayer. Under the Income Tax Act, one-half of the capital gain is included in the income of a taxpayer, and is called a "taxable capital gain". In certain circumstances, the tax consequences of disposing of capital property may be avoided because the Income Tax Act provides for a "roll-over". In general, a "roll-over" operates as follows. The transferor's proceeds of disposition are deemed to equal his adjusted cost base, so that mathematically no capital gain arises. However, the transferee's adjusted cost base is deemed to equal that of the transferor, so that when the transferee in due course disposes of the property his (or her) capital gain will be determined by reference to the transferor's adjusted cost base which has been "rolled-over" to the transferee.

The Income Tax Act generally provides for a tax free roll-over of capital property transferred between spouses, whether during marriage or on death. The roll-over applies even if there is actual consideration passing from the transferee's spouse to the transferor.

Section 73 of the Act contains the rules applicable to an *inter vivos* transfer of property to a spouse, former spouse, spousal trust, or "common law" spouse. The relevant provisions are as follows:

> 73. (1) For the purposes of this Part, where at any time after 1977 any particular capital property of a taxpayer has been transferred to
> (a) his spouse,
> (b) a former spouse of the taxpayer in settlement of rights arising out of their marriage,
> (c) a trust created by the taxpayer under which
> (i) his spouse is entitled to receive all of the income of the trust that arises before the spouse's death, and
> (ii) no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust, or
> (d) an individual pursuant to a decree, order or judgment of a competent tribunal made in accordance with prescribed provisions of the law of a province if that individual either entered into a written agreement with the taxpayer in accordance with such provisions or is a person within a prescribed class of persons referred to in such provisions,
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> and both the taxpayer and the transferee were resident in Canada at that time, unless the taxpayer elects in his return of income under this Part for the taxation year in which the property was transferred not to have the provisions of this subsection apply, the particular property shall be deemed to have been disposed of at that time by the taxpayer for proceeds equal to,
> (e) where the particular property is depreciable property of a prescribed class, that proportion of the undepreciated capital cost to the taxpayer immediately before that time of all property of that class that the fair market value immediately before that time of the particular property is of the fair market value immediately before that time of all of that property of that class, and
> (f) in any other case, the adjusted cost base to the taxpayer of the particular property immediately before that time,
>
> and to have been acquired at that time by the transferee for an amount equal to those proceeds.
>
> (1.1) For greater certainty, where, by the operation of prescribed provisions of the law of a province or by virtue of a decree, order or judgment of a competent tribunal made in accordance with such provisions, a person referred to in subsection (1)
> (a) acquires or is deemed to have acquired,
> (b) is deemed or declared to have or is awarded, or
> (c) has vested in him,
>
> property that was or would, but for such provisions, have been a capital property of the taxpayer referred to in subsection (1), that property shall, for the purposes of subsection (1), be deemed to be capital property of the taxpayer that has been transferred to that person.
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> (1.2) For the purposes of subsection (1), "spouse" and "former spouse" includes a party to a void or voidable marriage, as the case may be.
>
> (2) Where a transferree is deemed by subsection (1) to have acquired any particular depreciable property of a prescribed class of a taxpayer for an amount determined under paragraph (1)(e) and the capital cost to the taxpayer of the particular property exceeds the amount determined under

that paragraph, for the purposes of sections 13 and 20 and any regulations made under paragraph 29(1)(a)

(a) the capital cost to the transferee of the particular property shall be deemed to be the amount that was the capital cost to the taxpayer thereof, and

(b) the excess shall be deemed to have been allowed to the transferee in respect of the particular property under regulations made under paragraph 20(1)(a) in computing income for taxation years before the acquisition thereof.

Note that between paragraphs 73(1)(a) and (b) together, any transfer of property to a spouse or former spouse, whether before or after the dissolution of the marriage, will generally result in a tax-free disposition of the capital property by the transferor. Note further that there is no time limit for the transfer of the property to a former spouse, provided that the transfer is "in settlement of rights arising out of their marriage". Thirdly, note that this roll-over only applies if both the transferor and the transferee are resident in Canada at the time of the transfer. Fourthly, note that it is now possible for the transferor to opt out of the automatic roll-over. With respect to transfers occurring after 1979, the *transferor* may elect to opt out of the automatic roll-over provisions of subsection 73(1).[11] If such an election is made, the transferor will probably be deemed to have disposed of the capital property at its fair market value (because the transferor and the transferee will probably not be acting 'at arm's length' within the meaning of that term contained in the Income Tax Act, if not within the normal meaning which a domestic lawyer would attach to that phrase!). Accordingly, the normal rules for calculating a capital gain or capital loss will operate with respect to the transferor, and the transferree will be deemed to have received the property for "an amount equal to those proceeds" (contrary to the normal rule contained in s. 69 with respect to non-arm's length transfers). A transferor may wish to make such an election in two circumstances: if a capital loss would in fact arise; or if he has sufficient other capital losses to be able to off-set the capital gain arising from the disposition of the asset transferred to the spouse. Contrary to some commentators' views, this elective procedure is available for any transfer governed by any of the paragraphs in subsection 73(1), and not just to transfers to former spouses or to "common law" spouses.

The Federal Budget of November 12, 1981, proposes to extend a similar tax free roll-over to any transfer of a taxpayer's Registered Retirement Savings Plan to his spouse on the break up of the marriage. Under the law as it previously stood, such a transfer would be a disposition by the taxpayer, which would trip the inclusion of the entire value of the R.R.S.P. into the owner's hands and make it subject to income tax. This would leave only the net amount capable of being transferred to the former spouse, and the tax could not be refunded to the transferee spouse's by her contributing her net proceeds to her own R.R.S.P. As a result of the Budget, however, the entire amount of the transferor's R.R.S.P. may be transferred tax free to the former spouse's R.R.S.P., where it can either be retained as an investment or withdrawn over time (presumably at a low rate of tax). Although this proposal is a further subsidization of the break down of marriage, it nevertheless may greatly assist in the financial settlement of marriage break downs.

11. S.C. 1980-81, c. 48, s. 39.

III. ATTRIBUTION RULES

The "attribution rules" have been in the Income Tax Act since its first enactment in 1917. They provide that income from property transferred by one spouse to the other will always be "attributed" back to the hands of the transferor spouse for tax purposes.[12] Since 1971, the attribution rules have been extended to cover taxable capital gains arising from real or deemed dispositions by the transferee of capital property.[13] One of the problems with the attribution rules is that the income belongs to the transferee but the tax falls on the transferor.

When the property is transferred upon the actual termination of the marriage, the attribution rules do not apply, simply because the transferee ceases to be the *spouse* of the transferor. On the other hand, if the parties are merely separated, or the property is transferred sometime prior to the actual dissolution of the marriage, the attribution rules will in principle still apply. An exception to the attribution rules was enacted by S.C. 1980-81, c. 48, s. 40(2), with effect to transfers of capital property between *separated* spouses made after December 11, 1979. Accordingly, paragraph 74(7)(a) provides that the attribution rules do not apply to any income or loss arising during the period during which the transferee is living apart and is separated from the transferor pursuant to a decree, order or judgment of a competent tribunal or a written separation agreement. Such income belongs to, and is taxed in the hands of, the transferee.

Similarly, paragraph 74(7)(b) provides a slightly different rule with respect to taxable capital gains arising from property which has been disposed of by the transferee spouse. This provision requires the transferor and transferee to be living apart and separated pursuant to a decree, order or judgment of a competent tribunal or a written separation agreement. In addition, it also requires the transferor and the transferee to complete an election jointly opting out of the attribution rules, which the transferor must file with his tax return for the taxation year during which they commenced to live apart. This timing is important. The election cannot be filed in the year in which the transferee disposes of the capital property, and in which the tax consequences of the taxable capital gains arising from the disposition would normally be attributed back to the transferor. Rather, the election must be filed at the beginning of the separation.

Paragraph 74(7)(b) applies to the 1980 and subsequent taxation years. However, there is a transitional provision for separations which occurred prior to 1980. In that case, the election must be filed with either the taxpayer's 1980 or 1981 taxation year, even though the separation (or the disposition?) began earlier. Note, also, that a subsequent resumption of cohabitation would appear to terminate the applicability of paragraphs 74(7)(a) or (b), thereby revivifying the applicability of the attribution rules.

Finally, note that subsection 74(8) imposes a further requirement where the separation arises pursuant to a written separation agreement as opposed to a court order. In this case, the attribution rules will not apply only if the spouses in fact continue to live apart for twelve months

12. Income Tax Act, R.S.C. 1970, c. I-5, s. 74(1), as am. S.C. 1974-75-76, c. 26, s. 39, S.C. 1976-77, c. 4, s. 29.

13. *Id.* s. 74(2). Similar rules apply to transfers to children.

from the date on which the agreement was entered into. Accordingly, if the parties enter into a separation agreement, but do not live apart for twelve months, any income or taxable capital gain arising during the period of separation will nevertheless still be attributed back to the transferor spouse.

Consideration might be given to including a formal clause in the separation agreement or court order requiring such an election to be made, and specifying the consequences of failure to make such an election.

IV. LIQUIDATING ASSETS TO PAY A MATRIMONIAL PROPERTY AWARD

Tax consequences may also arise when a taxpayer has to liquidate assets in order to pay a matrimonial property award to a spouse or former spouse. For example, if the asset is a capital property, taxable capital gains may arise. Similarly, if it is depreciable property, a recapture of capital cost allowance may result from the liquidation of the asset. Unless the properties are transferred to the spouse or former spouse on a tax free basis, no roll-over will result, and tax will become payable to the government at the moment of the disposition, leaving less wealth in the hands of the two parties to the marriage. Consideration should, therefore, be directed to the tax consequences, and the possibility of transferring the asset to the spouse (rather than liquidating it) should be canvassed.

Another problem frequently encountered involves unmingling co-ownership of assets. For example, the husband may own 90 per cent of the shares of the family corporation and the wife 10 per cent. After the marriage break down, it may be clear that the husband should continue to operate the business, and as part of the matrimonial property settlement, the wife should divest herself of her shares in the company in exchange for a payment under the Matrimonial Property Act.[14] If the wife transfers the shares to the husband, the tax free roll-overs will operate to prevent immediate taxation of the latent capital on those shares. Of course, in the absence of an election to the contrary, the husband will acquire those shares at their adjusted cost base to the wife, and he will probably have a larger capital gain when he, in due course, disposes of them (or is deemed to dispose of them on his death). Secondly, such a transaction would almost certainly require the *husband* to come up with the cash to make the matrimonial property award to the wife. He may have ready cash with which to do so. On the other hand, finding that cash might require his taking funds out of the corporation, which almost certainly would be a taxable event for him. It might, therefore, be desirable to have the *company* deal with the former spouse directly, by redeeming her shares. Of course, this might be a taxable event in her hands, to the extent that the redemption amount exceeds the paid up capital of her shares. That difference will be deemed to be a dividend. The tax resulting from the receipt of such a deemed dividend might be acceptable to the former spouse, if her tax rate is sufficiently low that it is completely or partially offset by the dividend tax credit. Indeed, it might be possible to achieve this result by spreading the redemption of the minority shareholders' shares over a number of tax years; but this obviously requires consideration to be given to the interest foregone on the amounts not redeemed until future years, as well as to finding some enforceable mechanism to cause the company in fact to redeem those shares in the future.

14. R.S.A. 1980, c. M-9.

Another method of dealing with the problem is for the wife to incorporate her own company, to use the section 85 roll-over to transfer her shares in the husband's operating company to her holding company on a tax free basis (and this can still be done after the Federal Budget of November 12, 1981), and then having the husband's holding company redeem those shares. While a deemed dividend will still arise to the extent that the redemption amount exceeds the paid up capital of those shares, under s. 112 of the Act, such an inter-corporate dividend is not taxable in the hands of the recipient corporation. As a result, the wife's holding corporation would then have the full value of her pre-tax investment in the husband's operating company. However, the wife probably cannot take that equity out of her holding company without incurring some tax, although the dividend tax credit may significantly mitigate the amount of that tax, particularly if the distribution occurs over a number of years.

Finally, the incidence and timing of taxation will be relevant for determining the value of each of the spouses' assets for the purposes of making a matrimonial property statement. If a "break up" method is used, all of the tax consequences resulting from an instantaneous disposition should probably be taken into account, thereby reducing the amount of the available assets for division between the spouses. On the other hand, if a lengthier approach to valuation is taken, the tax consequences might be discounted.

V. LIABILITY FOR TAXES OWING BY A SPOUSE

Under s. 160 of the Income Tax Act, a transferee of property may become liable to pay tax owed by the transferor. This section only operates with respect to transferees who are married (now or subsequently) to the transferor, or are under 18 children of the transferor.

Two distinct sources of liability arise for the transferee. First, the transferee becomes jointly and severally liable with the transferor to pay any of the transferor's tax which results from the application of the attribution rules. Second the transferee is jointly and severally liable with the transferor to pay "any amount that the transferor was liable to pay under this Act on the day of the transfer", but limited to the value of the property received by the transferee from the transferor.

One difficulty which arises under this latter provision is the determination of the amount of the transferor's liability to pay tax on the day of the transfer. In the normal course of events, liability for tax crystallizes at the end of each taxation year, and it is difficult therefore to ascertain what is the transferor's liability to tax on any particular day in the course of the year. Similarly, a problem arises if there is a subsequent reassessment of the transferor's tax for the year of the transfer. Assume that at the date of the transfer, the transferor had paid all of the tax, and Revenue Canada had accepted and assessed his return on that basis. Does the transferee subsequently become liable for any tax which has been reassessed to the transferor? Finally, the question arises whether the transferee's derivative liability to pay the transferor's tax terminates with the dissolution of their marriage. If the transfer was made at a time when the parties were married, the liability of the transferee would appear to be unlimited in point of time, even if the marriage subsequently terminates. Accordingly, it would probably be wise to make certain that transfers of property as a result of a matrimonial property settlement are made at the very dissolution of the marriage, so that the parties are no longer spouses, and so that the draconian provisions of s. 160 cannot apply. Alternatively, the transferee might take an enforceable indemnity from the transferor to make certain that the transferor pays any assessed tax.

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