

Andrea Agnoloni



Tax Implications when Living Separate and Apart

Divorce marks the legal end of a marriage.

The event can be stressful and while it may be the best choice under the circumstances, it can have negative impact on the financial, social, and psychological well-being of the parties involved.

In Canada over the last 20 years, between 35 and 42 percent of marriages have ended in divorce.

For income tax purposes, currently both a legal married couple and common law partners are considered married. A common law partner relationship exists where the couple is living in a conjugal relationship, either for at least 12 months or if they are the parents of a child by birth or adoption.

As soon as the individuals start living separate and apart for a period of at least 90 days due to the breakdown in the relationship, CRA considers them separated. The key words are “breakdown in the relationship.” Spouses living apart for work or other reasons are still considered married.

It is still possible to be considered separated by CRA if the individuals decide to live in the same residence for the sake of their children, for example—but a few conditions must be met.

- The spouses live in separate bedrooms.

- There are no sexual relations.
- There is little or no communication.
- The spouses do not spend time together socially.
- There are no domestic services to each other.

Proof may be required if CRA challenges the fact that the individuals are living at the same address.

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Support Payments

Child or spousal support payments can be the cause of much stress between the parties and the payments are often reviewed by CRA.

- Child support is usually not taxable to the recipient and not deductible for the payer.
- Spousal support payments are deductible for the payer and taxable to the recipient. They must meet the following criteria.
 - The amounts are receivable under a Court Order or a written agreement.
 - The amounts are paid on a periodic basis, therefore a lump sum payment does not qualify.

- The recipient has discretion about the use of the funds.
- The recipient and payer are living separate and apart because of the breakdown in their relationship.
- The recipient is the spouse or common law partner or former spouse or common law partner of the payer.

Sometimes, the payments are required to be made to third parties. To be deductible, those payments must be stipulated in the written agreement.

If the written agreement does not specify the division of payments—that is, how much of the payment is for child support and how much is for spousal support—then the whole amount is treated as child support and is not deductible for the payer.

Legal Fees

- For legal fees to be deductible, the general rule is the fees must be incurred by the recipient of the support payments; that will establish receipts for the child support and the spousal support.
- Legal fees incurred by the payer are not deductible.
- The legal fees incurred by both spouses relating to the divorce itself and to child custody and property division are not deductible.

It is normal for CRA to request corroborating documentation to support the claim for support payments and legal fees, such as

- a copy of the separation agreement,
- copies of the cancelled cheques to prove the amounts were actually paid, and
- copies of the legal bills with a reasonable allocation of the legal services between child support and spousal support.

Tax Credits

Tax credits for children and dependents are often the subject of further conflicts between the spouses when they have to agree who claims the credits.

Eligible Dependent Credit, up to \$2104 per year, can be claimed by individuals if they are supporting a person who is related to them. The supporter must be single, widowed, separated, or divorced.

- In case of separation or divorce, the child must have lived with the individual at some time during the year.
- No claim can be made for a child to whom support must be made.
- In the event of shared custody and if no payments are made for the child, the parents must agree who will make the claim.

For the **Child Tax Credit**, valued at \$335 per child, only a parent who resides with the child can claim the credit. In a shared custody situation, either parent can claim the credit. If a parent has claimed the eligible dependent credit, that parent must claim the child tax credit

Canada Child Tax Benefit is a tax-free monthly payment provided to families, depending on the net income of the family unit. In marriage breakdowns, CRA will calculate the family income based on the income of the custodial parent. In case of shared custody, the benefit can be shared equally between the spouses.

Universal Child Care Benefit is paid at \$100 per month for children under

6 years of age. Generally, the benefit is paid to the parent with custody. In case of shared custody, the benefit can be shared equally between the spouses. The benefit is taxable in the hands of the recipient. A single parent can designate the income to be taxable in the child's hands, however.

Child Care Expenses Deduction is incurred by the parents to care for their children while the parents earn income from a business or employment.

- In a sole custody situation, the expense is deductible by the parent who lives with the child and if the child's expenses have been paid by that parent.
- In a shared custody situation, the expenses for the same child can be claimed by both parents.

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Division of Matrimonial Property

When property is transferred from related parties, a deemed sale is triggered at fair market value even though the property was transferred for less than market value. Transfers between spouses are an exception to the rule because the property is transferred at cost. The same principle applies in the case of divorce or separation and capital properties can be rolled between spouses at cost unless they elect to make the transfer at market value.

When dividing the property, it is important to determine the after-tax value of the assets to ensure the value reflects the intended proportional property split.

Some categories of assets have significant tax consequences when they are part of a matrimonial split.

RRSPs, RRIFs, Pensions

These accounts can be transferred directly between similar plans without triggering any tax consequences. These assets are fully taxable when they are withdrawn. The after-tax value of these assets will vary considerably depending on the withdrawal timeline and other income of the recipient. For example, the after-tax value of the assets will be much lower if the RRSP was cashed all at once and subject to the highest marginal tax rate, compared to the after-tax value of the assets if they were cashed over time and the recipient had little or no income.

Principal Residence and Vacation Properties

When these properties are sold at a later date, the capital gain may be reduced by the principal residence exemption if the property was ordinarily inhabited during the period of ownership.

- Since 1981, only one property can be designated as the principal residence for each family and a separated couple that has not yet received an official divorce is eligible for only one principal residence in each year of separation.
- In the situation where multiple properties are split between the spouses, to establish the after-tax value of the assets, it is advisable to provide in the separation agreement which property will be designated as the principal residence when the property is sold.

Please consult a financial professional to discuss your specific situation. ▲

Andrea Agnoloni, CPA, CGA, and BC Notary Public, is a Principal with EPR North Vancouver, an Independent Member Firm of EPR Canada Group Inc.

Telephone: 604 987-8101
andrea@eprnv.ca
www.eprnv.ca
www.facebook.com/eprnv