

## DIVORCE OF A TAX PAYER | Tax Implications

### What happens in a typical divorce scenario?

- The people getting divorced go to their accountant and their goal is to split up the assets they own (for instance, one spouse takes the investments, the other spouse can take the house)
- The husband and wife, before divorcing come to the accountant with a goal; i.e. 40%/60% split or 50%/50% split
- After determining the asset split, the spouse whose net asset value increased the most makes an payment called “equalization payment” so that they both end up with assets of equal value at the end of the marriage.
- In Ontario, equalization payments are done to ensure that the net value of both spouses are equal after the marriage.
  - *The law provides that the value of any kind of property that was acquired by a spouse during the marriage and still exists at separation must be divided equally between the spouses*

### What are the tax implications on the transfers of assets?

#### Scenario 1: Assets are transferred before they officially divorce:

While married (including while separated), the **capital assets** can be transferred from one spouse to the other without incurring tax. This is done under section **73(1.01)(a) - spousal tax free rollover**

- Assets transferred at cost (depreciable capital assets @ UCC; non-depreciable capital assets @ ACB)

#### Attribution Rules:

##### 1. If the husband and wife have yet to divorce or separate:

- If they do not divorce, then the interest, dividends and capital gain the transferee spouse (i.e. wife) earns is attributed to the transferor (i.e. husband); unless the couple elected to transfer at FV and if a loan is made, interest paid by January 30th of following year.

##### 2. If the husband and wife have separated but yet to be officially divorced

- Once the couple **separate**, the attribution **stops for dividends and interest** but the **capital gains still get attributed back (unless you jointly elect out S74.5(3)(b) - they must each sign a joint election where they agree not to have the capital gains attribution rules apply to any subsequent sale of the transfer of property)**

##### 3. If the husband and wife are officially divorced

- Once the couple **divorce**, the attribution rules stop for dividends, interest and capital gains

## Scenario 2: Assets are transferred after the husband and wife have been divorced

- the **capital assets** can be transferred from one spouse to the other without incurring tax, only if it is a in **settlement of rights** (i.e. pursuant to a written agreement between the former spouses);
- this is done under **73(1.01)(b) - spousal tax free rollover**
  - *a former spouse or common-law partner of the individual in settlement of rights arising out of their marriage or common-law partnership*

### Other Matters to Consider in Divorce Situations:

#### 1. Principal Residence:

Some spouses may own a home, and they need to consider how they will transfer this home for asset splitting purposes.

2 options when dealing with Principal Residence:

##### Option #1:

- **Opt out of the Section 73 Tax Free Rollover** and transfer to the spouse @ Fair Value
  - The spouse who transferred the house loses his/her principal residence exemption for the years elected.

##### Option #2:

- **Use section 73 spousal rollover**
  - Benefits: spouse who received the house, and the spouse who sold the house will have all the years for use in the principal resident calculation by virtue of S.40(4)(a) which says “*where a taxpayer disposed property under 73(1) to an individual, that individual is deemed to have owned the property throughout the period during which the taxpayer owned it*”
  - Problems: if wife doesn't wait and sells house while separated (notice I didn't say divorced), then CG will be attributed back to husband (see above for the attribution rules).

##### Example #1:

Suppose Jim and Michelle are husband and wife seeking a divorce. Jim has the family home and a cottage under his name.

As Part of the divorce settlement, Jim gives the family home to Michelle and uses section 73.

When they both ultimately sell their properties...

Michelle can get away by paying no taxes because the home can be elected as her Principal Residence from the time of divorce (i.e. since she gained ownership); since Michelle did not own the house prior to divorce, she will not need to even consider any years prior to divorce for principal residence exemption purposes.

Jim will also not pay any taxes because, "a couple" can designate one principal residence between them; Jim can choose to use the cottage as his principal residence for all years.

Had Jim opted out of the section 73 tax free rollover and transferred the house at fair value, he would have already used up some years of the principal residence exemption on the house, and therefore, he will not be able to designate those years when he sells his cottage. So in this situation section 73 makes more sense.

**Example #2:**

Suppose Jim and Michelle are husband and wife seeking a divorce. Jim and Michelle jointly own a family home and a cottage.

Their agreed divorce settlement is such that Jim will take the cottage and Michelle will take the house. In essence Jim disposes 50% of his share in the house to Michelle and Michelle disposes 50% of her share in the Cottage to Jim.

At the time of divorce, they agreed that for the years prior to the divorce, the house is their principal residence.

There will be an automatic tax free rollover under section 73

When Michelle ultimately sells the home, she can designate all years for the purposes of principal residence exemption and pay no taxes on the capital gain.

When Jim ultimately sells his Cottage, there is a problem. Only one property can be designated by a couple for principal residence exemption. Since Jim and Michelle were considered couples before their divorce only one of the house or cottage can be chosen for principal residence; and since both agreed that the house is the principal residence, Jim is stuck.

Jim will not be able to use any years prior to divorce for part of principal residence exemption on the cottage.

You work around this situation by making sure that the future taxes that Jim will pay/ and the taxes that Michelle will avoid is factored into the valuation of these assets for the purposes of equalization payments.

**2. Spousal support (lump sum payments vs. series of payments):**

- Any lump sum payments are not deductible by the paying spouse
- If it's a ***series of payments pertaining to a court order***, it is deductible by the payer and taxable in the hands of the recipient
- Both taxable and deductible
- Spousal support payment is considered "earned income" for RRSP, therefore it will generate additional RRSP contribution Room

**3. Child support**

- Not taxable or deductible

**4. RRSP**

- RRSP withdrawn or transferred for the purposes of equalization is be exempt from tax (if it is pursuant to written separation agreement or under a decree relating to a division of property in settlement of rights arising out of a breakdown of marriage)
- RRSP attribution rules do not apply when the taxpayer is living separate and apart from the taxpayer's spouse due to the breakdown of their marriage (per 146(8.3))

**5. Personal Use Properties and Listed Personal Use Properties**

- PUP/LPP Capital Gains taxes will apply

**6. Equivalent to Spousal Amount and Child Care Expenses**

- Parent with custody over the child is able to claim child care expense and the child will qualify as equivalent to spouse as long as the child is under 18