

Tax Considerations for Separated Spouses

Hull on Estate and Succession Planning Podcast #57

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Suzana Popovic-Montag: Hi, and welcome to Hull on Estate and Succession Planning. You are listening to Episode #57 of our podcast on Tuesday, April 24th, 2007.

Welcome to Hull on Estate and Succession Planning, a series of podcasts hosted by Ian Hull and Suzana Popovic-Montag, that will provide information and insights into estate planning in Canada, from the offices of Hull Estate Mediation in Toronto, Ontario, Canada. Here are Ian and Suzana.

Ian Hull: Hi Suzana.

Suzana Popovic-Montag: Hi there, Ian. So I guess now that it's tax time, it's kind of an appropriate time to just sort of recap the last few things that we talked about on our last podcast. We were just looking from a global perspective at some of the tax considerations to keep in mind when we have separated spouses who are planning for their future. And although we're certainly not tax specialists and don't hold ourselves out as being experts in the area, we did just want to sort of highlight those flagship kind of issues that we want to keep in mind when we're in these kinds of situations or dealing with clients who are finding themselves in these situations.

Ian Hull: I think that's right, I mean, from my perspective anyway, I look at the tax issues when we're dealing with estates as more in the context of issue identification. As long as I can identify, maybe not the specific tax problem, but that it is a tax problem, I feel a lot more comfortable. And so, it always helps me anyway to sort of just get a review, just to go and review some of the basic tax concepts in the context, certainly in this situation, of a separated spouse.

Suzana Popovic-Montag: And in particular, when parties are trying to negotiate some kind of agreement between them in terms of how to divide assets or other things like that, then it's just as you say, those, you know, issue identification things that they can then take back to qualified advisors to give them the advice. So, for instance, when you've got transfers of properties, I mean there may be inherent tax liabilities that are associated with, for instance, a transfer of a house or a transfer of a cottage, and you just want to be alert to those kinds of issues that have to be given consideration.

Ian Hull: And we often see, at the stage when we're dealing with an estate administration or a contentious estate situation, circumstances where, and certainly, separate spouses haven't properly accounted for tax liabilities. And what's turned out is, is that the estate is much more modest than it probably should be in their mind, because they haven't actually looked at after-tax values.

Suzana Popovic-Montag: And then when properties are being transferred, you'll want to keep in mind that there are possibly capital gains associated with them, or capital losses, or income might be attributed to certain assets that you wouldn't necessarily otherwise expect.

Ian Hull: So when you say attributed to certain assets, what are we getting at there?

Suzana Popovic-Montag: Well, Ian, the whole concept of income attribution that will attribute someone's income to another person in situations where the parties are living, for instance, separate and apart, as a result of a relationship breakdown.

Ian Hull: And that can be so important when you're dealing with complex corporate situations, or not even that complex. But income, that classic example is where you have a situation where the spouses are happily married and they have an ongoing corporation where they're drawing out of the corporation for their own day-to-day expenses, for example, paying their property taxes or paying their heat and light. And then at the end of the year, you need to reconcile that and they are proper draws that are taxable income, as opposed to business expenses. And often what can happen is, is that the one spouse isn't necessarily aware of how the funding is occurring and that it's being sourced through the company this way and then all of a sudden, if you split in midstream in the year, one of the spouses may get a big surprise as to how the tax is going to land. So these are issues that you'll want to properly consider, because although we're talking about separated spouses, and again, we're not talking about family law issues in that sense, we're not family law experts. But what we're talking about is the situation that we see so often and that is, when someone dies, these issues pop up, if they haven't been thought about before, in the context of tax planning and so forth, people get big surprises as to what's going to be left in the estate.

Suzana Popovic-Montag: And I think also one of the things you may want to keep in mind, just in terms of a planning perspective, is the fact that yes, this liability could arise, that it could be an inherent liability that you wouldn't necessarily know about, but that perhaps, you know, to plan for you might consider discussing at least the possibility of some kind of indemnity from your partner, so that if and when these liabilities arise, you've got some kind of built-in protection available to you.

Ian Hull: And that's important because sometimes one partner doesn't really know the business of the other on a day-to-day basis. And certainly in an estate situation where that partner, who has been operating the business without much information going to the other spouse, dies suddenly and there's significant liabilities there. You may want to allocate, certainly if you're a separated spouse, some indemnity arrangements.

Now Suzana, you mentioned the principal residence exemption. First of all, maybe we just take a moment to describe what it is and maybe just make a comment on its importance with separated spouses.

Suzana Popovic-Montag: Well, Ian, that exemption, the principal residence exemption, speaks to the home that the individuals are living in to and the fact that there is an exemption under the *Income Tax Act* for any tax liability that would arise as a result of a capital gain on this property that's been held over the years.

Ian Hull: So, as I understand it, couples, generally speaking, can only designate one principal residence in their portfolio, so to speak, for tax purposes.

Suzana Popovic-Montag: That's right, but on a marriage or on a relationship breakdown, it may be possible for a second principal residence exemption to become available.

Ian Hull: And what sort of restrictions does CRA look to in that situation? As I understand it, I think the exemption only becomes available once the couple has been living separate and apart for at least 12 months.

Suzana Popovic-Montag: And then that they're separated, either pursuant to some kind of Order made by a court or perhaps even a written Separation Agreement.

Ian Hull: Okay. So when you end up, as a sort of practice point, if you're in a situation where you are separating, as part of your property settlement, what's a good idea to do?

Suzana Popovic-Montag: It's a good idea, Ian, I think in those circumstances, to decide who's going to be able to take advantage of that exemption. And that's something that can be used to negotiate between the two parties as part of the whole settlement portfolio, as you suggested.

Ian Hull: Okay. Now, without getting too technical, another consideration is the spousal tax credit, and that is where spouses are entitled to claim a spousal tax credit in any year in which their spouse's income does not exceed a certain threshold.

Suzana Popovic-Montag: And that threshold tends to be, I think, relatively speaking, low in that it's only \$7,000 here in Ontario. But the fact is that once you're in a situation where a relationship has broken down, then the period of time during which Revenue Canada is looking at is not necessarily the full year. And so in those kinds of circumstances, you want to be alert to the possibility that this credit may in fact be a meaningful one to the parties.

Ian Hull: Another thought would be too, as well, is if you're supporting a child, an eligible dependent credit is available if the child is under 18 years of age and not earning much income. There are some tax considerations in that situation as well.

Suzana Popovic-Montag: And I think that one that's probably most commonly known to people are the concepts of, you know, the RRSPs and the RRIFs.

Ian Hull: And certainly, if you have a written Separation Agreement or you are entering into some sort of arrangement, you want to make sure that you've documented that issue

quite carefully, because in the context of an estate administration, again where a situation someone suddenly dies and they're separated, if it's not clear, you can get some rude awakenings. And one of the classic rude awakenings is, of course, that a situation where there is a second marriage and the happy new couple goes out and gets married, and don't tell their lawyer or don't tell anyone. And in Ontario anyway, the marriage revokes the Will and the whole estate plan may indeed come unraveled. It does come unraveled and may end up going a way that you had not anticipated.

Suzana Popovic-Montag: And I guess that sort of underscores the need to, in your estate plan, every once and awhile, just check those designations on your RRSPs, on your RRIFs, on your, you know, whatever instruments you have where you specifically designated someone to be the beneficiary of that.

Ian Hull: So staying in the context of the separated spouse, I just want to make a quick comment because again, we just don't have the expertise, and it's not really that particularly relevant until you pass away, how we deal with support orders. But if you are paying spousal support, you need to get some guidance from a professional as to what the tax is deductible. And, you know, what are the rules in respect of deductibility for spousal support. The same thing goes for situations where you're paying child support. Again, we just recommend that you consider that, make sure that you've talked about that with your financial advisor and the like.

One thing that people worry about, quite legitimately, is the deductibility of legal fees. And that again is a quagmire and a difficult issue to sort of summarize in a quick podcast. But it's just something to keep in mind when legal fees are deductible, when they're not. And again, you'll want to get some advice from a legal advisor on that, or an accounting advisor.

Suzana Popovic-Montag: And then also I think you want to keep in mind any possible childcare expenses that might be available to you and which may be deductible under the *Income Tax Act*, so that you can benefit from that to the extent possible.

Ian Hull: Okay. Well, we've talked a lot about tax today and I think that's been helpful and hopefully in our next podcast, we'll be through tax season, so we'll have to turn to something more exciting and less depressing, in the context of separated spouses. So we'll certainly turn to some different issues to consider from the estate planning standpoint at that point. So thanks very much, Suzana.

Suzana Popovic-Montag: Thanks to you, Ian.

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