Separation and divorce

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At AIC, our investment approach incorporates tax planning to minimize your investment tax bill each year. This approach to maximize your after-tax returns is evidenced by our commitment to tax-smart education, a strong corporate philosophy grounded in tax minimization, and our tax-smart investment products.

A tax-smart portfolio is one that focuses upon maximizing after-tax investment returns. After all, it's not how much you earn, but how much you keep that matters most.

AIC believes in maximizing after-tax wealth (i.e. your bottom-line cash flow). We're proud of being Canada's tax-smart investment manager, and a committed educator of Canadians in matters of investing, tax planning and an integrated tax-smart investment approach.

This brief is one in a series on tax-smart investing. We believe you'll find this brief, along with our tax-smart investment products, helpful in maximizing the value of your taxable investment portfolio.

Unfortunately, a marriage or common-law relationship breakdown (which we'll refer to in this bulletin as "separation or divorce") is something that you may have to deal with at some time. And, with such a life changing event, there are many things to think about – tax implications being one of them. This bulletin examines some of the issues you may be concerned with, or have questions about, when you become separated or divorced.

Definitions

As easy as it may seem, the definition of "separation" or "divorce" can be quite complicated at times because the definition of a "spouse" and "common-law partner" are each complex and have undergone changes in the last two decades and more significant refinement in recent years. Generally speaking, for income tax purposes the term "spouse" means an individual who's gone through a form of marriage (whether valid or possibly invalid) with another individual. Such individuals may be of the same or opposite sex.

Since 2000 (due to changes in the law dealing with same-sex partners), the *Income Tax Act* has included the term "common-law partner" wherever the term spouse is used. An individual becomes the common-law partner of another individual when the individuals have cohabitated in a conjugal relationship for at least 12 months (unless separated for at least 90 days at the particular time). Since 2005, the term common-law partner contains no reference (nor does the term "spouse") to the sex of the individuals (due to changes in the law dealing with same-sex marriages). Therefore, both the terms "spouse" and "common-law partner" encompass persons of the same or opposite sex.

Accordingly, for tax purposes, separation or divorce is equally applicable to spouses and common-law partners, and therefore we'll use and refer to "separation or divorce" throughout this bulletin as applying to both.

While divorce is the legal ending of a marriage, separation occurs when spouses or common-law partners are living separate and apart by reason of a marriage or relationship breakdown and have not resumed cohabitation. Again, for common-law partners, a 90-day period of living separate and apart is necessary for them to not be treated as common-law partners for tax purposes. It should also be noted that it's a question of fact whether spouses or common-law partners are living separate and apart, and that having a separation agreement (or court order to that effect) is not necessary for spouses or common-law partners to establish their separation. For certain other tax purposes (and as discussed further

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in this bulletin) it's important that separated spouses or common-law partners not resume cohabitation within the year.

Division of assets

Upon separation or divorce, it's common for former spouses or common-law partners to divide marriage or relationship assets between themselves. For tax purposes, division of assets such as shares (of private or public companies), mutual funds or real estate (including a matrimonial home or recreational property) upon separation or divorce generally takes place at adjusted cost base (ACB), meaning no tax should be triggered at the time ownership of the assets is transferred between the parties. In this case, the recipient of the assets would be taxable at the time he/she ultimately sells or disposes of the assets, and based upon the difference between the selling price (or its value) and the ACB of the assets.

However, if both parties wish, it's possible for them to elect to transfer assets at their fair market value, which would give rise to immediate tax (to the transferring party) if the assets have appreciated in value over the ACB. Any further increase in value (from the date of transfer) would then be taxable to the recipient of the asset (and upon his/her ultimate sale or disposition of the asset).

If some or all of the amount in a Registered Retirement Savings Plan (RRSP) or Registered Retirement Income Fund (RRIF) is being transferred between spouses or common-law partners as a result of separation or divorce, this transfer can take place on a tax-deferred basis so long as the money being transferred remains in a RRSP or RRIF of the receiving spouse or common-law partner. When this spouse or common-law partner later withdraws money from his/her RRSP or RRIF, the full amount withdrawn is taxable in that person's hands. In order to benefit from the tax-deferred transfer of amounts in an RRSP or RRIF, the transfer must be done pursuant to a court order or written separation agreement and using Canada Revenue Agency (CRA) form T2220.

A "spousal RRSP" is a plan to which one spouse or common-law partner contributes funds and on which the other spouse or common-law partner is named annuitant. The benefit of a spousal RRSP is that the contributing spouse or common-law partner receives a tax deduction for the contribution (assuming he/she has RRSP contribution room) while the annuitant spouse or common-law partner pays tax on any withdrawals from this RRSP (i.e. a spousal RRSP achieves income splitting between spouses or common-law partners). However, there's an exception to this rule – such that the withdrawn funds are taxed back to the contributing spouse or common-law partner. This attribution rule taxes the contributing spouse or common-law partner if moneys are withdrawn from the spousal RRSP:

1) In the year that contributions are made to the spousal RRSP; or

2) In either of the two following calendar years.

Upon separation or divorce, this attribution rule doesn't apply. Therefore, any withdrawals will be taxed in the hands of the annuitant (spouse or common-law partner) – even if the withdrawals are made by the annuitant within the prohibited three-year period. Again, there's no requirement to have a formal court order or separation agreement for this attribution rule not to apply.

Claiming credits and deductions

One of the issues you'll have to think about upon separation or divorce is claiming certain deductions and credits on your personal income tax return. The credits and deductions discussed below depend upon your marital status and/or total family income. You may find that you can no longer claim certain credits, but become eligible for others.

Childcare expenses

The cost of caring for children is allowed, as a deduction for tax purposes, from the income of a working parent (within prescribed limits). Generally speaking, the spouse or common-law partner with lower income must make the claim for childcare expenses on his or her income tax return. The lower income earning spouse or common-law partner is defined for tax purposes as the "supporting person." Eligible childcare expenses include: babysitting costs, daycare costs, or costs of boarding school or camp, provided these costs were incurred to enable that spouse or common-law partner, who resided with the child at the time the expenses were incurred, to go to school or work.

If a child lives at home with both parents, the parent who has the lower income must claim the childcare deduction. The exception to this general rule is if the higher-income earning spouse or common-law partner attends a post-secondary educational facility.

The issue of who claims a childcare deduction isn't as clear when spouses or common-law partners have separated or are divorced. Where separation occurs

during the year, the spouse or common-law partner with the higher income will be allowed to deduct childcare expenses during the period of separation provided that the:

- Spouse or common-law partner with the lower income was living separate and apart from the higher income spouse or common-law partner at the end of the year;
- Separation lasted for a period of at least 90 days beginning in that year because of a marriage or common-law relationship breakdown; and
- Taxpayer with the higher income paid those childcare expenses.

The lower-income spouse or common-law partner may deduct amounts paid by him or her from the time of separation to the end of the year. The same rules apply for the period before separation. That is, the lower income-earning spouse or common-law partner must claim all childcare expenses (regardless of who actually paid the expenses).

If separation occurs only for a portion of the year, and spouses or common-law partners reconcile by the end of the year, the same rules apply as if the spouses or common-law partners were together the entire year. In other words, the lower income-earning spouse or common-law partner must claim the childcare expenses and the higher income-earning spouse or common-law partner cannot claim any of these expenses.

In cases where reconciliation doesn't occur and spouses or common-law partners were separated during the entire year, the lower income-earning spouse is no longer considered the "supporting person." This means the spouse or common-law partner who paid the childcare expenses may claim the deduction provided the expenses were paid while he/she was living with the child. Therefore, the amount that can now be claimed is based upon both:

- Amount paid; and
- Percentage of time the child resides with that spouse or common-law partner.

For example, if spouses or common-law partners agree to each pay 50% of the cost and share joint custody of the child, then each spouse or common-law partner can claim the costs incurred. However, if one spouse or common-law partner agrees to pay 100% of the childcare costs, but only spends half of the time with the child, that spouse or common-law partner can claim only 50% of these costs (see CRA technical interpretation letter # 2002-0155775).

Eligible dependant amount

A spouse or common-law partner may be able to claim the eligible dependant amount, provided the following criteria are met:

- You were single, divorced, separated or widowed at any time in the tax year and supporting a dependant who lived with you in a home that you maintained. If your dependant lived away from home while attending school and the dependant ordinarily lived with you when not in school, the dependant is considered to live with you for the purposes of this credit; and
- The dependant whom you supported was:
  - Your parent or grandparent by blood, marriage or adoption; or
  - Your child, grandchild, brother or sister by blood, marriage or adoption (legal or in fact) who was either under 18 years of age or mentally or physically infirm.

This credit can be claimed if the above criteria are met, no claim is being made for a spouse or common-law partner, and no child support is being paid for the dependant. The eligible dependant amount (for federal tax purposes it's $7,505 for 2006) is reduced if the income of the dependant for whom the claim is being made exceeds $751.

Since the tax rules don't require a spouse or common-law partner to be separated, divorced or widowed throughout the entire year (just at some point in the year), a spouse or common-law partner would be entitled to claim the eligible dependant amount in the year of divorce or separation assuming all of the above criteria are met.

Normally, in a joint custody arrangement, only one spouse or common-law partner can claim the eligible dependant amount. However, a CRA technical interpretation letter dated January 7, 2002 (# 2001-0101105) supports the view that where there's joint custody over more than one child, it's possible that each spouse or common-law partner may be able to claim a full eligible dependant amount on the basis that the children would be wholly dependent upon both spouses or common-law partners at different times throughout the year. Any separation agreement would have to be structured so that one spouse or common-law partner claims the eligible dependant amount for one child, while the other spouse or common-law partner claims the eligible dependant amount for the other child.

Since you cannot claim the eligible dependant amount for a child for whom you pay support, any separation/support agreement should state that one spouse or common-law partner supports one child, while the other spouse or common-law partner supports the other child. Be sure to discuss this option with a lawyer, since there are other non-tax considerations of structuring a support agreement in this manner.

Child tax benefit

The child tax benefit is a monthly payment made to the custodial parent of children (described as "qualified dependants") who are under the age of 18. The custodial parent must live with the child, be the person who is primarily responsible for the care and upbringing of the child and be a resident of Canada.

Since eligibility for the child tax benefit is based upon family income, separation impacts both eligibility as well as who can receive the amount. Separation for income tax purposes is deemed to occur when spouses or common-law partners commence living separate and apart by reason of marriage or relationship breakdown continuing for at least 90 days.

In the event of separation or divorce, a spouse or common-law partner should notify CRA within 11 months of the separation or divorce since the income used to determine eligibility for the benefit would then be that of the custodial parent only. Any change in the marital or relationship status (e.g. marriage, separation or divorce) of a spouse or common-law partner receiving child tax benefits, should be reported to CRA using form RC65.

Medical expenses

Under subsection 118.2(2) of the *Income Tax Act*, eligible medical expenses of an individual for the purposes of the medical expenses credit are those paid for that individual, the individual's spouse or common-law partner and a dependant of the individual.

A child is considered your dependant if he or she is dependant upon you for support at any time in the year. This would occur if you regularly and constantly provide for the child's essential or critical needs. Your actions and involvement in providing a child's critical needs such as food, clothing and housing are factors that would be used in determining whether, in fact, a child is dependant on you.

A child may be a qualifying dependant even if you aren't the only person attending to the child's needs. This may occur if the child isn't living in the same dwelling as you, or even if you don't have legal custody of the child. The fact that a person is paying certain medical expenses for the child is not sufficient in itself to say that the child is a dependant of that person. To establish a dependency relationship, more concrete factors would have to exist, such as whether the individual is constantly involved in a child's life, attends to the child's security and education and, while not having sole custody, pays support for the child's benefit.

Tuition and education credit

The tuition and education tax credit must first be used by a student to the extent necessary to reduce his or her taxable income to nil. Any unused portion (to a maximum of $5,000) can be transferred to a parent, grandparent, spouse or common-law partner ("eligible person"). It's not necessary that the parent actually support the child or even pays the tuition amount for the child. The unused credit can't be split between two parents in the case of separation or divorce. As well the student may carry forward any amounts that aren't transferred to another eligible person.

Child support and spousal/common-law partner support

To determine whether or not amounts paid to a former spouse or common-law partner are tax deductible to the payor (and taxable to the recipient), you must first determine the purpose of the payments. Generally speaking, if payments are being made for "spousal support," these payments are deductible to the payor and taxable to the recipient.

However, "child support" payments made pursuant to court orders or written agreements made after April 30, 1997 (or changed after April 30, 1997) aren't deductible by the payor or included in the income of the recipient. Since spousal support payments remain tax deductible for the payor, and must be included in the income of the recipient (regardless of the date of the agreement) if an individual must make both child support and spousal payments, you'll need to determine which portion of the payment is for child support and which portion is for spousal support.

CRA requires payments to be allocated, first, to child support and, second, to spousal support. This ensures that all child support payments are paid before the payor can claim a deduction for spousal support, and before the recipient has to include spousal support

in income. If child support is in arrears, CRA will consider all future payments to be child support until the payments are caught up.

Legal fees

In the past, legal fees incurred to establish the right to support payments for a spouse or common-law partner was not considered to be tax deductible because they were either personal expenses or incurred on account of capital. However, on October 10, 2002, CRA reversed this position and now permits legal costs incurred to obtain spousal support to be deducted for tax purposes. In addition, legal costs of seeking to obtain an increase in support, or to make child support non-taxable, are also tax deductible. These new rules are effective from October 10, 2002 and do not apply retroactively unless a Notice of Objection was filed and is still outstanding, or can still be filed.

Principal residence exemption

Since 1982, each family unit (which today includes you, your spouse or common-law partner and any unmarried children under the age of 18) has been able to designate only one property as its principal residence for each year. Therefore, while you're married or in a common-law relationship, you're only able to designate one home as your principal residence – but you do not have to make this designation until you sell a property. Of course, this poses a problem for those who own multiple properties. When any of the properties are sold, there could be some tax to pay if more than one property has increased in value since its date of purchase. If there's a separation, relationship breakdown or divorce, it may make sense to consider allowing each spouse or common-law partner to take ownership of one property. The reason is, from the time of separation, relationship breakdown or divorce onward, each spouse or common-law partner may consider the home he/she owns as his/her principal residence for tax purposes (assuming all other criteria are met). As a result, there will be less tax to pay when the homes are eventually sold.

Conclusion

As you can see, there are many things to consider when a marriage or common-law relationship ends in separation, breakdown or divorce. Since many of the rules in the *Income Tax Act* relate to a spouse or common-law partner and children, it's important that you review the above amounts, credits and deductions prior to finalizing your legal arrangements and before preparing your personal tax returns.

In addition, separation and divorce may result in the liquidation or transfer of certain assets, including investments and can bring about an opportunity to re-evaluate your current investment strategies. Be sure to speak to your financial advisor about these opportunities and how AIC can help you preserve your capital, grow your money and minimize taxes.

Canadian provinces and territories impose their own tax rates in addition to the federal tax rates. Therefore, depending upon where an investor lives, that individual's tax rate may differ from any examples shown. The content of this bulletin is for informational purposes only and in no way should be construed as tax or investment advice. Please consult a professional advisor for advice related to your specific situation.

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