CLOSING THE GAP BETWEEN TAX LAW AND FAMILY LAW ON MARITAL BREAKUP

by

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ABSTRACT

Many tax consequences arise subsequent to the breakdown of marriage. The tax implications arising upon marital dissolution is a topic which elicits attention from both the realms of taxation and family law. However, upon considering the policy objectives underlying tax law and family law, it can be observed that a discord between these two areas of laws is clearly evident, with the family law system being equipped to better take into account the many social realities surrounding divorce as opposed to the tax system.

Accordingly, the objective of this thesis is to examine the taxation treatment accorded to marital dissolution in an attempt to identify weaknesses in the tax legislation and to provide appropriate recommendations. In this pursuit, the tax provisions related to spousal support payments, child support payments and the division of matrimonial property are examined. Policy objectives and assumptions underlying the tax provisions dealing with divorce are also evaluated in reaching the conclusion that the tax legislation governing marital dissolution does not adequately take into consideration many of the social realities surrounding the breakdown of marriage. While amending the tax legislation in an attempt to address this problem, it is of significance to remember that both the tax law system and family law system will be required to work hand in hand to find viable solutions.
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CHAPTER 1

WHO SAID DIVORCE WOULDN’T BE TAXING?

1.1 INTRODUCTION

"In this world nothing can be said to be certain, except death and taxes."
- Benjamin Franklin (1706-90) ¹

Interestingly, Benjamin Franklin’s comment on the unwavering characteristic of taxes seems to hold true centuries after it was made. His assertion may be further augmented with the observation that almost no topic or realm is immune from the far-reaching clutches of the tax legislation. Indeed, even the emotionally charged area of marital dissolution, which lies deep within the heart of the family law system, is scrutinized within the Income Tax Act² and is subjected to taxation.

Studying the tax consequences arising out of marital breakdown is of significant importance as marital dissolution has become increasingly prevalent with nearly 40% of marriages ending in divorce in Canada.³ After the enactment of the Divorce Act⁴ in Canada

⁴ Divorce Act, R.S.C. 1985 (2nd Supp.), c.3.
in 1968, divorce rates rose until the late 1980s.\textsuperscript{5} In fact, the divorce rate increased by more than 500\% in Canada over the past three decades.\textsuperscript{6} With the frequency of marital dissolution, divorce and separation have become topics eliciting attention from a family law perspective. While marriage breakdown is most commonly associated with immediate financial and emotional hardships, the long-term financial and economic aspects can often be overlooked.

The occurrence of divorce and the emerging need for professional advice have resulted in the rise of a new niche industry surrounding the financial planning of divorce.\textsuperscript{7} This is clearly apparent when considering the recent creation of the Financial Divorce Specialist (FDS) designation, which may be earned after successfully completing a course which focuses on the Canadian rules of tax planning, pensions and RRSPs. In considering the financial issues relating to divorce, it is important to recognize the significant role that taxation issues play.

The objective of this thesis is to offer a critical analysis of the taxation scheme governing marital breakdown and to provide appropriate recommendations for improving the tax legislation. For this purpose, the tax treatment accorded to spousal support payments, child support payments, and the division of property will be evaluated. In studying the tax consequences arising out of marital dissolution, it is recognized that the subject is governed by both family and taxation laws. Thus, it is of significance to consider first the relationship


\textsuperscript{7} Jade Hemeon “Guiding divorce dollars: New Canadian course helps advisors sharpen skills for niche market” The [Canadian] National Post (25 May 2004) FP6. The course has been designed by the Academy for Financial Divorce Specialists to enable financial planners to best serve their clients. The first course will be offered in Toronto in the summer of 2005 and will subsequently be offered in British Columbia.
between the realms of taxation and family law before embarking upon an analysis of tax legislation. However, prior to such analysis, some of the social realities arising out of the breakdown of marriage will be discussed in an effort to provide a deeper understanding of the taxation issues on divorce.

1.2 SOCIAL REALITIES SURROUNDING DIVORCE

Many detrimental ramifications can manifest themselves on the breakdown of marriage. According to Margaret Brinig, negative consequences potentially arising on a divorce include financial, social and psychological matters. Of interest to note is the observation that the impact of the consequences suffered following divorce will vary according to the gender of the spouse, with women suffering more from financial difficulties in comparison to men who generally endure more psychological stress. While it is not denied that divorce has harmful effects on both men and women alike, it has been contended that the negative effects of divorce bear more heavily on the average woman than on the average man. Aside from the impact divorce has on the adults involved in a relationship, the ramifications for children of the marriage should not be overlooked. To understand typical consequences arising out of divorce, a brief survey of a few social realities follows.

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1.2.1 Financial Consequences

It is undisputed that divorce can result in destructive financial consequences.\textsuperscript{11} That is, following divorce, the combined household income is split and must be utilized to cover the expenses incurred by two separate households. As discussed in the pages that follow, it has generally been found that custodial parents and women, ironically the same person in a majority of cases, suffer the most from an economic point of view following a divorce.\textsuperscript{12}

Much of the research related to the financial effects arising from divorce focuses on the adverse economic effects suffered by women. Numerous studies have found that divorce is a cause of poverty, especially amongst women.\textsuperscript{13} While the figures vary from study to study, it has been found that, in general, women’s household income significantly decreases in comparison to men’s household income following a divorce.\textsuperscript{14} The impoverished state of women following divorce has led to the recognition of the feminization of poverty. This phrase is utilized to describe the propensity of women, usually single mothers, who become “poor without the support of a man”.\textsuperscript{15}

In support of the contention that women suffer economically following divorce, in the Supreme Court of Canada decision, \textit{Moge v. Moge},\textsuperscript{16} Justice L’Heureux-Dubé attributed the

\begin{itemize}
\item \textsuperscript{11} \textit{Ibid.} at 43.
\item \textsuperscript{12} \textit{Ibid.}
\item \textsuperscript{13} Nancy Mandell & Anne Duffy, \textit{Canadian Families: Diversity, Conflicts and Change}, 2\textsuperscript{nd} ed. (Toronto: Harcourt Canada Ltd., 2000).
\item \textsuperscript{14} Anne-Marie Ambert, “Divorce: Facts, Causes and Consequences”, online: Vanier Institute of the Family <http://www.vifamily.ca/library/cft/divorce_05.html>. The report has cited numerous studies which support the assertion that women’s standard of living decrease after divorce in comparison to men’s.
\item \textsuperscript{15} Mandell & Duffy, \textit{supra} note 13 at 198, 365.
\end{itemize}
financial hardship suffered by women, in part, to the tendency to put the family and their marriage ahead of their careers, as follows:

Today, though more and more women are working outside the home, such employment continues to play a secondary role and sacrifices continue to be made for the sake of domestic considerations. These sacrifices often impair the ability of the partner who makes them (usually the wife) to maximize her earning potential because she may tend to forego educational and career advancement opportunities. These same sacrifices may also enhance the earning potential of the other spouse (usually the husband) who, because his wife is tending to such matters, is free to pursue economic goals. This eventually may result in inequities.\(^\text{17}\)

The above-mentioned sacrifices made by women, coupled with the earning gap existing in the work force between males and females, place women in a financially vulnerable position following divorce when they are forced to provide for themselves.\(^\text{18}\) Further adding to the economic troubles suffered by women, it has been observed that women experience more difficulty than males in integrating into the paid work force.\(^\text{19}\) Aside from labour force challenges resulting from marital dissolution, it has been found that tax law has, in many cases, further worsened the poverty experienced by women and children during and after divorce.\(^\text{20}\)

\(^{17}\) Ibid, at para. 70.


\(^{20}\) Durnford & Toope, supra note 5 at 5.
It has also been found that custodial parents suffer financially from the breakdown of marriage.\textsuperscript{21} This results, in part, because the custodial parent must find a job that allows enough flexibility for child-care. To complicate matters, custodial parents may be forced to find part-time jobs because day-care expenses may be well beyond their means.\textsuperscript{22} Part-time jobs are usually less remunerative than full-time employment. Additional financial hardship is placed on custodial parents as it has been found that “noncustodial parents . . . pay a disgracefully small part of their court-ordered support”.\textsuperscript{23}

1.2.2 Psychological, Physical and Social Consequences

While it has been found that divorced and separated individuals suffer from increased levels of psychological morbidity as compared to married individuals, generally individuals that initiate the separation or divorce process tend to fare psychologically better than the other spouse.\textsuperscript{24} Such differential is generally attributed to the psychological liberation achieved through the dissolution process.\textsuperscript{25} Of interest to note, however, is the finding that men have a tendency to suffer more psychologically than women subsequent to the breakdown of marriage. Such psychological trauma is most likely to stem from reduced social and emotional contact with their children, along with the financial burden associated

\begin{itemize}
  \item \textsuperscript{21} Allen & Richards, \textit{supra} note 8 at 43.
  \item \textsuperscript{22} \textit{Ibid.} at 49.
  \item \textsuperscript{23} \textit{Ibid.} at 52.
  \item \textsuperscript{24} Gay C. Kitson & Leslie A. Morgan, “The Multiple Consequences of Divorce: A Decade in Review” (1990) 52:4 J.M.F. 913.
  \item \textsuperscript{25} Allen & Richards, \textit{supra} note 8 at 54.
\end{itemize}
with having children.\(^{26}\) It has been observed that divorce is “among the most stressful events that many individuals experience”.\(^{27}\) The stressful nature of marital dissolution not only produces adverse psychological effects, but also results in negative health effects due to the suppression of the immune system.\(^{28}\)

From a social perspective, as the prevalence of divorce has increased in society, the social stigma associated with divorce has slowly faded.\(^{29}\) Despite the disappearance of negative social connotations related to marital dissolution, it has been found that divorced individuals suffer from “reduce[d] social esteem”.\(^{30}\) Several reasons have been identified for the lowered social esteem, including the fact that friends of the couple are typically forced to choose sides.\(^{31}\)

1.2.3 Effects on Children

Children can be the most vulnerable to the effects of divorce, with both short term and long term ramifications impacting their lives. Aside from the emotional trauma suffered

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\(^{26}\) Ibid. at 36; “Divorce: The Forgotten Injury”, online: Colorado Chiropractic Journal <www.fact.on.ca/Info/dom/26altern.htm> [“Forgotten Injury”]. While the notion that individuals undergoing divorce suffer more psychologically as compared to their married counterparts is commonly accepted, the actual amount of psychological suffering induced by divorce is difficult to measure because of the numerous variable affecting an individual’s psychological health. One study has actually found that divorced men are twenty-one times more likely to be admitted to a psychiatric hospital as compared to married men.

\(^{27}\) Kitson & Morgan, supra note 24 at 915.

\(^{28}\) “Forgotten Injury”, supra note 26. While results vary from study to study, one study has found that divorced individuals are more susceptible to most types of terminal cancer in comparison to married individuals. More astonishing is a study which has found that the rate of early death of divorced men, due to cardiovascular disease and strokes, is double that of married men.

\(^{29}\) Allen & Richards, supra note 8 at 53.

\(^{30}\) Ibid.

\(^{31}\) Ibid.
by children, financial difficulties have severe consequences. In addition, it has been found that children from divorced families are less prone to achieve education success as compared to children whose parents remain married. Other adverse effects on children include a higher prevalence of mental and physical health issues. Aside from health issues, research has shown that children whose parents have divorced experience a higher level of emotional and behavioral problems as compared to children whose parents have not divorced or separated.

It has been asserted that these issues ultimately result in the placing of a heavier burden on the government, through child welfare agencies and various social assistance programs. Additionally, as it has been found that children from divorced families are more likely to divorce themselves, a generational cycle of dependence on governmental institutions may result.

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32 Ibid, at 42. It has been observed that financial consequences in some circumstances result in a higher exposure to crime.

33 Gordon, supra note 18 at 61 notes that this indirectly leads to such children experiencing more trouble with the law.

34 Gordon, supra note 18 at 61; “Forgotten Injury”, supra note 26. Furthermore, the propensity of alcohol and drug abuse was found to be much higher for children from divorced families.


36 Gordon, supra note 18 at 61.

37 Freeman, supra note 35 at 84.
With an awareness of the social realities surrounding divorce, an investigation of the relationship between taxation and family law follows, as a background for the dynamics of the tax legislation governing marital dissolution.

1.3 THE INTERPLAY BETWEEN TAXATION AND FAMILY LAW

It is imperative that the treatment accorded to individuals undergoing the breakdown of marriage from both taxation and family law perspectives be considered as both areas play significant roles in the divorce process. Such a comparison is essential for determining whether the tax scheme governing marital dissolution is harmonious with divorce and family legislation.

In considering the legal aspects of divorce, a lack of coherence between the realms of taxation law and family law is quite apparent. It has been asserted that the discord between family and tax law "has been an embarrassment in an era of freely available divorce".38 The disparity has resulted in significant implications as it has been observed that the tax consequences arising out of divorce, which should be regarded as a "family law" issue, are often overlooked by divorce lawyers and judges.39 Explanations can be offered for the lack of harmony between taxation law and family law.

38 Durnford & Toope, supra note 5 at 5.

39 Richard Kirby, "Tax and Alimony – Almost as Complicated as Marriage Itself?" Law Now 27:3 (December 2002) 38.
The rationale for drawing a line between these two areas of law may simply stem from the different structures of tax law and family law:\(^40\) that is, tax law is concerned with raising revenue for the government. Therefore, tax legislation is comprised of comprehensive and exhaustive rules seeking to prevent tax avoidance. Family law, however, is perceived to provide general guidance to families, comprising rules qualified by extensive discretion left to judges to deal with unquantifiable situations and circumstances that can arise.

Another explanation for treating tax matters as distinct from family law issues may result from the deeply rooted public/private divide, which has been imposed on society.\(^41\) The public/private divide refers to the creation of the invisible boundary, which serves to distinguish between those matters which are of public or political concern as opposed to personal or private affairs. Within this dichotomy, familial relationships and various issues surrounding the family are placed within the private sphere. In conformity to a classic liberal notion, the state tends not to intervene in these private family matters since it is thought that such intervention is inappropriate as private matters are best dealt with by individuals. In contrast, economic issues, including taxation matters, are generally associated with the public side of the divide.

In an attempt to further examine the relation, or lack thereof, between these two areas of law, a description of the divergent legislative policy objectives underlying tax law and family law, respectively, follows.

\(^{40}\) Durnford & Toope, supra note 5 at 4.

1.3.1 Income Tax Objectives

While the generation of public revenue is the primary purpose for the enactment of a taxation system, several other objectives have been used as a foundation for Canada’s taxation legislation.\(^{42}\) The objectives include equity, neutrality, simplicity, economic stabilization, international competitiveness, certainty and balance.\(^{43}\) In considering these objectives, it can be seen that tax law is not only concerned with economic values, but also with social and political values. Conflicts can arise among the policy objectives requiring compromises to achieve a balanced taxation system.\(^{44}\) A discussion of the main objectives follows.

As previously mentioned, the primary purpose for implementation of a taxation system is to raise a sufficient amount of revenue to finance the government’s undertakings.\(^{45}\) The amount of revenue that is generated by a tax system depends on the tax rate as well as the determination of entities to be taxed, and the subject-matter of the tax, which can be called the “tax base”.\(^{46}\) Another policy objective, simplicity, encourages the notion that a tax system should be relatively straightforward and easy to understand.\(^{47}\) Simplicity results


\(^{43}\) Ibid. at 1-20; N. Brooks, “Future Directions in Canadian Tax Law Scholarship” (1985) 23 Osgoode Hall L.J. 441 at 457-473 [Brooks, “Future Directions”].

\(^{44}\) Royal Commission Report, ibid. at 21.

\(^{45}\) Ibid. at 2-3.

\(^{46}\) In Canada, the tax base is taxable income.

in higher rates of compliance by taxpayers as well as increased administrative efficiency of the tax. An increase in compliance and administrative efficiency in turn results in a reduction of enforcement costs incurred by the government.

An additional policy objective underlying the *Income Tax Act* is the principle of equity. The equity objective looks at taxpayers' ability to pay.\(^{48}\) The principle allows for the fair sharing of the tax burden throughout society. Tax equity is further broken down into two categories: horizontal and vertical.\(^{49}\) Horizontal equity advocates for taxpayers in similar circumstances to be taxed in a similar manner. On the other hand, vertical equity promotes the notion that taxpayers in different circumstances should be taxed differently, e.g., individuals with greater incomes paying tax at higher rates.

Neutrality is yet another objective that should be incorporated within tax legislation. Neutrality is based on the principle that a tax system should not affect taxpayers' behaviours.\(^{50}\) Thus, individuals should be free to make business or personal decisions without being enticed to skew their behaviour in order to receive more favourable tax treatment.

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\(^{48}\) *Royal Commission Report*, *supra* note 42 at 10.


\(^{50}\) *Royal Commission Report*, *supra* note 42 at 8.
1.3.2 Family Law Objectives

Although divorce generally is governed by the Divorce Act, reference to other pieces of legislation within the family law system is imperative to include the objectives underlying the whole system. While the topic of divorce falls under the jurisdiction of the federal government, provinces and territories are responsible for legislating on issues surrounding the family. Despite the fact that each province has different legislation enacted with respect to family matters, the objectives underlying all family legislation remain similar. That is, the family law system aims to “strengthen the role of the family in society,” and recognizes “the equal position of spouses as individuals within marriage”.

Specific to the breakdown of marriage, objectives underlying the family law system include: an “orderly and equitable settlement of the affairs of the spouses,” recognition that “childcare, household management and financial support are joint responsibilities of spouses,” and contributions made in these regards ultimately entitle both former spouses to rights to family or matrimonial assets.

In addition to the broad policy objectives underlying the family law system, within the legislation itself, the Divorce Act outlines objectives specific to the granting of spousal support payments. One of the objectives underlying the granting of spousal support payments is the recognition of the financial difficulties arising upon the breakdown of marriage.

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51 Divorce Act, supra note 4.
52 Matrimonial Property Act, R.S.N.S. 1989, c. 275.
54 Ibid.
55 Matrimonial Property Act, supra note 52 at preamble.
marriage and “any economic advantages or disadvantages” that may occur to the former spouse.\textsuperscript{56} While spousal support payments are intended to allow expenses related to the care of children to be allocated between spouses and are meant to alleviate “economic hardship of the spouses”, it is important to note that an objective underlying spousal support payments is to “promote the economic self-sufficiency of each spouse”.\textsuperscript{57} Further to the objectives specified within the \textit{Divorce Act} with regards to spousal support, provincial family legislation recognizes the “effect that having custody of a child of the spouse has on a spouse’s earning capacity and career development”.\textsuperscript{58}

In identifying further objectives underlying the support payments, reference is made to the Federal Child Support Guidelines,\textsuperscript{59} (hereinafter, the “Guidelines”) which are utilized to determine the quantum of child support payments. As clearly outlined in section 1, the objectives of the Guidelines are:

(a) to establish a fair standard of support for children that ensures that they continue to benefit from the financial means of both spouses after separation;

(b) to reduce conflict and tension between spouses by making the calculation of child support orders more objective;

(c) to improve the efficiency of the legal process by giving courts and spouses guidance in setting the levels of child support orders and encouraging settlement; and

\textsuperscript{56} \textit{Divorce Act}, supra note 4 at s. 15.2(6).
\textsuperscript{57} \textit{Ibid.}
\textsuperscript{58} \textit{Family Law Act}, S.N.W.T. 1997, c.18, s. 16(4)(c).
(d) to ensure consistent treatment of spouses and children who are in similar circumstances.\textsuperscript{60}

An underlying theme to all of the objectives found within the realm of family law that relate to marital dissolution is the promotion of equity: i.e., the family law system strives to prevent the burden of marital dissolution from falling disproportionately on one of the spouses by advocating for fairness with respect to spousal and child support payments, as well as division of property.

1.3.3 Comparison between Taxation and Family Law Objectives

In studying the objectives underlying the taxation and family law systems, a similarity can be seen between the equity objective advocated within the tax realm and the underlying theme of fairness identified underscoring the family law system. More specifically, both of these objectives recognize that spouses with lower income should be aided. Aid comes in the form of attempting to alleviate economic hardships through the granting of support from the family law field, as well as through assistance under the taxation system of being taxed at a lower marginal rate.

Despite the commonality identified between the objectives underlying both the tax and family law systems, considerable differences also exist between the two areas of law. It can be observed that the policy objectives underlying tax law are broad in scope. This is presumably due to the wide application of the \textit{Income Tax Act}. On the other hand, the objectives underlying family law tend to be detailed, and many objectives specific to the issues arising out of the breakdown of marriage have been established. This is a direct result

\textsuperscript{60} \textit{Ibid.} at s. 1.
of the fact that the Divorce Act has been enacted to deal specifically with the topic of marital dissolution. In this respect, the treatment accorded to divorce, from a family law perspective, can be starkly contrasted with the treatment of divorce in taxation laws. Thus, the comparison of both taxation and family law policy objectives further demonstrates the lack of harmony between these two areas of law with respect to divorce proceedings.

In addition, the objectives of the family law system are clearly stated within legislation and take into consideration many of the social realities surrounding the breakdown of marriage, with emphasis on the financial difficulties. On the other hand, tax legislation has not expressly incorporated any of the policy reasons for enacting the provisions governing marital dissolution. Thus, from a taxation perspective, many of the social issues surrounding divorce may be overlooked as they are not recognized within the statute. It can, therefore, be concluded that a lack of harmony exists between tax law and family law with respect to divorce. The discrepancies that exist in the treatment of marriage breakdown between these areas of law ultimately leads to adverse implications for individuals undergoing the divorce process.

Therefore, it is argued that the tax legislation pertaining to marital dissolution does not take into consideration many of the social realities associated with divorce, resulting in part, from the lack of interplay between family and taxation law. In an attempt to support this contention, this thesis contains critical analysis in chapters two and three, of the taxation of spousal support and child support payments. In chapter four, the taxation treatment accorded to the division of property is investigated and evaluated. Chapter five contains
conclusions on the effectiveness of the Income Tax Act to take into consideration the social realities surrounding marital dissolution.
CHAPTER 2

WEIGHING THE SCALES ON THE TAXATION OF SPOUSAL SUPPORT

2.1 THE GRANTING OF SPOUSAL SUPPORT

Upon the breakdown of marriage, spousal support is a contentious issue that may have to be addressed. Among the considerations are entitlement and quantum. Reliable data on the prevalence of spousal support is practically non-existent; however, "the scant data available suggests that spousal support is awarded in only a small percentage of divorce cases – ranging from the low twenties at best, to the low teens at worst".

Although the incidence of spousal support occurs in a relatively low number of divorce cases, the topic is more significant taking into consideration the divorce rate. In an attempt to gain a greater understanding of the taxation treatment and its implications towards spousal support payments, the fundamental concepts underlying spousal support must be examined. Thus, a brief background from a family law perspective on spousal support payments follows beginning with reference to the Divorce Act.

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61 Amy Carron Day, “Spousal Maintenance: Confronting the Emotion” New York Family Law Monthly (5 April 2004) 3. Many divorce lawyers note that spousal support is one of the most difficult issues to deal with during the negotiation process due to the fact that “spousal support often represents something entirely different for each spouse”. However, it has been noted that dealing with the issue of spousal support through mediation or the collaborative law process is often successful as it allows both parties to explore their emotions.

The objectives underlying spousal support are clearly outlined within the *Divorce Act*. These objectives mandate that support payments should:

a) recognize any economic advantages or disadvantages to the spouses arising from the marriage or its breakdown;

b) apportion between the spouses any financial consequences arising from the care of any child of the marriage over and above any obligation for the support of any child of the marriage;

c) relieve any economic hardship of the spouses arising from the breakdown of the marriage; and

d) in so far as practicable, promote the economic self-sufficiency of each spouse within a reasonable period of time.\(^\text{63}\)

The objectives were carefully analyzed by the Supreme Court of Canada in the decision of *Moge v. Moge*.\(^\text{64}\) L’Heureux-Dubé J. for the Court observed that Parliament’s intention in establishing objectives for spousal support payments was to accommodate “the diverse dynamics of many unique marital relationships”.\(^\text{65}\) Consequently, four different objectives were incorporated into the *Divorce Act* to account for the economic affairs of all divorcing couples. It was noted that the purpose of the objectives was to allow for equitable sharing upon marital dissolution of financial matters. Of significance was the observation made by the Court that all four of the objectives governing spousal support must be considered in conjunction, without assigning paramouncty to any particular objective. The

\(^{63}\) *Divorce Act, supra* note 4 at s. 15.2(6).

\(^{64}\) *Moge, supra* note 16.

\(^{65}\) *Ibid.* at 853.
Court noted that judicial discretion would play a determining role in the application of the enumerated objectives to the facts of a case.

In commenting on the emphasis given by Parliament to judicial discretion with respect to support payments, an author contends that such discretion was purposefully integrated into family law legislation to allow male dominance in the family. The author notes that the objectives allow for too much judicial discretion, resulting in variance in the results, as judges may attach importance to different factors.

Judicial discretion left spousal support vague and ambiguous, especially with respect to the amount and duration of payment. As acknowledged in a background paper issued by the Federal Department of Justice, “the law of spousal support is confused, uncertain and controversial”. Thus, in an attempt to provide more certainty, the Federal government has drafted a set of spousal support guidelines. The “spousal support advisory guidelines”, which were released in early 2005, is simply a draft proposal which practitioners are encouraged to review and provide feedback on before the final drafting of the guidelines. The guidelines basically aid in the process of determining the quantum of spousal support as well as provide guidance for deciding the appropriate duration of such payments.

66 Langer, supra note 19 at 68.

67 Stephen M. Grant, “The Ex-Files” CA Magazine 130:2 (March 1997) 18 at 22.

68 Rogerson, supra note 62.


70 Ibid. at 1-2; Cristin Schmitz, “Spousal Support Discussion Paper Food For Thought” The Lawyer’s Weekly 23:13 (25 July 2003) 9. More specifically, the spousal support guidelines provide a mathematical formula which aims to set the amount of spousal support at a percentage of the difference between the payor and recipient spouses’ incomes. While spousal support guidelines have been enacted in America, these guidelines generally accord prominence to the length of marriage in determining the amount of spousal support.
Although spousal support might be a topic of uncertainty within the realm of family law, in stark contrast, spousal support has a very precise meaning within the *Income Tax Act*, as seen in the pages that follow, containing an analysis of the definition of “support amount” in the *Income Tax Act*, the intricacies of the taxation treatment applied to spousal support payments and legal fees incurred with respect to spousal support payments. Finally, the tax treatment accorded to spousal support is evaluated, with suggested solutions for weaknesses identified in the tax system.

### 2.2 SPOUSAL SUPPORT DEFINITION

Before considering the taxation scheme applied to support payments, it is first important to examine the definition of support under the *Income Tax Act*.\(^7\) To qualify as a support amount, payments must be made under an order from a competent tribunal or written agreement, in the form of an allowance, and be payable on a periodic basis. Additionally, to qualify as a support payment, the payor and recipient spouses must be living separate and apart, as a result of their marriage breakdown, and the recipient spouse must have discretionary power with respect to the use of the support payments. To provide a clearer understanding of the meaning of “support amount”, as defined in tax legislation, an analysis of these requirements follows.

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\(^7\) *Income Tax Act, supra* note 2 at s. 56.1(4).
2.2.1 Pursuant to Order of Competent Tribunal or Written Agreement

It is imperative that the payments be made pursuant to a court order or written agreement in order to qualify for the tax treatment accorded to support payments. In considering this criterion, two issues must be addressed. First, the definitions of “competent tribunal” and “written agreement” must be considered. Moreover, support payments must be made pursuant to the court order or written agreement, thus giving rise to the question of the fate of payments made prior to the issuing of an appropriate order or agreement.

The meaning of “under an order of a competent tribunal” and “under a written agreement” is further considered. With respect to court orders, only orders issued by appropriately empowered courts or tribunals are recognized by the Income Tax Act. This is important to remember as the Canada Revenue Agency (hereinafter, “CRA”) will not accept an agreement which has been deemed to be a court order by provincial maintenance enforcement legislation as fulfilling the requirement that support payments be made under an order granted by a competent tribunal. Alternatively, payments made pursuant to a written agreement will also be characterized as support amounts under the Income Tax Act. From case law, it is well accepted that a written agreement constitutes “a formal or legal document in writing and signed by the parties”. If the parties have not signed such a document, they may establish that their support payments are made pursuant to a written agreement if they

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72 Ibid. at s. 56.1(4).
74 Ibid.
75 Barbara A.F. Suzuki, “Income Tax Consequences of Separation and Divorce” (1979) 2 Can. J. Fam. L. 33 at 42. It has been observed that usually any correspondence between the former spouses or their solicitors or pleadings in a divorce action will not be considered as a “written agreement”.

22
are able to provide sufficient written documentation, outlining and evidencing their agreement to the essential terms and conditions of such an agreement. Additionally, such documentation must clearly demonstrate both parties’ intention to enter into a contractual agreement.

Even though a valid order or agreement may be in place, any payments made in lieu of spousal support before the issuing of such an order or making the agreement will not qualify as a “support amount” as defined as the payment has not been made pursuant to a court order or agreement. To overcome this obstacle, it is imperative that the court order or written agreement expressly provide for prior payments thus qualifying the payments as being made pursuant to an order or agreement. In this instance, the payments are considered as early payments and will be taxed as support payments. To qualify within this exception for prior payments, it is important to note that the early payment(s) must have been made in the same year that the order or agreement came into force or in the prior year to be considered as a support payment.

2.2.2 Allowance Payable Periodically

According to the CRA, payments qualify as an allowance if there is a “specified sum of money which has been established in advance of payment”. As estimating future support payments may prove to be difficult when taking into consideration inflation and

77 Income Tax Act, supra note 2 at ss. 56.1(3), 60.1(3).
78 Kirby, supra note 39 at 38.
future cost of living, a specified sum of money subject to adjustment qualifies as an allowance if such adjustment is accomplished through use of a standard index or formula.\(^80\)

Periodic payments must be made in the form of an allowance, thus it is of significant importance to distinguish between those payments that are allowances payable on a periodic basis verses lump sum payments paid in installments.\(^81\) This issue was examined by the Federal Court of Appeal in the decision of *The Queen v. McKimmon*.\(^82\) In the *McKimmon* case, a payment of $115,000, in lieu of periodic maintenance, was ordered. The payments had many attributes commonly found in lump sum payments, such as: "the obligation to pay a finite amount, security for payment, interest on the outstanding balance, penalty for default and the privilege of prepayment of the amount due to the payee".\(^83\) Despite carrying many of the attributes commonly associated with lump-sum payments, the Federal Court - Trial Division held that payment was not a lump sum, therefore allowing the payment to qualify for the tax treatment accorded to spousal support payments. However, the Federal Court of Appeal reversed this decision, stating that annual payments, made over a fixed term with interest payable on any unpaid portion could not qualify as an allowance payable on a periodic basis.\(^84\) Furthermore, the payment in question constituted a significant portion of the payor spouse’s income, another factor indicating that the payment did not qualify as an allowance.


\(^{81}\) Ibid.


\(^{84}\) *McKimmon*, supra note 82 at para. 20.
In attempting to provide some guidance as to the distinction between lump sums paid by installments versus periodic payments made in the form of an allowance, the Federal Court of Appeal in the McKimmon decision outlined various criteria. These factors include the payment interval length, term of payment, amount of payment, interest payable, and purpose of payment. Assignability of payments as well as release of future obligations are also distinguishing features of lump sums as opposed to allowances. Another consideration is the recipient’s ability to accumulate capital through the payments; however, the court does acknowledge that some capital payments, including life insurance premiums and blended monthly mortgage payments, qualify as an allowance. Thus it can be seen that the distinction between a lump sum installment payment and an allowance payable on a periodic basis is a complex question of fact and law.

Generally, amounts paid over a fixed period of time, with intervals spanning greater than a year, will be considered as lump sum payments, especially if the amount of the payment is significantly greater than that required to maintain the lifestyle enjoyed prior to marital dissolution. Furthermore, if a payment is made with the intention of releasing the payor from any future obligation, or if the payment is interest bearing prior to the due date,

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86 *Ibid.* at para. 15. Payments towards life insurance and blended monthly mortgage payments, while allow for capital accumulation, are considered to be allowances because they are normal expenses of living. K.M. Fong, “Tax Implications of Support Payments” (1972) 5 R.F.L. 253 at 261. On the other hand, payments towards the maintenance of the recipient spouse’s car will be considered as a capital payment and thus not subjected to the tax treatment accorded to spousal support payments.


such payment is considered a lump sum.\(^{90}\) Moreover, acceleration clauses are generally associated with lump sum payments.\(^{91}\) On the other hand, payments which are payable on a weekly or monthly basis for an indefinite period of time or until the occurrence of an event, such as the child reaching the age of majority, are more likely be viewed as a “support amount” and will thus elicit the tax treatment accorded to spousal support payments.\(^{92}\) Spousal support payments are not assignable, but terminate upon the intended recipient’s death, as distinct from lump sum payments, which survive the recipient.\(^{93}\)

While no economic differences may arise between the two methods of payment, from a taxation perspective, a distinction is drawn as the *Income Tax Act* only taxes income, and not capital receipts in the absence of an explicit provision turning capital receipts into income for tax purposes.\(^{94}\) As a result, because lump sum payments are considered to be capital, such payments will have previously been taxed and will not elicit any additional tax consequence. Drawing a distinction between these two forms of payments is beneficial from a tax perspective as the spousal support payments receive special treatment within the tax legislation. To avoid any potential confusion arising from periodic payments being labeled as lump sum payments, it has been suggested that the court order or written agreement providing for the payment of spousal support expressly state that the payments be made at

\(^ {90} \) McKimmon, *supra* note 82 at para. 13.


\(^ {92} \) M.N.R., “IT-530R”, *supra* note 73 at para. 21.

\(^ {93} \) McKimmon, *supra* note 82 at para. 14.

\(^ {94} \) Krishna, “Lump Sum”, *supra* note 83 at C153.
regular intervals, and fix the payments at predetermined amounts. Furthermore, cancelled 
cheques or receipts should be kept as an evidentiary record to confirm that payments were 
made in the stated manner.

While the tax legislation clearly prescribes that payment must be made in the form of 
an allowance and be paid on a periodic basis to be considered as a support amount, certain 
lump sum payments qualify as a support amount. For example, if the support payments fall 
into arrears, any lump sum payment made in an attempt to pay the arrears will be 
characterized as support, despite the form. Another example of lump sum payments that will 
be considered as a support amount arises with respect to an acceleration or advance of future 
support payments. However, it is important to note that such a lump sum payment will only 
be considered as support if the sole motive for the lump sum payment is to provide security 
for the receipt of the payments by the recipient. On the other hand, where a lump sum 
payment is a release of liability for arrears, such payment will not be considered as a support 
amount within the Income Tax Act.

2.2.3 Living Separate and Apart

Aside from an amount being paid on a periodic basis, in the form of an allowance, the 
payor and recipient must be living separate and apart for the amount to be considered as a 
support payment. The determination of whether former spouses are living "separate and

95 John Syrtash “Child Support, Spousal Support and your Taxes: Knowing the Rules can Save you Money” Canadian Jewish News (16 April 2003), B15.
97 Ibid.
98 Ibid. at para. 21.
"separate and apart" is a question of fact, and the circumstances of each case will be closely scrutinized.\textsuperscript{99} It has long been established that individuals living under the same roof can indeed be living "separate and apart", as long as an intent of withdrawing from the marital consortium is established coupled with an actual physical separation.\textsuperscript{100}

The question of adequately fulfilling the criterion of living separate and apart under the \textit{Income Tax Act}, while residing under the same roof, was a central issue in the Tax Court of Canada decision of \textit{Kelner v. Canada}.\textsuperscript{101} In the \textit{Kelner} case, the appellant claimed that she was eligible to receive a child care deduction because as a result of the breakdown of their marriage, she and her husband were living separate and apart. As both the appellant and her husband were living under the same roof, the court analyzed the meaning of "living separate and apart". In reaching the decision that the couple lived separate and apart, Judge Bowman relied on the decision of \textit{Cooper v Cooper} (1973), 10 R.F.L. 184 (Ont. H.C.), in which the court provided the following list of factors that are indicative of spouses' living separate and apart:\textsuperscript{102}

- a) occupying separate bedrooms
- b) absence of sexual relations between spouses
- c) little, if any, communication between spouses
- d) wife performing no domestic services for husband
- e) eating meals separately.

\textsuperscript{99} Fong, \textit{supra} note 86 at 254.


\textsuperscript{102} \textit{Ibid}. at para. 20.
f) no social activities together

If some form of physical and psychological separation is not established, it is unlikely that spouses will be considered to be living separate and apart.\(^{103}\)

### 2.2.4 Recipients’ Discretion

The definition of “support amount” clearly states that the recipient must have discretion over the use of the payment, to qualify for the tax treatment accorded to spousal support payments.\(^{104}\) However, there is an exception to this rule for some support payments. That is, payments pursuant to court orders or written agreements made between March 27, 1986 and December 31, 1988 are taxed as spousal support payments, irrespective of whether or not the recipient has discretionary power over the utilization of the payment.\(^{105}\)

This exception stems out of the Supreme Court of Canada case of *Gagnon v. The Queen*.\(^{106}\) In the *Gagnon* case, the payor spouse was required to pay a portion of the support amount, as stipulated in the court order, only if that support amount was paid towards the recipient spouse’s mortgage and tax payments. The Supreme Court held that such amount qualified as a support payment as the recipient spouse was able to use that payment for their own benefit, irrespective of whether or not they had the discretion as to the utilization of the payment.\(^{107}\) Consequently, despite the clear language used in subsection 56.1(4) of the

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\(^{104}\) M.N.R., “IT-530R”, *supra* note 73 at para. 20.

\(^{105}\) *Ibid.*


The **Income Tax Act**, which expressly requires that the recipient spouse have discretionary power regarding the use of the support payment, payments made pursuant to orders or agreements made between March 27, 1986 and before 1988 do not need to meet this requirement because of the coming-into-force provision for subsection 56.1(4).

### 2.2.5 Third Party Payments

The tax legislation differentiates between third party payments made on behalf of the other spouse for maintenance expenses, as opposed to other purposes. The treatment accorded to third party payments generally will be examined before considering the third party payments made for maintenance expenses.

The **Income Tax Act** provides that payments made by the payor spouse to third parties for the benefit of the other spouse will be deemed to have been paid to the other spouse. Such deeming provisions are necessary to allow these payments to fall within the definition of support amount, which clearly states that payments must be made to "the spouse or common-law partner or former spouse or common-law partner of the payor". Consequently, payments made to third parties on behalf of the other spouse will be taxed as spousal support payments, assuming all of the other criteria under the definition of "support amount" are met.

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109 **Income Tax Act**, supra note 2 at ss. 56.1(1), 60.1(1).

110 Ibid. at s. 56.1(4).
Caution must be exercised when payments are made to third parties on behalf of the other spouse in lieu of support. Despite the fact that the payment is made to a third party, it is imperative that the other spouse have discretionary power as to the utilization of the payment, to qualify as a support amount.\textsuperscript{111} For example, if a court order provides that the payor spouse pay the other spouse’s rent every month in addition to a specified support amount, the rent payment will not attract support payment tax treatment as the other spouse has no discretion as to the use of the payment.\textsuperscript{112} It has been advised that in order to avoid potential confusion as to the characterization of the payment, any third party payments made as a form of support payments should be expressly stated as such in the order or agreement.\textsuperscript{113}

In contrast, the \textit{Income Tax Act} provides that third party payments, made pursuant to an order or agreement, and paid towards specific maintenance expenses will receive the same tax treatment as that received by other forms of spousal support.\textsuperscript{114} Such tax treatment is provided by subsections 56.1(2) and 60.1(2), which deems these payments to fulfill the necessary requirements to be characterized as a support amount. That is, such payments will be deemed to be “receivable by [the spouse] as an allowance on a periodic basis, and [the spouse] is deemed to have discretion as to the use of that amount”.\textsuperscript{115} As third party payments made towards maintenance expenses are deemed to satisfy the support amount

\textsuperscript{111} M.N.R., \textit{"IT-530R"}, \textit{supra} note 73 at para. 27.

\textsuperscript{112} \textit{Ibid}.  

\textsuperscript{113} Kirby, \textit{supra} note 39 at 38.  

\textsuperscript{114} M.N.R., \textit{"IT-530R"}, \textit{supra} note 73 at para. 29.  

\textsuperscript{115} \textit{Income Tax Act, supra} note 2 at ss. 56.1(2), 60.1(2).
definition, they receive the special tax treatment accorded to spousal support payments. The CRA has stated that for these provisions to apply, the court order or written agreement must clearly refer to the application of subsections 56.1(2) and 60.1(2) to third party payments made towards maintenance expenses.\footnote{M.N.R., “IT-530R”, supra note 73 at para. 29.}

While most third party payments for maintenance expenses fall within the scope of subsections 56.1(2) and 60.1(2), there are exceptions: notably, third party payments towards expenses pertaining to both the spouse’s residence and most tangible property will not fall within the deeming provisions.\footnote{Ibid.} In contrast, payments made towards the maintenance of the recipient spouse’s dwelling, such as the payment of property taxes or utility bills, or made towards the purchase or improvement of the residence will qualify for the deeming treatment.\footnote{Ibid. With respect to payments towards the purchasing or improvement of the recipient spouse’s dwelling, a maximum deduction of 20\% of the original amount of the loan will be deductible.} Additionally, third party payments towards tuition and medical expenses of the spouse or children will fall within the deeming provisions.\footnote{Kirby, supra note 39 at 38.} The rationale behind the rules governing third party payments is to prevent income splitting where property is transferred between the former spouses.\footnote{Steve Z. Ranot & Michael S. Penner, “Taxable Spousal Support – Special Situations” (2004) 19 Money & Fam. L. 22 at 23.}
2.3 TAXATION OF SPOUSAL SUPPORT PAYMENTS

In an attempt to alleviate the financial difficulties arising out of marital dissolution, the inclusion-deduction system was incorporated into the tax legislation with respect to support payments. Through this system, the payor spouse is able to deduct spousal support payments, and reciprocally, these amounts are included in the recipient spouse’s taxable income. Parliament invoked this system in an attempt to reduce the economic burden on divorced or separated couples by using the mechanism of income-splitting. Income splitting is achieved when the support payments are deductible at the payor’s higher marginal rate of tax, and taxed at the recipient spouse’s lower marginal tax rate. The rationale behind this system is that the taxes saved through the inclusion/deduction system increase the after-tax resources available to the recipient and payor spouses. Of significant importance to note is the rule that individuals cannot “contract into or out of taxation by characterizing the payments as [support]”.

2.3.1 Deduction Mechanism

The value of the deduction that the payor spouse can claim can be determined by the formula set out in paragraph 60(b) of the Income Tax Act (refer to Appendix 1). The

121  

122  
Income Tax Act, supra note 2 at s. 60(b).

123  
Ibid. at s. 56(1)(b).

124  
Thibaudeau, supra note 121 at para. 94.

125  
James G. McLeod, Case Comment on Urichuk v. R. (1993) 45 R.F.L. (3d) 195; Anthony F. Sheppard, “Taxation of the Family Divided: Divorce – Canadian Style (Part 1)” (1975) 33:1 The Advocate 12. While provisions indicating desired tax treatment will not be binding on courts, it has been suggested that including such provisions into an agreement will serve both as a helpful tool in the interpretation of the contract as well as a deterrent for either of the parties intending to act contrary to the position settled upon.
deductible amount is determined by taking into account support payments paid from 1996 to the current year as well as cumulative child support payments. Assuming that the payments fit within the definition of “support amount”, the cumulative value of all support payments paid from 1996 to the end of the current year is reduced by the total value of child support payable to the recipient spouse from the commencement date of the agreement until the end of the current year. This amount is further reduced by the sum of the deductions taken by the payor spouse with respect to support payments made since 1996. The calculation for determining the deductible amount allowed by the payor spouse is illustrated in the following example.

**EXAMPLE:** Under a written separation agreement executed on October 1, 2003, Jason is to pay Lisa $400 of spousal support a month. Thus in 2003, Jason paid $1,200 in support payments ($400 x 3 months), and paid $4,800 in support payments in the following year ($400 x 12 months).

The value of the deduction claimable by Jason in 2003 and 2004 is calculated as follows:

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126 *Income Tax Act, supra note 2 at s. 60(b).*

While Jason would be eligible to claim the above deductions for the respective years, Lisa would correspondingly include the above amounts into her taxable income under the operation of paragraph 56(1)(b).

Multiple agreements entered into by the payor and recipient spouse will be considered in conjunction with one another in the process of determining the deduction available under paragraph 60(b). On the other hand, it is important to note that if a payor spouse is obliged to pay support to more than one recipient spouse, through more than one marriage or common-law relationship, the deduction calculation under paragraph 60(b) should be calculated separately for each recipient spouse. Of significance to note is that periodic payments may only be deducted in the year of payment, thus if the payor spouse has defaulted on some of the payments, they will not be eligible to claim the deduction.

Court orders and written agreements, made after April 1997, providing for spousal support should be registered at CRA.

2.3.2 Personal Credits

By virtue of subsection 118(5) of the Income Tax Act, the payor spouse is prevented from claiming any personal credits such as the married status credit, the wholly dependent person credit, the single status credit, or dependants credit, to name a few, if the payor spouse claims the deduction available under paragraph 60(b) for spousal support payments.

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129 Suzuki, supra note 75 at 40.
130 M.N.R., “Guide P102(E) Rev. 04”, supra note 80 at 8. Registration can be done by completing and submitting Form T1158, Registration of Family Support Payments, in addition to a copy of the order or agreement.
131 Income Tax Act, supra note 2 at s. 118(5)(b).
Moreover the payor spouse will be denied personal credits if he or she is required to pay support and is living separate and apart, due to the breakdown of their marriage, from the recipient spouse throughout the entire year.\textsuperscript{132} It is important to note that regardless of whether the payor spouse is actually making the payments or not, he will be denied any personal credits if he is required to pay support amounts and is living separate and apart from the recipient spouse.\textsuperscript{133} As the legislation expressly states that the payor spouse will be denied claiming any personal credits if he or she has lived separate and apart from the recipient spouse "throughout the entire year",\textsuperscript{134} it has been noted that in the year of marital breakdown, where the individuals were still together for a portion of the year before the dissolution of the marriage, the payor spouse will be eligible to either claim a personal credit in subsection 118(1), or to take the deduction in paragraph 60(b), whichever is more economically profitable for the payor spouse.\textsuperscript{135}

\section*{2.4 LEGAL FEES}

Legal fees will generally be deductible where two elements exist.\textsuperscript{136} First, the legal fees cannot be expenditures of a capital nature. Moreover, the legal fees must be incurred during a process where there is an intention of collecting “income from a business or

\textsuperscript{132} Ibid. at s. 118(5)(a).
\textsuperscript{134} Income Tax Act, supra note 2 at s. 118(5)(a).
\textsuperscript{135} M.N.R., “IT-530R”, supra note 73 at para. 35.
Thus, in the context of legal fees incurred with respect to spousal support payments, an important distinction must be drawn between expenses which are considered as personal or living, which are non-deductible as they are not incurred for the purpose of earning income, and expenses incurred to establish legal rights as they are capital in nature, as opposed to legal expenses incurred to enforce a pre-existing right to income, which are neither personal nor capital in nature. The rules regarding deductions of legal fees incurred for support payments have fluctuated greatly over the years, with significant cases shaping this area of law.

In the case of *The Queen v. Burgess*, Ms. Burgess sought to deduct legal fees that she had incurred, during divorce proceedings, for the purpose of obtaining support payments. She contended that her right to support was a property right and as her legal fees were incurred for the purpose of producing income from her property right, such fees should be deductible under paragraph 18(1)(a) of the *Income Tax Act*. In denying her claim, the Trial Division of the Federal Court differentiated between the right to maintenance, which existed throughout the duration of the marriage, and the right to maintenance following marital dissolution. The court held that the entitlement to support following the breakdown of marriage was not a guaranteed right as “the right to bed and board and the right to pledge the husband’s credit both end with the dissolution of the relationship”.

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137 *Income Tax Act*, *supra* note 2 at s. 18(1).


140 *Ibid.* at paras. 6-7.

conclusion, the court held that the right for support following the breakdown of a marriage was a new right which was to be granted upon the court’s discretion. Therefore, it was held that legal fees incurred for the establishment of a new right, as distinguished from an existing right, for such support was capital in nature and thus not deductible.

From the Burgess case, it was clearly established that legal fees incurred for establishing a new right, such as spousal support payments, were not deductible. However, this line of reasoning was brought into question in the case of Gallien v. The Queen. In the Gallien case, the taxpayer was denied deduction of legal fees incurred for obtaining support payments following the breakdown of her marriage. The taxpayer argued that she had paid the legal fees, not to acquire capital, but rather in an attempt to gain income. In response, the Minister relied upon the Burgess case to argue that establishing a right to support was a capital expenditure, thus any legal fees incurred for this purpose would not be eligible for deduction under paragraph 18(1)(b) of the Income Tax Act.

Justice Lamarre Proulx found that entitlement to support following the breakdown of a marriage did indeed exist, as governed by the Divorce Act and provincial legislation, stating, “the judge does not create the right. It was created by legislators”. Justice Proulx went further to say that rather than creating the right to support, judges ascertain whether the post-marital financial circumstances warrant support payments to be made and if so, the quantum of such payments are determined under the judge’s discretion. On this reasoning, the court held that legal fees incurred to obtain spousal support payments were deductible. It

143 Ibid. at para. 21.
was also stated in *obiter* that in the event the right to support following marital dissolution was not a pre-existing right and had to be created, the creation of such a right may not “necessarily [be] of a capital nature” as it must be determined whether such a right is associated to the individual’s capital.\textsuperscript{144}

Currently, CRA considers all legal fees incurred for obtaining spousal support “under the *Divorce Act* or under the applicable provincial legislation in a separation agreement” as deductible as such entitlement is pre-existing.\textsuperscript{145} It is important to note, however, that the deductibility of such legal fees will only apply to tax assessments taking place after October 10, 2002.\textsuperscript{146} Furthermore, legal fees paid by the recipient spouse in an attempt to defend the quantum of support will also be deductible as no new entitlement is sought in such an instance.\textsuperscript{147}

It is interesting to note that the jurisprudence has been consistent in holding that legal fees that are incurred by the payor spouse are never deductible.\textsuperscript{148} The deductions for legal fees surrounding support payments are only available to the recipient spouse, because the recipient spouse is obtaining income from which the legal costs can be deducted.\textsuperscript{149} However, legal fees incurred with respect to support payments may not be deductible by the

\textsuperscript{144} *Ibid.* at para. 23.


\textsuperscript{146} Syrtash, *supra* note 95 at B15.

\textsuperscript{147} M.N.R., “TN 24", *supra* note 145 at 1.


payor or the recipient, in other situations. For example, legal fees will never be deductible by payor spouses where they are defending applications to pay support payments to their former spouse or common-law partner as such expenses are considered to be personal or living expenses.\textsuperscript{150} The same holds true for legal fees by payor spouse for negotiating support payment agreements.\textsuperscript{151} Moreover, legal fees paid for the obtaining of a support payment, which is in the form of a lump sum, will not be deductible due to the fact that such a payment does not qualify as a support amount, as defined in the \textit{Income Tax Act}.\textsuperscript{152}

On a practical note, only legal fees that have been paid, not payable, will be deductible thus providing a tax planning opportunity as deductions will only be made in the year that the fees are paid.\textsuperscript{153} In this light, it has been noted that lawyers should prepare detailed fee statements for their clients and should clearly note the amount of fees paid for spousal support on the statement.\textsuperscript{154}

### 2.5 Evaluation of Inclusion/Deduction System

As previously mentioned the government recognizes financial difficulties may arise upon the breakdown of marriage and provides a tax benefit in the form of taxing spousal support payments under the inclusion/deduction system. The rationale is that the tax benefits

\begin{itemize}
  \item \textsuperscript{150} McGowan v. Canada, [2005] T.C.J. No. 21 (QL).
  \item \textsuperscript{151} M.N.R., "IT-99R5-CONSOLID", supra note 136 at para. 21.
  \item \textsuperscript{152} Sabour v. Canada, [2001] T.C.J. No. 783 (QL).
  \item \textsuperscript{153} Michael Ganley “Legal costs of obtaining spousal support now deductible” \textit{The Lawyers Weekly} 3:13 (16 May 2003), 13. As suggested by Elizabeth Jollimore, a family law specialist, if a client is billed in two separate taxation years, it may be more advantageous for the client to pay both of the bills in the second taxation year so as to take advantage of the combination of both of the deductions, thus creating a greater tax reduction.
  \item \textsuperscript{154} Neilson, supra note 149 at 36.
\end{itemize}
will allow for greater resources between the payor and recipient spouses. However, upon closer analysis, the tax advantages afforded to separated or divorced couples through the inclusion/deduction system may not alleviate the economic hardships suffered by those most in need, as the payor spouse, who is generally in a better financial position than the recipient spouse, is favored through this system.

The bias against the recipient spouse through inclusion/deduction is clearly evident in considering the underlying presumption of the system that the divorced or separated couple is a single unit. That is, the inclusion/deduction system does provide tax savings, but only the payor spouse, and not the unit as a whole, benefits from a tax perspective, while the recipient spouse has to bear the burden of paying taxes on the support payments. Thus, it can be seen that the so-called tax savings are only accorded to the payor spouse.

While at first glance, the notion that the recipient spouse pays taxes on support payments that they receive does not seem unreasonable, the social reality of the financial consequences arising out of marital dissolution should be considered. It has been observed that men are more likely to be the payor spouse while women are generally the recipient of support payments. In a survey conducted on support payments in Canada between 1998 and 2003, it was found that husbands were the payor spouse of spousal support in an overwhelming 98.7% of the cases. Moreover, as previously discussed, divorce is a cause of poverty, especially amongst women. While the figures vary from study to study, it has

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156 Mandell & Duffy, supra note 13 at 245.
been found that in general, women’s household income significantly decreases in comparison to men’s, following divorce.\textsuperscript{157}

Thus, the problem is that spousal support payments are intended to alleviate financial difficulties arising out of marital dissolution; however, the recipient spouse, who generally requires the use of the support payment in its entirety, does not gain the benefit of the full payment because of income tax on the amount under the inclusion/deduction system. Matters worsen when the recipient spouse is on the borderline between marginal tax brackets. Including the spousal support payments into taxable income may push the recipient spouse into a higher tax bracket, thus imposing tax at a higher rate because of the support payment.

Although it may be argued that such tax consequences should be taken into consideration when determining the amount of spousal support, the reality is that tax consequences often can be overlooked. This concern was clearly voiced by Justice McLachlin in the decision of \textit{Thibaudeau v. Canada}, as follows:

\begin{quote}
The evidence indicates that in practice the family law regime does not and cannot succeed in rectifying the inequality created by the deduction/inclusion scheme. Tax impact is not always considered by the courts and, when it is, the adjustment is often insufficient to cover the additional tax which the custodial parent must pay as a result of being subject to the deduction/inclusion scheme.\textsuperscript{158}
\end{quote}

\textsuperscript{157} Ambert, \textit{supra} note 14. The report has cited numerous studies which support the assertion that women’s standard of living decrease after divorce in comparison to men’s.

\textsuperscript{158} \textit{Thibaudeau, supra} note 121 at para. 197.
Justice McLachlin's observations are further supported by empirical data collected by Glenn Feltham and Alan Macnaughton in their study of tax consequences and support payments.\textsuperscript{159} It was found that even when courts had taken tax consequences into consideration before granting support, recipient spouses did not benefit from the use of the deduction/inclusion system as courts generally failed to adequately gross-up the payments to cover the amount of income tax payable by the recipient because of the support payment. Furthermore, in commenting on the old taxation regime of child support, it was said that "the tax factor was applied inconsistently, unfairly and, sometimes, not at all".\textsuperscript{160} Although this observation was made in the context of child support payments, it can be inferred that courts also fail to appropriately take into consideration tax consequences arising from the deduction/inclusion system in the granting of spousal support. Thus it can be seen even when tax consequences are taken into consideration in the granting of support, the recipient spouse still bears the tax burden.

This distinction between tax and family law often leads to adverse consequences for individuals undergoing divorce. For example, there have been cases in which legal counsel have actually been criticized by judges for overlooking tax issues in the drafting of separation agreements.\textsuperscript{161} This may be due, in part, to the fact that "many divorcing couples rely on the

\textsuperscript{159} Glenn Feltham & Alan Macnaughton, "Who Benefited from the Deduction-Inclusion Regime for Taxing Child Support?" (1999) 47:6 Can. Tax J. 1479 at 1499. While the effect of the deduction/inclusion system was considered through the lens of child support payments in this article, the observations made can be generalized to the effect of the deduction/inclusion system on spousal support payments.

\textsuperscript{160} Stephen M. Grant, "Family Valuations" CA Magazine 130:7 (September 1997) 14 at 16 [Grant, "Valuation"].

\textsuperscript{161} Kirby, supra note 39 at 38.
assistance of general practitioners who lack tax expertise.\textsuperscript{162} However, the lack of tax expertise has also been exhibited by the judiciary where tax court judges have criticized fellow members of the judiciary for granting divorce orders that simply cannot conform to tax legislation.\textsuperscript{163} This result may arise because the judicial system has a tendency to classify an issue as either a “family law” issue or an issue to be dealt with through the tax system.

A second illustration of the tax legislation’s lack of consideration of the social realities surrounding the breakdown of marriage lies within the presumption that the recipient spouse falls into a lower marginal tax bracket. In today’s society, more than ever before, there is an increased prevalence of dual-earner families, with a rising percentage of women being considered as the primary wage earner.\textsuperscript{164} The policy objective behind the inclusion/deduction system is to reduce financial difficulties realized upon the breakdown of a marriage. However, the tax benefit accorded through the use of this system is not enjoyed by all those individuals undergoing marital dissolution.

Where the recipient spouse is taxed in a higher tax bracket than the payor spouse, instead of realizing a tax savings, the inclusion/deduction system actually imposes a greater amount of tax. Such a consequence arises due from income splitting, whereby the support payment is taxed at the recipient’s tax rate. The presumption underlying the


\textsuperscript{163} Kirby, supra note 39 at 38.

\textsuperscript{164} Human Resources and Skills Development Canada, Canadian Gender Trends in Education and Work (1999), online: HRSDC <http://www11.hrsdc.gc.ca/en/cs/sp/hrscd/arb/publications/research/1999-002380/page08.shtml>. In 1967, only 11% of dual earning families had women acting as the primarily income earner. This percentage significantly increased to 24% of women being considered as the primary earner in 1996.
inclusion/deduction system that the payor spouse falls into a higher marginal tax bracket than
the recipient spouse is also problematic where the payor and recipient spouse actually are
taxed in the same tax bracket. No tax benefit will be accorded through the
inclusion/deduction system as any form of income splitting will be ineffective in providing
tax savings. Although the inclusion/deduction system only truly provides a tax benefit to the
payor spouse, on the odd occasion that the payor spouse opted to share this benefit with the
recipient spouse, those recipient spouses not falling into a lower tax bracket than their
counterpart would not even have the possibility of this option available to them.

While no tax savings are realized through the inclusion/deduction system where the
recipient spouse does not have a lower tax rate as compared to the payor spouse, of more
concern is the disparity in the application of the inclusion/deduction system. Consider, for
example, a payor spouse, earning $70,000 of annual income, who is ordered to pay spousal
support payments to the recipient spouse, who earns $40,000 a year. This couple, in which
both individuals have relatively high incomes, will be able to take advantage of the tax
savings offered by the inclusion/deduction system. In contrast, imagine a scenario where
both the payor and recipient spouses earn $25,000 annually. This lower earning couple
would not be able to benefit from the inclusion/deduction system as both individuals fall in
the same tax bracket.

The tax legislation's ability to provide a tax benefit to a potentially higher income
family, while denying the same benefit to a lower income family, both of which are
undergoing marital dissolution, is irreconcilable, especially when taking into consideration
the Income Tax Act's policy objectives of equity and fairness. That is, in looking at the
ability of an individual to pay, the equity objective advocates for individuals in similar circumstances to be taxed in a similar manner. Thus individuals undergoing the breakdown of a marriage, regardless of their income levels, should be able to take advantage of any tax savings afforded to them.

It has been observed that a class bias is inherent within the inclusion/deduction system, as it currently operates. More specifically, the tax benefits derived through the use of this system depends directly upon the quantum of support payments as well as the marginal tax rate of the payor spouse. The tax saving realized through the inclusion/deduction system is directly proportional to the payor spouse’s marginal tax rate. Thus, as an individual’s marginal tax rate increases, so will their tax benefits derived through the deduction provided for the payment of spousal support. The Income Tax Act’s decision to provide the greatest value in tax savings to those individuals with the highest income once again brings into question equity and fairness, objectives espoused within the tax legislation. In fact, in view of the vertical equity principle endorsed by the Income Tax Act, it is arguable that such tax savings should be more readily accessible to lower-income individuals or those living in or near poverty as compared to high income individuals.

2.6 CONCLUSION

From the above evaluation of the inclusion/deduction system, it is clearly evident that the taxation legislation pertaining to spousal support payments does not take into account many of the social realities surrounding families and the breakdown of marriage. The irony

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in the granting of a deduction to the recipient spouse for legal fees incurred with respect to support payments while simultaneously placing the tax burden of such support payments on the recipient spouse is a classic example of the tax legislation's oversight of the financial consequences suffered by individuals upon divorce. The allowance for such deduction of legal fees most likely is not commonly known by divorcing individuals. On divorce, many individuals suffer from poverty or a significantly reduced income and thus are in dire need of the support payments. The irony lies in the fact that since these individuals will generally not have the resources available to retain a lawyer, who can impart the knowledge of the availability of such deductions, their chances of obtaining a fair and reasonable support order are minimized. Moreover, if they do attain some form of spousal support, the onerous responsibility of paying tax on these payments falls on their shoulders.

In attempting to find a remedy or solution for this problem, many conflicting policy objectives will have to be addressed. For example, if an intricate taxation scheme is designed, based on providing various levels of relief depending on the recipient spouse's taxable income, issues of compliance and enforcement would have to be dealt with and may actually prove to be more costly and inefficient for the government. Even in the instance where the Income Tax Act includes a provision to provide for an equal sharing of the tax benefit conferred upon the payor spouse between the former spouses, once again, concerns surrounding compliance and enforcement arise. While the motive for providing any tax benefit at all to individuals who have undergone the divorce process may be questioned, the possibility of eliminating the inclusion/deduction system, and any resulting tax savings, also seems to be a solution which may result in more turmoil than resolution. That is, if the payor spouse is compelled to pay taxes on the spousal support amount, there may be less incentive
for the payor spouse to actually comply with the support order, thus resulting in more financial difficulties for the recipient spouse.

While maintaining the use of the inclusion/deduction system, one possible solution would be to provide a spousal support credit to the recipient spouse. The utilization of such a credit would reduce the recipient spouse’s taxes payable. One of the policy objectives underlying the granting of credits includes the recognition of an individual’s ability to pay tax. The utilization of a credit would be preferable over providing a deduction for the recipient spouse as the value of a deduction varies according to the recipient spouse’s tax rate, with the value of the deduction increasing as the tax rate increases. On the other hand, the tax savings achieved through the use of a credit remain the same, irrespective of recipient spouse’s tax bracket, thus allowing for an equitable treatment for parties to the breakdown of a marriage.

Although it may be argued that spousal support payments are personal in nature and thus non-deductible, it is important to note that the tax system does recognize that support payments are extraordinary expenses that reduce the payor spouse’s ability to pay, hence the utilization of the inclusion/deduction system. Conversely, such reasoning should be applied to the recipient spouse, after taking into consideration the financial consequences suffered as a result of divorce. Granting such a credit to the recipient of spousal support would help alleviate the tax burden placed on them through the inclusion/deduction system, thereby allowing the recipient spouse to maximize the use of their spousal support payments.

Royal Commission Report, supra note 42 at 11. As noted in the Report, it is important for the tax system to take into consideration "special responsibilities", such as onerous medical expenditures and education costs, which affect the taxpayer’s ability to pay.
While it may be contended that income support for the lower-income spouse may be achieved directly through social programs rather than indirectly through the taxation system, it is maintained that the issue of unintended tax consequences placed on the recipient spouse should be resolved within the taxation system. That is, if the recipient spouse does not enjoy the full benefit of their spousal support payment because of an additional tax burden, resulting in lower levels of disposable income, addressing the issue of income assistance through the social system would in effect be shifting the burden of a problem created by the tax system. Therefore, providing the recipient spouse with a tax credit would allow the tax system to internally deal with any inequalities arising from its application. In providing a credit to recipient spouses, many complex issues would have to be addressed, such as the duration or the amount of the credit. While it is not reasonable, nor feasible, to suggest that the spousal support credit cover the entirety of the support payment, the actual amount of the credit, as well as its duration, should be determined after taking into consideration the weight that divorced individuals put on the various institutions within the social system on a long-term basis.
CHAPTER 3

THE EVOLUTION OF CHILD SUPPORT TAXATION

3.1 BACKGROUND

Child support can be a major issue on the breakdown of marriage. It is significant as children are often the victims of marital dissolution. Child support payments attempt to ensure that children are not subjected to serious financial suffering as a consequence of marital breakdown. Until recently, the granting of child support payments was left largely to the discretion of judges, and uniformity was lacking. For this reason Parliament decided that a framework was required, not only for consistency purposes, but also to ensure that fair treatment was accorded to the children in terms of child support.

Thus, the Federal Child Support Guidelines came into force on May 1, 1997, requiring all child support payments pursuant to orders or agreements made after April 1997 to comply with the Guidelines. The mandatory Guidelines provide a mechanism to determine the quantum of child support payments, taking into consideration the income level

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167 Minister of Public Works and Government Services Canada, *A Guide to the New Approach* (1997), online: Department of Justice Canada <http://canada.justice.gc.ca/en/ps/sup/pub/jag/approa.html> [Minister of Public Works and Government Services Canada, *New Approach*]. The Federal Child Support Guidelines will also apply in the situation where the court order or agreement for child support was made before May 1997 and either the recipient or payor spouse applies to vary the quantum of the payment. Moreover, as the Guidelines are encompassed within the *Divorce Act*, they will not apply to child support orders made between separated or common-law couples.
of the payor spouse,\textsuperscript{168} number of children, custody arrangements, and the province of residence of both the payor and recipient spouses.\textsuperscript{169} Additionally, special expenses, such as child care or extracurricular expenses, will also factor into the determination of the amount of child support required.

Taking these factors into consideration, the amount of child support payments can be ascertained by reference to the appropriate tables within the Guidelines. While it is acknowledged by the government that “there is no single fixed cost of raising a child”, the amounts established by the Guidelines have been premised on the percentage of income that parents allocate to their children, irrespective of the level of income earned by the family.\textsuperscript{170} Therefore, the amounts specified within the Guidelines are merely the average amount that a parent would contribute towards their child, within a specific income range of the payor spouse.

The rationale for enacting the Guidelines is two-fold.\textsuperscript{171} First, the Guidelines provide a relatively simple method for determining the amount of child support payments, thus aiming to reduce the cost and time invested by the former spouses in reaching agreement on

\textsuperscript{168} Grant, “Valuations”, supra note 160 at 16. It is of interest to note that only the payor spouse’s income, and not both the income levels of both the payor and recipient, is taken into consideration under the Federal Child Support Guidelines, bringing into question the fairness of the Guidelines.

Lorne H. Wolfson, “Creating Confusion” \textit{CA Magazine} 130:10 (December 1997) 36 [Wolfson, “Creating Confusion”]. Generally, the payor spouse’s income will be taken directly from line 150 of his or her tax return.

\textsuperscript{169} Minister of Public Works and Government Services Canada, \textit{New Approach}, supra note 167.

\textsuperscript{170} \textit{Ibid}.

\textsuperscript{171} \textit{Ibid}.
the quantum of the payment.\textsuperscript{172} Moreover, the Guidelines promote the principle of the best interest of the child by attempting to guarantee an appropriate amount of financial support from both parents following the breakdown of marriage. This is evident from the statement in the Federal Child Support Guidelines that prominence should be accorded to child support, in comparison to spousal support payments. Thus, in the event that a significant child support amount has been awarded, a correspondingly reduced amount of spousal support will likely be ordered.\textsuperscript{173}

Some issues arising out of utilization of the Federal Child Support Guidelines need to be addressed. For example, while the Guidelines have eliminated a great deal of judicial discretion that was previously exercised in the arena of child support, the area of retroactive child support payments still remains vague and uncertain.\textsuperscript{174} Moreover, the Guidelines are a controversial attempt at providing a standardized formula to determine the amount of child support payments after taking into consideration various factors. Attacking the Guidelines as

\textsuperscript{172} Wolfson, "Creating Confusion", supra note 168 at 37. While the Federal Child Support Guidelines have been enacted to simplify the process for determining child support payment amounts, it has been observed that the Guidelines require complicated tax calculations to be made, which require the aid of tax professionals, in all but the simplest cases.

\textsuperscript{173} Philip M. Epstein, "The Federal Child Support Guidelines and New Income Tax Rules" (1996) 6 Can. Current Tax 103; Wolfson, "Creating Confusion", supra note 168 at 50. The corresponding reduction in spousal support payments may have long term effects on the poverty levels of custodial parents, especially after their children leave and the child support payments stop.

\textsuperscript{174} The issue of retroactive child support payments was examined in the Alberta Court of Appeal decision of \textit{D.B.S v. S.R.G.}, [2005] A.J. No. 2, 249 D.L.R. (4th) 72 (QL) (Alta C.A.) at paras. 68-94. Despite the arguments made that retroactive support orders were unfair to the payor spouse as a "presumption [existed] that court orders are correct", the Alberta Court of Appeal held that "child support awards are not immutable and variation on a regular basis constitutes the intended norm, not the exception". Paperny J.A. supported his reasoning on the basis that children are entitled to support from both of their parents and as the child's entitlement to support is determined from the payor's income, under the Federal Child Support Guidelines, the amount of support payments should vary with changes in the payor's income level. An application for leave to appeal to the Supreme Court of Canada was granted for this case, which will heard with \textit{Henry v. Henry}, [2005] S.C.C.A. No. 118 (QL) and \textit{L.J.W. v. T.A.R.}, [2005] S.C.C.A. No. 101 (QL).
discriminatory towards fathers, a lawsuit has been filed against the government in December 2002. In the lawsuit A.B. and G.H. v. Her Majesty the Queen, the Federal Court has been asked to strike down the Federal Child Support Guidelines, based on the contention that they violate fathers’ rights to equality, as guaranteed under the Charter of Rights and Freedoms (the “Charter”). It has been suggested that the current Guidelines should be replaced by a system that respects the role of fathers as parents. In support of this contention, it is alleged that the formula utilized by the Guidelines to determine the amount of child support is not based on a realistic assessment of the cost of raising a child, thereby imposing unduly burdensome payments. Such onerous payments are generally placed upon fathers, as fathers pay support in approximately ninety percent of child support cases. Furthermore, the lawsuit alleges that the Guidelines have an adverse effect on fathers as they exclude the payor spouse from any financial decision making regarding the children.

Until the Federal Court rules on the constitutionality of the Guidelines in the A.B. and G.H. v. Her Majesty the Queen case, they remain the overriding method utilized to determine the quantum of child support payments. After the enactment of the Federal Child Support Guidelines, a study was conducted between 1998 and 2003 to determine the status of child support in Canada. In the study, it was found that in a majority of the cases, mothers were given sole custody of the children and correspondingly, in 92.8% of the cases, the

175 “Child support laws discriminate against fathers, Montreal lawsuit claims” Canada NewsWire (24 December 2002), online: LexisNexis Academic <http://web.lexis-nexis.com/universe/document?m=8837c4000cf58b89064940a2911fbeb685&docnum=1&wchp=dGLhVtb-zSKVb&_md5=06c57d8a2723b483b8c7526dd27e8dd58>.
responsibility of child support payments fell on the fathers.\textsuperscript{176} Moreover, it was observed that the median amount of child support paid on a monthly basis was $435.

It is clear that payments made under the Guidelines will unquestionably be labeled as “child support payments” within the realm of family law. The definition of child support payments accorded under the \textit{Income Tax Act} as well as the tax treatment of such payments are less certain, however, and is discussed in the pages that follow. Furthermore, the taxation scheme applied to legal fees incurred with respect to child support payments is evaluated prior to undertaking a critical analysis of the case of \textit{Thibaudeau v. Canada}.\textsuperscript{177} Finally, the current tax system applied to child support payments is scrutinized to identify any weaknesses.

\section*{3.2 Child Support Definition within \textit{Income Tax Act}}

Child support payments elicit attention from Canadian tax legislation. The \textit{Income Tax Act} defines “child support amount” as any support amount under a court order or written agreement that has not specifically been designated as a spousal support payment.\textsuperscript{178} Hence, in addition to the criteria required to qualify as a support amount, as examined in the preceding discussion of spousal support, support payments intended for a child must be expressly labeled as such. The definition of child support amount is important as child support payments and spousal support payments receive different tax treatments. That is, if an order or agreement provides for one support payment, accounting for both spousal and

\begin{flushright}
\textsuperscript{176} Bertrand \textit{et al.}, supra note 155.
\textsuperscript{177} \textit{Thibaudeau}, supra note 121.
\textsuperscript{178} \textit{Income Tax Act}, supra note 2 at s. 56.1(4).
\end{flushright}
child support and this intention has not been qualified, from a tax perspective, such a support amount is considered entirely as child support and taxed accordingly.\textsuperscript{179} Similarly, third party payments are considered as child support unless it is expressly stated in the order or agreement that such payments are intended for the sole benefit of the spouse.\textsuperscript{180}

3.3 TAXATION OF CHILD SUPPORT PAYMENTS

3.3.1 History

The year 1997 marked significant changes to child support. Not only did the Federal Child Support Guidelines come into effect on May 1, 1997, but also a new regime for the taxation of child support was put into place.\textsuperscript{181} From 1917, when the income tax was introduced, until 1942, child support payments were neither deductible by the payor nor taxable to the recipient parent. Since 1942, child support payments were subjected to an inclusion/deduction taxation system whereby the payor was able to deduct any child support amounts paid to the recipient. The policy reason behind the system was to utilize the tax benefits produced by income splitting, thus allowing for a tax savings which, in theory, would result in higher child support payments.\textsuperscript{182} The inclusion/deduction system most


\textsuperscript{180} M.N.R., “IT-530R”, supra note 73 at para. 6.

\textsuperscript{181} Paul Millar & Anne H. Gauthier, “What Were They Thinking? The Development of Child Support Guidelines in Canada,” online: Fathers are Capable Too <http://www.google.ca/search?hl=en&ie=ISO-8859-1&q=what+were+they+thinking+child+support+guidelines&meta=>.

certainly came at a price. It has been estimated that the government lost $300 million of revenue annually, because of this system.\textsuperscript{183}

However, effective May 1, 1997, the tax treatment accorded to child support payments was amended so that payments made pursuant to agreements made after this date would not be taxed under the inclusion/deduction system. That is, the payor spouse is no longer able to deduct child support payments and correspondingly, payments are no longer included into the recipient spouse’s income. While it may be argued that the impetus for changing the tax treatment was primarily due to the workings of a task force, which was established to examine the various issues surrounding child support payments, many have contended that the real motive for amending the taxation scheme arose from the Supreme Court of Canada’s decision in the case of Thibaudeau v. Canada (M.N.R.).

In the Thibaudeau case, the taxpayer, a single divorced mother receiving child support payments, claimed that she was being unfairly taxed on child support payments while the father received corresponding deductions.\textsuperscript{184} Not only did Ms. Thibaudeau bear the tax burden of the child support payments on her, but also in determining the quantum of child support payments, tax consequences were not accounted for, thus making the utilization of the inclusion/deduction system more onerous for her. Furthermore, her former husband did not share the tax savings resulting from the taxation scheme applied to child support payments.

\textsuperscript{183} \textit{Ibid.}

\textsuperscript{184} Thibaudeau, supra note 121 at para. 71.
In making her case, Ms. Thibaudeau claimed that the tax burden fell unduly heavily on the recipient spouse and that in comparison, married couples were not subject to a transfer of tax liability between spouses through the taxation system. Ms. Thibaudeau further argued that the utilization of the inclusion/deduction system for taxing child support payments actually resulted in higher taxes payable for the thirty percent of separated or divorced couples in which the recipient fell into a higher marginal tax bracket than the payor. Thus, Ms. Thibaudeau alleged that the inclusion/deduction scheme within the *Income Tax Act*, as applied to child support payments, violated subsection 15(1) of the *Charter of Rights and Freedoms*.

Ultimately, a majority of the Supreme Court of Canada held that the paragraph 56(1)(b) inclusion provision within the *Income Tax Act* did not infringe subsection 15(1) of the *Charter* as such tax consequences should be taken into consideration in the process of determining the support amount. The majority of the Court went held that the disproportionate tax savings were realized between the payor and recipient spouses also did not result in a *Charter* violation. In coming to this decision, the court was divided 5:2, along gender lines, with all five male judges finding no *Charter* violation, with dissenting opinions presented by both of the female judges on the panel.

In finding that the inclusion provision in paragraph 56(1)(b) did not violate the *Charter* guarantee of equality, Justices Cory, Iacobucci and Gonthier made reference to the fact that the inclusion/deduction system helped to alleviate the economic burden arising out

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of marital dissolution, through income splitting, and in fact, was a benefit bestowed upon the payor and recipient by the tax system through this tax savings.\textsuperscript{187} The extra resources available through this tax savings would in turn benefit the children. Another common theme between the judgments of Justice Gonthier and Justices Cory and Iacobucci was the prominent role of the family law system in the allocation of these resources and in remedying inequality that may arise with respect to support payments.\textsuperscript{188} It was noted that such roles did not fall within the realm of taxation law, but rather that of family law.

Two strong dissenting opinions were presented by Justices McLachlin and L’Heureux-Dubé.\textsuperscript{189} Both opinions recognized and acknowledged that the inclusion/deduction system, while providing an overall tax benefit, truly only benefited the payor while an onerous tax burden was placed on the recipient. Justice McLachlin also noted that the tax consequences surrounding support payments are not always taken into consideration by courts, and that family law does not provide a remedy for inequalities. This reasoning was supported by Justice L’Heureux-Dubé, who also stressed the family law system’s inability to remedy injustices resulting from the misallocation of tax benefits realized through the use of the inclusion/deduction system.

Recognizing that the issues in this case were of concern to the public at large, the government established a task force to examine the various matters surrounding the taxation

\textsuperscript{187} Ibid. at paras. 94, 158.

\textsuperscript{188} Ibid. at paras. 137, 141, 160.

\textsuperscript{189} Ibid. at paras. 2-64, 166-248.
of child support payments. It is interesting to note that the task force was created before the Supreme Court of Canada had handed down its decision in *Thibaudeau*. The task force held meetings across Canada before recommending that the inclusion/deduction system no longer be applied as the method of taxing child support payments. The change in taxation of child support payments was introduced in the federal budget, presented on March 6, 1996.

### 3.3.2 Current Taxation Scheme

The rules for the taxation of child support are applicable to agreements or orders made after April 30, 1997. That is, the recipient spouse does not include child support payments in their income and the payor spouse is not able to deduct the amount paid. According to the CRA, the new taxation scheme can also be applied to a variety of situations in which the court orders or written agreements were made prior to May 1997. For example, the payor and recipient spouse can either jointly elect, using the Form T1157, entitled “Election for Child Support Payments,” not to have the inclusion deduction system apply or the order or agreement can specify that child support payments made after a certain date.

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190 Faye Woodman, “Tax Aspects of the New Child Support Guidelines: One Year Later” (1998) 15 Can. J. Fam. L. 221. The Liberal government, which was in power at the time, established this task force. Sheila Finestone, Secretary of State (Status of Women), chaired the task force.

191 Epstein, *supra* note 173 at 103. Despite the announcement that a new tax system for child support would be effective as of May 1, 1997, from a practice standpoint, there was concern as to the drafting of separation agreements and order made between the announcement of the implementation of a new tax system in 1996 and the actual enactment of the new taxation system. The concern that there would be a delay in implementing the new taxation scheme arose both at a federal and a provincial level. Therefore, practitioners drafting interim agreements and orders were cautioned to not specify the date May 1, 1997 in their agreements, but rather to use specific language indicating that the terms of the agreement or order would change upon the implementation of the new child support payments taxation scheme.

192 Syrtash, *supra* note 95 at B15.

193 Martin S. Pont & Julie K. Hannaford, “Cross-Border Support Payments” (2004) 19 Money & Fam. L. 37. Under the tax treaty between Canada and the United States of America, support payments usually elicit the same tax treatment. Thus, cross-border child support payments are not subjected to the inclusion/deduction system in either of the countries.
should be taxed under the new regime.\textsuperscript{194} In addition, variations to or the making of subsequent orders or agreements after April 1997, in which the quantity of child support payment is modified, will also qualify for the new regime of taxing child support payments.

Many tax provisions dealing with child support payments make reference to the "commencement date" of the court order or written agreement.\textsuperscript{195} As noted by CRA, child support payments paid pursuant to agreements that contain commencement dates will not be subjected to tax under the inclusion/deduction system, while conversely, child support paid under orders and agreements that do not contain a commencement date will be taxed under this system.\textsuperscript{196} Subsection 56.1(4) provides a definition for the term "commencement date", which correlates directly to the date on which the order or agreement was made. Commencement dates of orders and agreements can only take place after April 1997.

For agreements or orders made after April 1997, under the new child support taxation regime, the commencement date is simply the date on which the order or agreement is made.\textsuperscript{197} With respect to court orders, it is important to note that the commencement date is the date on which the order is rendered, which may differ from the date that the order takes legal effect.\textsuperscript{198} The determination of the commencement date for agreements or orders made previous to May 1997 tends to be more complex, however. For such orders and agreements,

\textsuperscript{194} M.N.R., "IT-530R", supra note 73 at para. 2.
\textsuperscript{195} References to the commencement date of an order or agreement pertaining to child support payments can be found in ss. 56(1)(b), 56.1(3), 60(b) and 60.1(3) of the \textit{Income Tax Act}.
\textsuperscript{196} M.N.R., "IT-530R", supra note 73 at para. 7.
\textsuperscript{197} \textit{Income Tax Act}, supra note 2 at s. 56.1(4).
\textsuperscript{198} M.N.R., "IT-530R", supra note 73 at para. 7.
the commencement date will be the *earliest* date taking place after April 1997, of the following: date stated in the joint election; the date of a subsequent agreement made to vary the quantum of the child support payment; the date listed as the commencement date in the order or agreement; and for an agreement or order which has had its child support amount varied, the date when the first payment is made.\(^{199}\) It is important to note that court orders or agreements that have provided for changes in the amount of child support payments, for example, by taking into account the cost of living, will not qualify as a variation of the order or agreement to which a commencement date can be attached.\(^{200}\) In the instance where none of the above listed events occur, the order or agreement will not have a commencement date.

All court orders and written agreements made after April 1997, which provide for child support, should be registered with CRA using Form T1158, Registration of Family Support Payments.\(^{201}\) Additionally, orders and agreements made before May 1997 which provide that the child support payments not be subject to the inclusion/deduction system after May 1997 or orders and agreements which have had the quantum of the child support amount varied after April 1997 should be registered with CRA.\(^{202}\) Similarly, where subsequent orders have been made or agreements have been entered into after April 1997 by the payor and recipient, resulting in the variation of the child support amount, but the original order or agreement remains valid, both the original and varying agreements and orders should be registered with CRA.

\(^{199}\) *Income Tax Act*, *supra* note 2 at s. 56.1(4).

\(^{200}\) M.N.R., “IT-530R”, *supra* note 73 at paras. 7-8.


While child support payments made on or after the commencement date are taxed under the new regime, it is important to remember that child support payments not falling within this category as well as spousal support payments are still included in the recipient’s income and deductible by the payor. Despite the non-deductible nature of child support payments made pursuant to orders and agreements after May 1997, the formula for calculating the deduction in paragraph 60(b) requires the full payments of these child support amounts before the payor spouse is eligible to claim the maximum deduction available (refer to Appendix 1). An example demonstrating the effect of the commencement date as well as the deduction mechanism follows.

EXAMPLE: Christopher and Alexandra signed a written separation agreement on January 1, 1997, in which Christopher was to pay $150 a month in spousal support and $200 a month for their daughter. Subsequently, Christopher and Alexandra jointly elected, using T1157 Election for Child Support Payments, to have child support payments paid after April 1997 excluded from the inclusion/deduction system.

ANALYSIS: The effect of signing the joint election is to have the commencement date of the written agreement become May 1, 1997. Thus, in 1997, child support payments made for the first four months would be deductible by Christopher in addition to the spousal support payments made for the entire year. However, child support payments made from May 1, 1997 to the end of the year would not be subjected to the inclusion/deduction scheme.
Christopher may claim deductions for the 1997 and 1998 years for support payments, calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total Support Payments Paid Since 1996</th>
<th>Total Child Support Payments Payable After Commencement Date</th>
<th>Total Deductions Previously Claimed Since 1996</th>
<th>Value of Deduction Claimable for Current Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>$350</td>
<td>$200</td>
<td>0</td>
<td>$4,200</td>
</tr>
<tr>
<td></td>
<td>x 12</td>
<td>x 8</td>
<td></td>
<td>-1,600</td>
</tr>
<tr>
<td></td>
<td>$4,200</td>
<td>$1,600</td>
<td></td>
<td>$2,600</td>
</tr>
<tr>
<td>1998</td>
<td>$4,200</td>
<td>$1,600</td>
<td>$2,600</td>
<td>$8,400</td>
</tr>
<tr>
<td></td>
<td>+4,200</td>
<td>+2,400</td>
<td></td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>$8,400</td>
<td>$4,000</td>
<td></td>
<td>-2,600</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$1,800</td>
</tr>
</tbody>
</table>

If Christopher defaulted on three child support payments in 1998, thus paying $3,600 (9 x $200 = $1,800 in child support and 12 x $150 = $1,800 in spousal support) in the year, his deduction under paragraph 60(b) is calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>Total Support Payments Paid Since 1996</th>
<th>Total Child Support Payments Payable After Commencement Date</th>
<th>Total Deductions Previously Claimed Since 1996</th>
<th>Value of Deduction Claimable for Current Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>$350</td>
<td>$200</td>
<td>0</td>
<td>$4,200</td>
</tr>
<tr>
<td></td>
<td>x 12</td>
<td>x 8</td>
<td></td>
<td>-1,600</td>
</tr>
<tr>
<td></td>
<td>$4,200</td>
<td>$1,600</td>
<td></td>
<td>$2,600</td>
</tr>
<tr>
<td>1998</td>
<td>$4,200</td>
<td>$1,600</td>
<td>$2,600</td>
<td>$7,800</td>
</tr>
<tr>
<td></td>
<td>+3,600</td>
<td>+2,400</td>
<td></td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>$7,800</td>
<td>$4,000</td>
<td></td>
<td>-2,600</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$1,200</td>
</tr>
</tbody>
</table>

As compared to the first example, it can be seen that the value of Christopher’s deduction in 1998, when he did not fulfill the child support obligation in the agreement, has a lesser value.
that if he had paid all of the support payments. Such a result is due to the fact that the formula in paragraph 60(b) takes into consideration the total support amounts paid while factoring in all child support amounts that are payable.

Child support payments made prior to the issuing of a court order or written agreement will not be considered as a “support amount”, as defined in subsection 56.1(4) of the Income Tax Act, as such payments have not been made pursuant to an order or agreement. However, subsections 56.1(3) and 60.1(3) provide that prior payments will be deemed to be made under the order or agreement if this is provided for. It is important to note, however, that only prior payments that have been made in the year of the order or agreement or in the preceding year fall within the scope of these sections, because of the significance of the commencement date and the fact that the order or agreement will be deemed to have been made at the time of the first payment. Thus, any order issued or agreement made in the year 1999 or later to recognize prior payments qualifies for the new taxation scheme applicable to the child support payments. That is, an agreement made in 1999 will account for prior payments made in that year and in 1998. Consequently, the commencement date for the agreement will be in 1998, resulting in the child support payments not being subjected to the inclusion/deduction taxation scheme, unless its application is expressly provided for.

3.4 LEGAL FEES

As previously discussed, the Income Tax Act allows deduction of legal fees incurred for the purpose of “producing income from a business or property” and not capital in

\[\text{Ibid. para. 24.}\]
nature. It has been established that legal costs incurred with respect to seeking spousal support will be deductible if the entitlement to such support is a pre-existing right. With the introduction of the Federal Child Support Guidelines in 1997, child support payments became an absolute statutory right. Thus, applying the reasoning utilized for determining the deductibility of legal fees for spousal support received, legal fees incurred in seeking child support should be deductible. However, the practice of deducting legal fees incurred for support, spousal or child, came into question in the case of *Bergeron v. The Queen*.

In the *Bergeron* case, the taxpayer incurred legal fees in defending against the recipient spouse’s contention to increase the amount of child support to be paid by him. The taxpayer’s attempt to deduct these fees was denied on the basis that the fees had not been paid for the objective of gaining income from either property or a business. The taxpayer appealed this assessment on the basis that the legal costs were an expense incurred to prevent paying a higher level of child support, thereby trying to maintain his income level.

In denying the taxpayer deduction of his legal costs, Justice Archambault noted that such costs incurred in the defence of the quantum of child support payments were personal in nature and no deduction was available for such expenses. More troubling to Justice Archambault, however, was the Minister’s argument regarding paragraph 18(1)(a) in the denial of the deduction. In determining whether the deduction in section 18 was applicable

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205 *Income Tax Act*, *supra* note 2 at s. 18(1).

206 Neilson, *supra* note 149 at 36.

207 *Bergeron v. The Queen* 99 D.T.C. 1265 (T.C.C.).


to legal fees incurred regarding support payments, Justice Archambault provided an analysis of the structure of the *Income Tax Act*.\(^{210}\) The judge observed that the *Income Tax Act* was organized such that income is separated into different sources, each governed by different subdivisions in the Act. Thus, the various types of income are calculated separately, using rules stipulated in their own respective divisions. From this line of reasoning, Justice Archambault questioned the validity of using the section 18 deduction, which was within the subdivision pertaining to income from business and property income, for expenses relating to income from support payments, which are categorized as “other income” within the Act. Furthermore, subdivision e of the *Income Tax Act*, entitled “Deductions in Computing Income” did not contain any specific reference to deducting legal fees incurred with respect to support amounts.\(^{211}\) Therefore, as the *Income Tax Act* contained no provision for deducting such legal fees, Mr. Bergeron was denied his deduction.

Justice Archambault then applied his line of reasoning beyond the facts of the *Bergeron* case and considered the general deductibility of legal fees incurred with respect to support amount.\(^{212}\) CRA had issued Interpretation Bulletin IT-99R-5, entitled “Legal and Accounting Fees”. As noted by Justice Archambault, the interpretation bulletin outlined the circumstances in which legal costs incurred regarding support payments would be deductible.\(^{213}\) However, according to Justice Archambault, the business and property income deduction available in subsection 18(1) would not be applicable to legal fees surrounding support payments in *any* circumstance as such support payments are classified as “other income” in the *Income Tax Act* and similarly, no specific provision for deduction was within

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\(^{210}\) *Ibid.* at paras. 4-10.  
\(^{212}\) *Ibid.* at paras. 32, 48-49.  
the tax legislation. He stated further that the allowance by CRA of the recipient’s claim to deductions for legal fees while simultaneously denying such privilege to the payor is “totally unfair” as they are accorded different tax treatment.\textsuperscript{214}

In addressing the reasoning presented by the Minister to deny Mr. Bergeron the deduction, it was held that although a right to support fell under the definition of “property” in the \textit{Income Tax Act}, this did not necessarily lead to the conclusion that support payments made pursuant to that right were to be considered income from property.\textsuperscript{215} Archambault J.T.C.C. differentiated between a property right and the object of the right, claiming that it was the latter rather than the former that was responsible for producing income. Since the payments did not constitute income from property, he concluded that such legal fees should not attract the deduction under the business and property income subdivision.\textsuperscript{216} Justice Archambault concluded that for any legal fees incurred regarding support payments to be deductible, “Parliament would have to again amend the Act so as to provide for that deduction”.\textsuperscript{217}

In noting that there was no statutory provision in the tax legislation that would allow of the deduction of any legal fees incurred regarding support payments, Justice Archambault’s comments seemed to have potentially broad implications for the status of deductions available to all legal fees incurred with respect to support payments. However, it

\textsuperscript{214} \textit{Ibid.} at para. 19.


\textsuperscript{216} \textit{Ibid.} at 430.

\textsuperscript{217} \textit{Bergeron, supra note 207 at para. 57.}
is important to note that his remarks were *obiter dicta* regarding legal fees and the recipient spouse.\(^{218}\) Moreover, as the *Bergeron* case was heard under the Informal Procedure, the decision is not binding on the Tax Court of Canada.

After *Bergeron*, much speculation took place as to the future of legal fee deductibility. In response to the *Bergeron* case, Barry Corbin reflected on possible responses from the legislature, judiciary and CRA.\(^{219}\) With respect to the Department of Finance, Corbin concluded that they only had three possible alternatives: affirm the status quo; amend the legislation such that it expressly allowed for the deduction of legal fees incurred with respect to support payments; or change the legislation so that it specifically prohibited deductions of legal fees incurred to claim support. In looking at the judicial response to the remarks made by Archambault J.T.C.C., Corbin observed that case law has not been consistent, ranging from full agreement to dismissal. Corbin put most emphasis on the likelihood of CRA changing its administrative policy to disallow deductions of legal costs paid in relation to support as he notes that “tax authorities have never been shy to take advantage of jurisprudence that favours the fisc”.\(^{220}\)

Following the *Bergeron* case, the CRA released Technical News No. 24, which served to update Interpretation Bulletin IT-99R-5 on legal fees.\(^{221}\) The release amended two positions previously followed by CRA. First, CRA noted that legal fees incurred in the process of increasing child support payments or for the purpose of making child support

\(^{218}\) Corbin, *supra* note 215 at 432.

\(^{219}\) *Ibid.* at 432-436.

\(^{220}\) *Ibid.* at 436.

\(^{221}\) M.N.R., “TN 24”, *supra* note 145 at 1.
payments non-taxable under the Federal Child Support Guidelines would now be deductible. Furthermore, CRA stated that legal fees incurred to obtain an entitlement to spousal support, where such right was established under legislation, would also be considered to be deductible. It was noted that these changes would only affect future assessments and would generally not apply retroactively.222

Except for these updates, CRA’s position from IT-99R5 remains unchanged regarding legal fees incurred with respect to child support.223 That is, as an entitlement to child support was a pre-existing right arising out of court orders, written agreements or legislation, legal costs surrounding child support would be deductible. Nonetheless, it is held that legal costs paid with respect to the custody of children or visitation rights are non-deductible.

3.5 IMPLICATIONS OF THE THIBAudeau CASE

While the taxation scheme applied to child support payments has been amended since the ruling in the Thibaudeau case, we should examine the judges’ reasoning for insight into the logic utilized by the Supreme Court of Canada, which guides all lower courts. As previously noted, five judges agreed that the inclusion/deduction system to child support payments did not violate the equality guarantee, as provided in subsection 15(1) of the Charter.

222 Ganley, supra note 153 at 13.

In coming to this decision, one of the overriding themes between the judgments was the treatment of the payor and recipient spouses as a single unit coupled with the fact that the inclusion/deduction system provided a tax benefit to the unit. Justices Cory and Iacobucci observed that the taxation scheme applied to child support "confers a benefit on the post-divorce 'family unit'." Furthermore, in acknowledging that the tax benefit derived from the inclusion/deduction system was indirectly conferred to the entire family following the breakdown of a marriage, Justice Gonthier noted:

> It is by means of this income splitting operation that the legislature has sought to increase the available resources that can be used for the benefit of the children. This measure generally results in a net tax saving, allowing the court which has to set the amount of maintenance to increase the alimony to be paid by an amount equal to the amount thus saved.\(^\text{225}\)

Such a rationale proves to be problematic for several reasons. While theoretically, the notion is that the tax benefit is shared between the former spouses, in practice, it is difficult to imagine that individuals who have undergone divorce maintain an amicable relationship allowing for sharing of the tax benefit. Although some divorcing or separating individuals might share the tax benefit derived from the inclusion/deduction system, a study to determine the percentages of such cases would be useful in determining the efficiency of the inclusion/deduction system, and the distribution of the tax savings. While it is acknowledged that the inclusion/deduction system is no longer applied for the taxation of child support payments, it is the same flawed rationale which is used to validate the application of the inclusion/deduction system for the taxation of spousal support payments.

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\(^{224}\) *Thibaudeau, supra* note 121 at para. 158.

It is important to note that not all of the judges in *Thibaudeau* viewed the inclusion/deduction system as beneficial to the post-divorce family unit. In a dissenting opinion, Justice McLachlin seemed to consider the social realities surrounding marital dissolution, noting that the inclusion/deduction system created inequitable treatment between former spouses as the onerous tax burden of the support payment was placed on the recipient while the payor was able to take advantage of a tax benefit.\footnote{226}{Ibid, at para. 178.} Additionally, Justice McLachlin observed that no mechanism for the equitable division of such tax savings had been incorporated within the legislation, further supporting the contention that the inclusion/deduction system provided a tax benefit solely to the payor, not to the “post-divorce family unit”.\footnote{227}{Ibid, at para. 222.} Thus, the onus of sharing the tax savings falls solely on the payor, and the likelihood of an individual sharing a tax benefit, especially with a former spouse, seems to be an unlikely premise to justify to utilization of the inclusion/deduction system.

A second similarity identified in the majority and concurring opinions was the shifting of responsibility of any inequality arising with respect to child support payments away from the realm of tax law to the family law system. As noted by Justice Gonthier, the disproportionate tax savings accorded through the inclusion/deduction scheme should be corrected as “the distribution takes place in accordance with family law,”\footnote{228}{Ibid. at para. 141.} and that “the inadequacy of maintenance is due to numerous factors governed by family law and is not the result of these provisions of the *Income Tax Act*.\footnote{229}{Ibid. at para. 151.} Justices Cory and Iacobucci also rid the
tax system of any accountability with respect to the unequal tax benefit conferred through the use of the inclusion/deduction system by observing that “if there is any disproportionate displacement of the tax liability between the former spouses . . . the responsibility for this lies not in the Income Tax Act, but in the family law system”.230

The shifting of responsibility to family law while simultaneously ridding the tax system of any accountability for inequality arising out of the taxation of support payments is illogical. It seems unreasonable to place the responsibility of correcting any tax inequalities arising out of the use of the inclusion/deduction system on the family law system. It would be logical to assume that if any differential treatment arose from the direct application of tax legislation, the tax system should attempt to reach a more equitable result. In the other dissenting opinion, Justice L’Heureux-Dubé addresses the concerns of assigning responsibility for the unequal distribution arising out of the use of the inclusion/deduction system:

While I agree that the effects of the family law system are relevant to this inquiry because they are incorporated by reference into the inclusion/deduction regime, I respectfully disagree with their conclusion for two reasons. First, on both a practical and theoretical level, I do not believe that the family law system is capable of remedying the initial unequal distribution effectuated by the inclusion/deduction system. Second, even if the family law system were up to the task, I believe that it would only address the symptoms of the inequality, rather than its source.231

It may safely be assumed that the inclusion/deduction system was established without the anticipation of any aid from the realm of family law. The system was designed on the

230 Ibid. at para. 160.

231 Ibid. at para. 15.
premise that taxpayers undergoing marital dissolution, properly advised, would take tax consequences into consideration when determining the amount of support to avoid any disproportionate tax liability. While in theory the inclusion/deduction system produces a tax benefit for both the payor and recipient spouses, the reality is that the recipient spouse often bears the burden of the tax consequences. This may be due, in part, to the fact that “many divorcing couples rely on the assistance of general practitioners who lack tax expertise”.  

Because taxpayers undergoing marital dissolution are generally not able to adequately determine the correct amount of support payments that would result in the intended tax benefit through the use of the inclusion/deduction system, the onus falls upon legislators to remedy inequalities arising from the inclusion/deduction system’s application. While it is acknowledged that the entire burden with respect to the distribution of support payments not be borne exclusively by the realm of tax law, conversely, the same rationale should be applied to the family law system. Rather, as the issue at hand encompasses both the realms of tax and family law, both systems should work together to find a reasonable solution.

As previously mentioned, of the seven member panel presiding over the Thibaudeau case, the court was divided along gender lines as the five male judges held that the inclusion/deduction system was not discriminatory while the two female judges each provided strong dissenting opinions. In examining the current composition of the Supreme Court of Canada, it is noted that the court consists of five male judges and four female judges, including a female Chief Justice. With a gender balanced panel in place, it is of

\[232\] Berman, supra note 162 at 59.

\[233\] Supreme Court of Canada, About the Court, online: Supreme Court of Canada <http://www.scc-csc.gc.ca/aboutcourt/judges/curjudges_e.asp>.
interest to consider whether the decision in the Thibaudeau case would differ if the case were heard today.

### 3.6 EVALUATION OF TAXATION SCHEME

Despite the amendments made to the taxation scheme applied to child support payments, the new regime does not escape criticism. As argued by Faye Woodman, without any positive taxation incentives afforded to the payor spouse to pay child support payments, the issue of compliance comes to the forefront.\(^{234}\) While it is recognized that various factors exist which contribute to the lack of payment of child support, including lack of affordability in supporting two separate households, geography, occupation and parent/child contact, Woodman nevertheless contends that eliminating the inclusion/deduction system will have a negative effect on the payment of child support.

It is important to note that such argument only holds true in the instance where the court order or written agreement, which has a commencement date, provides solely for the payment of child support payments and no spousal support is ordered. That is, while only spousal support payments are taxed using the inclusion/deduction system, the formula for calculating the deduction in paragraph 60(b) takes into account the amount of child support payable. Namely, child support amounts payable after the commencement date of the agreement or order must be paid in full before the payor will be permitted to claim the deduction for spousal support payments.\(^{235}\) Thus, although the inclusion/deduction system

\(^{234}\) Woodman, *supra* note 190 at 221.

\(^{235}\) M.N.R., “IT-530R”, *supra* note 73 at para. 15.
does not apply to child support payments, in circumstances in which both spousal and child support are ordered, an incentive to comply with the child support order most certainly exists as the deduction provided for payment of spousal support is contingent on full payment of child support.

While paragraph 60(b) provides that child support payments must be made in full before the payor spouse will be able to claim the deduction, thus encouraging full payment of support obligations, it is somewhat distressing to note that if the payor pays in full all of the arrears, he or she will be eligible to claim the full amount of the deduction that was cumulatively foregone during the years in which the payments were not made. An illustration of the deduction claimable with respect to payment of arrears follows:

**EXAMPLE:** Under a written separation agreement signed on February 1, 2003, Mark is to pay Christina $150 in spousal support and $300 for the children, on a monthly basis. Mark defaults on the support payments and only pays support for five months. In the following year, Mark is able to pay all of the support payments ordered as well as the payments that were in arrears.

**ANALYSIS:** In 2003, Mark will have paid $2,250 in support payments (5 x $450 = $2,250). In 2004, Mark pays a total of $8,100 ($5,400 for 2004 + $2,700 in arrears).

The deduction claimable by Mark in 2003 for support payments made is calculated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Support Payments Paid Since 1996</th>
<th>Total Child Support Payments Payable After Commencement Date</th>
<th>Total Deductions Previously Claimed Since 1996</th>
<th>Value of Deduction Claimable for Current Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$450 x 5 = $2,250</td>
<td>$300 x 11 = $3,300</td>
<td>0</td>
<td>$2,250 (-,300) $0</td>
</tr>
</tbody>
</table>
As illustrated above, because Mark has not paid the full child support, he will not be able to claim any deduction with respect to the spousal support. In 2004, Mark’s deduction is calculated as follows, taking into account the arrears:

<table>
<thead>
<tr>
<th></th>
<th>Total Support Payments Paid Since 1996</th>
<th>Total Child Support Payments Payable After Commencement Date</th>
<th>Total Deductions Previously Claimed Since 1996</th>
<th>Value of Deduction Claimable for Current Year</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2004</td>
<td>$2,250</td>
<td>$3,300</td>
<td>+8,100</td>
</tr>
<tr>
<td></td>
<td></td>
<td>+8,100</td>
<td>+3,600</td>
<td>+3,600</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$10,350</td>
<td>$6,900</td>
<td>$10,350</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>0</td>
<td>- 6,900</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$ 3,450</td>
</tr>
</tbody>
</table>

In the event that Mark had not defaulted on the support agreement, he would have been able to claim a $1,650 deduction under paragraph 60(b). In every subsequent year, Mark can claim a deduction of $1,800, contingent on the fact that he pays the support order in full. Thus, it can be seen that Mark’s deduction claimable in 2004 comprises of both the deduction for the payments made for the 2004 year ($1,800) as well as the deduction available for the arrears payments ($1,650).

While the main policy objective in utilizing the inclusion/deduction system is to provide a tax benefit, which translates into extra resources available to the former spouses, it cannot be overlooked that the provision of a deduction to the payor spouse also serves as an incentive for payment. The fact that the *Income Tax Act* does not allow the payor spouse to claim any deduction for spousal support payments until all child support payments have been made in full serves as a safeguard to ensure that child support orders are complied with. However, it is objectionable that the payor spouse may not pay support payments for years, thereby stranding the recipient spouse and children without the additional financial resources, and when the payor spouse finally decides to comply with the order or agreement and pay the arrear payments, the cumulative deduction is bestowed upon the payor spouse as an “award”
for their willful behaviour. Furthermore, while the payor spouse receives the cumulative deduction, the recipient spouse is penalized as he or she is responsible to bear the tax burden for the lump sum of the arrear payments, which may push the recipient spouse into the next marginal tax bracket.\footnote{Rosemarie Boll “To Deduct or Not to Deduct” Law Now 27:4 (March 2003) 43. Any lump sum arrear payments under $3,000 will automatically be included into the recipient spouse’s income. However, for any outstanding arrear payment received over $3,000, the recipient spouse may submit Form T1198 “Statement of Qualifying Retroactive Lump-Sum Payment”, which would ultimately result in CRA calculating the recipient spouse’s tax liability as if each payment had been received as scheduled in the support order or agreement.}

In observing the interplay between the inclusion/deduction system and child support payments, it can be seen that the system heavily favours the payor over the recipient, who is generally in financial need of the support payments. That is, no remedy is available through the tax system to the recipient for non-compliance with the support order. On the other end of the spectrum, the payor faces no penalty from the tax system if support payments are not made. To the contrary, the payor spouse may elect to pay support payments at a time that is most convenient to him or her and they are still able to claim the full deduction cumulated throughout the duration of the arrears payments. The tax system does not punish the payor spouse by decreasing the value or simply denying the availability of the deduction for arrear payments. Rather, the current system permits the payor spouse the opportunity to engage in tax planning, such as to withhold support payments and to “save up” the deduction until it is most economically advantageous to the payor spouse. While the payor spouse is able to enjoy this hidden tax break, such a tax break is granted at the expense of the recipient spouse and the children.
Although the provisions of the tax legislation seem to favour the payor over the recipient spouse, it is important to note that divorced couples may both benefit from a tax perspective by utilizing a more amicable process, such as mediation, to resolve their divorce. However, even when taxpayers desire to negotiate their issues within an amicable environment, a lack of tax expertise may result in unintended, and possibly unfair, tax consequences. Hence, it is important that the tax system cater to the possibility that the parties may not be able to adequately take into consideration various tax issues in the negotiation process, which may result in unjust tax consequences.

3.7 CONCLUSION

The taxation of child support payments has undergone scrutiny in the past decade, and the government has taken an active role in amending the taxation scheme applied to child support. Although the inclusion/deduction system no longer applies to current child support, weaknesses in the new taxation system have been identified and must be addressed. It is apparent that the tax provisions relating to the taxation of child and spousal support payments do not adequately take into consideration the social reality surrounding the prevalence of non-compliance with support orders. Despite the fact that each province has established

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237 Lynne Cohen “Tax strategies for mediated divorces” Law Times 12:40 (19 November 2001) 13. It has been advocated that tax savings can be optimized when separating parents, who agree to a joint custody arrangement, opt to use mediation as their vehicle to resolve their divorce issues. For example, child support payors are not eligible to claim children as dependents for the purpose of claiming the equivalent-to-spouse credit. However, through the use of mediation, the divorced couple may be able to optimize their individual tax savings by eliminating any child support payments and notionally splitting the children such that each parent is able to claim one of the children as the spousal-equivalent dependant. Therefore, the utilization of mediation to cooperatively reach a joint resolution may provide more advantageous resolutions, from a tax perspective, for the divorcing couple.
maintenance enforcement programs to "enforce and collect money owing to a family support recipient", compliance still remains a concern.²³⁸

While it would be simplistic to treat the problem of non-compliance as an issue which is to be dealt with exclusively through the realm of family law, it is important to consider the role that taxation law can play in collaborating with the family law system to find a viable solution to this problem. The Income Tax Act indirectly addresses the subject of compliance by preventing the payor spouse from claiming the deduction available in paragraph 60(b) until all child support payments have been fully satisfied. However, a loophole in this scheme can be realized as the payor is able to default on payments and is still eligible to claim the deduction if the arrears payments are accounted for, even years after they were due, and thus can utilize the available deduction as a tax planning tool. Thus, during the interim period the recipient and children are abandoned to provide for themselves without the much needed aid of the payor.

One possible solution would be to incorporate a provision within the Income Tax Act whereby the payor spouse would be subjected to a penalty tax for non-compliance with child support orders and agreements. As it has been observed that the positive incentive provided by the inclusion/deduction system does not always provide enough motivation for such compliance, perhaps the utilization of a deterrent would influence the percentage of payors complying with support orders and agreements. Such a rationale was utilized by the Canadian government in its attempt to lower the level of tobacco consumption. In commenting on the efficiency of the tax deterrent, it has been observed that the "tax increases

²³⁸ Department of Justice Canada, Overview of the Canadian System of Support Enforcement, online: Department of Justice Canada <http://canada.justice.gc.ca/en/ps/sup/enforcement/enforcement_overview.html>.
continue to contribute to the decline in tobacco consumption. Thus, extrapolating such findings to the arena of support order compliance would likely lead to the conclusion that an increased tax levied on non-compliance of support orders would contribute to a decreased level of non-compliance.

While it may be argued that such a tax is contrary to the objective of neutrality, it is important to remember that our tax legislation is built on a balancing of the various policy objectives that underlie the *Income Tax Act*. In considering the equilibrium, it would seem prudent to weigh on the side which promotes a form of economic justice as opposed to holding high the objective of neutrality as the main reason to deny the establishment of such a tax. Of course, it is recognized that the implementation of a non-compliance tax will not be simple as many factors will have to be taken into consideration, including the situation where the payor spouse was genuinely unable to fulfill their support obligations due to financial difficulties. While a remedy to the problem of non-compliance may not be instantly obvious, it would be prudent for both the taxation and family law systems to work collaboratively in an attempt to find feasible solutions.

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CHAPTER 4

DIVISION OF MATRIMONIAL PROPERTY

4.1 DIVISION OF PROPERTY

The breakdown of marriage or a common-law relationship can have long lasting effects on the parties, both emotionally and financially. One of the most contentious issues is the division of assets.\textsuperscript{240} As most issues arising out of marital dissolution are governed by the federal \textit{Divorce Act}, the issue of property division is unique in falling under provincial jurisdiction. Thus, each province and territory provides procedures for an equitable division of property. As observed by Alastair Bissett-Johnson, reliance upon case law from other jurisdictions for matters related to property division may prove to be dangerous as even similar legislation governing property division might have received different interpretations by the courts elsewhere.\textsuperscript{241}

Whilst each province and territory differs in the method utilized to divide property, two overriding methods have been identified.\textsuperscript{242} The first of such methods relates to the equal division of property between the former spouses. The other dominant method of

\textsuperscript{240} Boll, supra note 236 at 43. Any legal fees incurred in the process of obtaining a court order or agreement with respect to the division of matrimonial property will not be deductible.


\textsuperscript{242} Barbara J. Hendrickson, “Tax Implications of Pension Division at Source on a Marriage Breakdown” (1996) 14 C.F.L.Q. 249.
dividing property is achieved through the equalization process. To illustrate these two methods of property division, family legislation in British Columbia and Ontario will be contrasted in the pages that follow.

4.1.1 British Columbia

The division of property in British Columbia is governed by the *Family Relations Act* (hereinafter, “FRA”), under which each spouse is entitled to an undivided half interest in each family asset.\(^{243}\) The entitlement is not to an equal division of the *value* of the property, but rather to the property itself. This general rule does not apply where an equal division would result in unjust consequences or where the parties consent to anything other than a 50/50 split of family assets, provided that the division is fair to both parties.\(^{244}\) Additionally, both former spouses will be held responsible for any debts incurred in the process of purchasing family assets or paying family expenses.\(^{245}\) The general rule that the *Family Relations Act* allows for undivided half interests in family assets leads to consideration of timing and definitions of terms that determine the scope of the Act.

In determining the applicability of the *Family Relations Act* to marital property, it is of significance to examine to whom the FRA applies, time limitations, and which events trigger entitlement to a half interest in the family assets. The presumption of an equal division in family assets under the *Family Relations Act* only applies to legally married

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\(^{243}\) *Family Relations Act*, R.S.B.C. 1996, c. 128, s. 56(2).


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individuals and former spouses, as provided in the definition of the term, "spouse". The FRA also applies to common-law spouses in the event that they enter into an agreement to have the provisions of the Family Relations Act apply. The limitation provisions of the Family Relations Act require the spouses to make application within two years of the earliest of the following dates: the breakdown of marriage, separation ordered by a court, or a declaration affirming that the marriage is null and void. Entitlement to an interest in family assets comes into being where a separation agreement or divorce order is made or in the instance where a judicial declaration has been made affirming that the "spouses have no reasonable prospect of reconciliation with each other". Entitlement to an interest in family assets will also occur where a declaration has been made as to nullity of the marriage.

Once the scope of the Family Relations Act has been determined, the meaning of the term "family asset", as distinct from business venture assets and personal assets, must be examined. Generally, a property will be considered a family asset if it is ordinarily used

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246 Family Relations Act, supra note 243 at s. 1.

247 Ibid. at s. 120.1. In the event that such a contract is not entered into, property division for common-law spouses may take place, on the basis of a constructive trust.

   Government of British Columbia, Basics of Family Law: I am not married: What are my Rights?, online: Ministry of Attorney General <www.ag.gov.bc.ca/family-justice/law/property/commonlaw.htm>. Where common-law couples do not enter into such an agreement and are unable to decide as to how the property should be divided, they may obtain a judgment from the Supreme Court. Generally, individuals will be allowed to retain items that they brought into the relationship as well as any purchased items which have a bill of sale with their name on it. Aside from this, any items bought together as a common-law couple will most likely be divided or shared.

248 Family Relations Act, ibid. at s. 1.

249 Ibid. at ss. 56(1), 57.

250 Ibid. at s. 56(2).
for a family purpose.\textsuperscript{251} The meaning of "family purpose" was examined in the decision of \textit{McLennan v. McLennan}.\textsuperscript{252} It the context of determining which assets are family assets, it was held that the words "family purpose" meant the purpose would have to be "connected with the whole family, not merely one or more individuals in it. While property may actually be used by only one member of the family, the purpose for its use must be related to the family group".\textsuperscript{253} Thus, in determining whether a property falls within the definition of "family asset", judicial discretion plays a significant role. In addition to being ordinarily used for a family purpose, many other assets will be considered as family assets, including rights arising under a pension plan, or venture and business assets towards which the non-owning spouse has made a direct or indirect contribution.\textsuperscript{254} Personal items which are only used by one person in the family, such as jewelry, will generally not be characterized as a family asset.\textsuperscript{255}

While a presumption in the \textit{Family Relations Act} states that a family asset should be split equally between former spouses, the presumption may be rebutted as the FRA provides for the allowance of judicial reapportionment on the premise that an equal division would be unfair.\textsuperscript{256} In making a decision to reapportion the interests, the court must take into consideration several factors, including the length of period of both the marriage and the

\begin{footnotes}
\footnote{251}{Ibid. at s. 58(2).}
\footnote{253}{Ibid. at para. 11.}
\footnote{254}{\textit{Family Relations Act}, supra note 243 at ss. 58(3), 59.}
\footnote{255}{B.C. Legal Services Society, \textit{supra} note 244 at 21.}
\footnote{256}{\textit{Family Relations Act}, \textit{supra} note 243 at s. 65.}
\end{footnotes}
period of separation, as well as the time of acquisition of the asset, and the needs of each spouse to maintain economic self-sufficiency.\textsuperscript{257} Furthermore, the Supreme Court may take into consideration any other matters associated with the nature of the property, or any liabilities of the spouse in determining the appropriateness of such a reapportionment. It has been observed that the financial independence factor plays a significant role in the determination of reapportionment.\textsuperscript{258} Additional broad powers have been conferred upon the Supreme Court, as in the process of property divisions, it is permitted to “make orders that are necessary, reasonable or ancillary”\textsuperscript{259}.

\textbf{4.1.2 Ontario}

To ensure a fair division of assets upon marital dissolution, Ontario’s \textit{Family Law Act} mandates that all family property be valued and that an equalization payment be made to the spouse with the lesser net family property.\textsuperscript{260} The objective behind the equalization system is the recognition of equal contributions made by both spouses of “child care, household management and financial provision,” which are “joint responsibilities of the spouses”.\textsuperscript{261}

Under the scheme, each spouse must tabulate the value of all of their property utilizing an objective balance sheet approach.\textsuperscript{262} The debts and liabilities secured against the

\begin{itemize}
\item \textsuperscript{257} \textit{Ibid.} at s. 56(1).
\item \textsuperscript{259} \textit{Family Relations Act}, supra note 243 at s. 66(1).
\item \textsuperscript{260} Hendrickson, supra note 242 at 249.
\item \textsuperscript{261} \textit{Family Law Act}, supra note 53 at s. 5(7).
\item \textsuperscript{262} Simon Fodden, \textit{Family Law} (Ontario: Irwin Law, 1999) at 220.
\end{itemize}
properties are deducted from the total. Furthermore, the value of certain property may be subtracted from the net value of family property, including gifts, inheritances and the value of property brought into the marriage. While the legislation provides that the value of assets owned by spouses before entering marriage may be excluded such that only the value accrued during the marriage is accounted for during the equalization payment, this does not hold true for the matrimonial home. For the purposes of calculating the value of the net family property, the date on which valuation should occur is important. The valuation date will be the earliest of the following dates: the date on which the spouses separated with no reasonable prospect of cohabitation; the date of divorce; the date that a declaration was made as to the nullity of the marriage; the date on which an application for improvident depletion was commenced; and the date of the day prior to the day that a spouse died.

Thus, a spouse must calculate the value of their net family property and in the event that the spouses' values of net family property differ, an equalization payment will be made by the spouse with the greater value to the other spouse. The equalization payment will be equal to one-half of the difference between the two net family properties. A strong presumption exists of a 50/50 division of the value accumulated during the marriage. While

263 Family Law Act, supra note 53 at s. 4(1), definition of “net family property”.

264 Ibid. at s. 4(2).

265 Jack Marmer, “Divvying up Matrimonial Assets” CA Magazine 121:3 (April 1988) 54. While the Family Law Act provides explicit guidelines for the determination of the valuation date, the legislation does not define the term “value”. As the term remains undefined, courts generally interpret the meaning of “value” as the fair market value of the asset.

266 Family Law Act, supra note 53 at ss. 4(1), 5(3). An application for improvident depletion would be made by a spouse if the couple was cohabiting, but the spouse felt that there was an imminent threat that the other spouse would recklessly deplete their net family property.

267 Ibid. at s. 5(1).
it is possible for judges to exercise their discretion and deviate from the equal split in value of the family property, it is interesting to note that such discretion can only be exercised in the event that an equalization payment of the net family properties would be unconscionable.\textsuperscript{268} The equalization scheme under the \textit{Family Law Act} only applies where an application is made on the earlier of either: two years after a divorce or a nullity of judgment; or six years following the separation of the spouses where there is no reasonable prospect of cohabitation.\textsuperscript{269}

\subsection*{4.1.3 Comparison between British Columbia and Ontario Property Division Regimes}

Many differences can be observed between the property division regimes of British Columbia and Ontario. The most obvious is that while property is divided in British Columbia using the half-interest in family assets presumption, property is divided in Ontario through the utilization of an equalization scheme. Therefore, in Ontario, the \textit{value} of family property is taken into consideration during the division process, while in contrast, British Columbia legislation grants a half-interest in the property itself, not taking into account the value of the property. Furthermore, under Ontario’s legislation, spouses do not gain a right to each other’s property solely due to the result of marriage whilst the opposite holds true in British Columbia.\textsuperscript{270}

An additional dissimilarity between the provincial legislation governing the division of property is that within the Ontario system, there is very little room for judicial discretion

\begin{footnotes}
\item[268] \textit{Ibid.} at s. 5(6).
\item[269] \textit{Ibid.} at s. 7(3).
\item[270] Fodden, \textit{supra} note 262 at 221.
\end{footnotes}
as the legislation provides very clear and unambiguous rules as to dividing the property as compared to the British Columbia legislation. While Ontario’s legislation governing property division does allow for some discretion to be exercised by judges to deviate from the 50/50 split, the threshold to invoke such discretion is set at a higher standard than that provided in British Columbia’s legislation. In Ontario, judicial discretion can be exercised in the event that the application of the equalization scheme would be unconscionable whereas in British Columbia, such discretion can be evoked if the resulting division would be unfair. Furthermore, in both Ontario and British Columbia, parties can contract out of the family legislation governing the division of property; however, in Ontario, no statutory provision has been established which allows judges to inquire into the fairness of the contract. In comparison, section 65 of the British Columbia Family Relations Act expressly provides that courts can intervene in instances where such contracts would have inequitable results.

4.2 TAXATION OF PROPERTY DIVISION

4.2.1 Capital Property

As discussed within the context of support payments, the distinction between allowances payable on a periodic basis and lump sum payments made by installments often becomes blurred. While both payments only differ in form from an economic standpoint, the latter and former forms of payment must be distinguished due to the fact that different taxation schemes are applied to allowances and lump sums, which are capital in nature. Capital property, as defined in the Income Tax Act, includes depreciable property in addition to any property that would produce a capital gain or loss on its disposition.271

271 Income Tax Act, supra note 2 at s. 54.
Spouses in a marriage or partners in a common-law relationship are deemed not to deal at arm’s length with each other by the *Income Tax Act*. It is thus, transfers of capital property between non-arms’ length taxpayers result in the transferor being deemed to receive proceeds of disposition equal to the fair market value of the property. Consequently, upon such a transfer, the transferor will be liable to pay tax on any capital gains or losses that have accrued on the property. On the other hand, the transfer of capital property between former spouses as part of “the settlement of rights arising out of their marriage or common-law partnership” is governed by subsection 73(1) of the *Income Tax Act*.

In transferring capital property, subsection 73(1) allows the former spouses the option of either electing to realize any accrued capital gains, losses or recapture at the date of transfer, or rolling over the property to the recipient spouse, thereby shifting the tax burden to the recipient spouse. Both the transferor and the recipient spouses must be resident in Canada for the rollover treatment to apply. Regardless of which method is chosen, the

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272 *Ibid.* at ss. 251(1), 251(2).

273 *Ibid.* at ss. 69(1)(b).

274 Suzuki, *supra* note 75 at 57. Such tax treatment will be accorded to the transfer of non-capital properties between former spouses.

275 *Income Tax Act, supra* note 2 at ss. 73(1.01)(b); Anthony F. Sheppard, “Taxation of the Family Divided: Divorce – Canadian Style (Part II)” (1975) 33:2 The Advocate 105 at 109. Legal fees incurred for the division of capital property will not qualify for the deduction under paragraph 18(1) of the *Income Tax Act* as these expenses are considered to be capital outlays. As noted by Sheppard, legal expenses may “be added to the cost of the capital asset . . . , amortized as eligible capital expenditures, or . . . added to cost as an expense of disposition”.


277 *Income Tax Act, supra* note 2 at ss. 73(1).
recipient spouse’s adjusted cost base will be the same value as the transferor’s proceeds of disposition.

If the transferor opts to elect out of the rollover provision, they would have to expressly provide so in their personal income tax return for the year.278 No official form has been established by CRA for the opting out of the subsection 73(1) rollover.279 Under this election, the transferor is deemed to have disposed of the property at its fair market value by virtue of subsection 69(1), and the recipient is deemed to have acquired the property at the same amount.280 Electing out of the rollover would result in the transferor realizing any accrued capital gains, losses, or recapture. Such election would be advantageous to the transferor if they had any capital losses to absorb the tax consequences arising out of the transfer.281 Furthermore, electing out of the rollover may prove to be beneficial to the transferor in the sense that the willingness of the transferor to realize the immediate tax consequences on the transfer, thereby potentially reducing the recipient spouse’s future taxes payable, can be utilized as leverage in the negotiation of the settlement process.

On the other hand, if the transferor does not make an election in their tax return, the rollover in subsection 73(1) applies automatically to any property transferred between former spouses as a result of the settlement process. The rollover mechanism does not eliminate the


281 Audrey C.W. Branham, “Tax Consequences of Separation and Divorce” in Canadian Bar Association, *Papers on Family Law* (British Columbia: Canadian Bar Association - B.C. Branch, 1989-1995) 15. The transferor spouse may also elect out of the subsection 73(1) rollover if he or she had an unused portion of the capital gains exemption available.
tax consequences arising out of the disposition of the property, but rather postpones such tax consequences. The rollover basically puts the recipient spouse "in the same position as the transferor". The recipient spouse is deemed to acquire the property at a cost value equal to the proceeds of disposition of the transferor.

The rollover mechanism can be illustrated as follows:

**EXAMPLE:** As part of the divorce settlement, George is to give Sharon a painting which is currently valued at $3,000. George has owned the work of art for several years, thus his adjusted cost base is $1,500, a value significantly lower than the fair market value of the item. George does not elect out of the rollover treatment in subsection 73(1). Thus the tax consequences for both George and Sharon are as follows.

**ANALYSIS:**

**Tax Consequences for George:**
Under the subsection 73(1) rollover, George's deemed proceeds of disposition would be $1,500.

\[
\text{Capital Gains} = \text{Proceeds of Disposition} - \text{Adjusted Cost Base}
\]

\[
\begin{align*}
\text{Capital Gains} &= $1,500 - $1,500 \\
\text{Accrued Capital Gains} &= \text{Nil} \\
\text{Taxable Capital Gains} &= \text{Nil}
\end{align*}
\]

**Tax Consequences for Sharon:**
Sharon is deemed to take the painting at a value equal to George's proceeds of disposition. Consequently, Sharon will take the painting at a cost of $1,500. At the time of transfer, Sharon is not subjected to any tax liability. A few months later, Sharon decides to sell the painting and is able to find a buyer who will pay her $5,000. At the time of selling the art, her capital gains will be calculated as follows:

\[
\begin{align*}
\text{Capital Gains} &= \text{Proceeds of Disposition} - \text{Adjusted Cost Base}
\end{align*}
\]

\[
\begin{align*}
\text{Capital Gains} &= $5,000 - $1,500 \\
\text{Accrued Capital Gains} &= \text{Nil} \\
\text{Taxable Capital Gains} &= \text{Nil}
\end{align*}
\]

282 Wolfson, Lorne H. "Tax Considerations in Drafting Domestic Contracts" (1996-1997) 14 C.F.L.Q. 233 at 239 [Wolfson, "Tax Considerations"].
Capital Gains = Proceeds of Disposition – Adjusted Cost Base

Capital Gains = $5,000 - $1,500

Capital Gain = $3,500

Taxable Capital Gain = $1,750

In the event that George had elected out of the rollover provision in subsection 73(1), his proceeds of disposition would be equal to the fair market value of the painting. Thus, he would have realized a capital gain of $1,500 ($3,000 - $1,500) and Sharon would have taken the painting with an adjusted cost base of $3,000. In the event that she sells the painting for $5,000, Sharon would realize a smaller capital gain of $2,000 ($5,000 - $3,000), as compared to the above example where the rollover was utilized, as her adjusted cost base is significantly higher.

The determination of the value of the transferor’s proceeds of disposition depends upon whether the capital property is classified as depreciable or non-depreciable. Such a distinction arises due to the fact that a capital cost allowance is permitted for property which is depreciable. 283 With respect to non-depreciable property, the transferor’s proceeds of disposition will simply be equal to their adjusted cost base. 284 However, in dealing with depreciable property, the transferor’s proceeds will be deemed to be equal to the undepreciated capital cost (UCC) of the property. 285 In the event that there is more than one property within the prescribed depreciable property class, the UCC of the property will be

284 *Income Tax Act, supra* note 2 at s. 73(1)(a)(ii).
calculated by multiplying the UCC of the class with the ratio of the fair market value of the property over the fair market value of all of the property within the class.\textsuperscript{286}

4.2.2 Principal Residence

In the division of property upon the breakdown of a marriage, allocation of the residence is significant as the principal residence comprises of approximately 41\% of a family’s accumulated assets.\textsuperscript{287} As noted by Lorne Wolfson, a distinction should be drawn between “principal residence”, a term defined in the \textit{Income Tax Act}, as opposed to “matrimonial home”, a term utilized within the realm of family law.\textsuperscript{288} Such differentiation can have a significant impact on the tax consequences arising out of the division process that occurs subsequently to marital dissolution. One distinguishing factor between a principal residence and matrimonial home is that individuals may have multiple matrimonial homes; while conversely, a family unit can only designate one principal residence. Another difference is that upon marital dissolution, a residence is no longer considered a matrimonial home under the family law regime while the \textit{Income Tax Act} expressly allows an individual’s former spouse to occupy the individual’s principal residence.

The \textit{Income Tax Act} accords preferential treatment to the principal residence. When the principal residence is sold or transferred, any capital gain realized on the disposition will not be liable to tax under the principal residence exemption provided under section 40.\textsuperscript{289}

\begin{itemize}
  \item \textsuperscript{286} M.N.R., “IT-325R2”, \textit{supra} note 279 at para. 3.
  \item \textsuperscript{287} “Family Wealth Across the Generations” \textit{The Daily} (16 October 2003), online: Statistics Canada <www.statcan.ca/Daily/English/031016/d031016a.htm>.
  \item \textsuperscript{288} Wolfson, “Tax Considerations”, \textit{supra} note 282 at 242.
  \item \textsuperscript{289} \textit{Income Tax Act}, \textit{supra} note 2 at s. 40(2)(b).
\end{itemize}
Not all family homes will qualify for this exemption; rather, the dwelling must fall within the "principal residence" definition, as outlined in section 54. A principal residence consists of a dwelling which is owned and "ordinarily inhabited" by an individual, his or her spouse or former spouse, or children of the individual during the year of disposition.\textsuperscript{290} The dwelling may be a housing unit, an interest in leasehold or alternatively, shares of a cooperative housing corporation.\textsuperscript{291} To claim the principal residence exemption in the year of disposition, individuals must both be resident in Canada throughout the year.

While only one principal residence may be designated by a family unit, upon the breakdown of a marriage, both former spouses can each claim a principal residence if they are legally separated and living separate and apart.\textsuperscript{292}

4.2.3 Attribution Rules

In an attempt to prevent income-splitting between spouses, the \textit{Income Tax Act} has incorporated attribution rules whereby any capital gains or income accrued on property transferred between spouses will be taxed in the hands of the transferor.\textsuperscript{293} The attribution rules apply not only to property that has been transferred, but also to any property that has

\textsuperscript{290} M.N.R., Interpretation Bulletin IT-120R6, “Principal Residence” (17 July 2003) at para. 5 [M.N.R., IT-120R6]. The determination of whether the dwelling is “ordinarily inhabited” is a question of fact. As noted by the CRA, this criterion will be fulfilled even if the individual inhabits the dwelling for a short duration of time throughout the year.

\textsuperscript{291} Of interest to note is that the principal residence exemption also applies up to one half acre of land which surrounds the residence if it can reasonably be considered that the land has contributed to the individuals use and enjoyment of the residence.

\textsuperscript{292} M.N.R., “IT-120R6”, supra note 290 at para. 6.

\textsuperscript{293} \textit{Income Tax Act}, supra note 2 at ss. 74.1, 74.2.
been substituted for the original property.\textsuperscript{294} The attribution rules only apply to transfers made between spouses if both are resident in Canada.

**EXAMPLE:** Daniela gives her husband Tim $1,000 for his birthday. Tim, a stock market enthusiast, immediately takes the money and invests it. He later receives $200 of dividends from the stocks he invested in. Both Tim and Daniela are resident in Canada.

**ANALYSIS:** As Tim is making income from property that has been transferred to him from his wife, this income will be attributed to Daniela. That is, Daniela will be liable to pay tax on the $200 of dividend income through the operation of the attribution rules.

While the attribution rules have been established to prevent income splitting between spouses, they do not apply following divorce.\textsuperscript{295} Thus, any property that is transferred between former spouses, in the division of property process which follows the breakdown of a marriage, will not be subjected to the attribution rules. The transferor of the property will not be liable to pay tax on any income or capital gains related to the transferred property. However, it has been advised that the transferor spouse ensure that the recipient spouse not sell any of the transferred properties until after their marriage status terminates.\textsuperscript{296}

### 4.3 EVALUATION OF TAXATION SCHEME

Upon a cursory glance, the tax treatment accorded to capital property seems to be a fair scheme as the tax legislation provides the option of a rollover or of electing out of the rollover. Thus, the spouses are able to choose who will bear the tax burden of the property.

\textsuperscript{294} Bowley, *supra* note 283 at 147; Branham, *supra* note 281 at 15. The attribution rules will also apply to gifts exchanged between the spouses.

\textsuperscript{295} M.N.R., Interpretation Bulletin IT-511R, "Interspousal and Certain Other Transfers and Loans of Property" (21 February 1994) at paras. 18-20.

\textsuperscript{296} Suzuki, *supra* note 75 at 58.
However, the fairness of this scheme can be questioned. The rollover provision in subsection 73(1) applies *unless* the transferor taxpayer expressly elects out of the provision. Thus, with the application of the rollover as the presumptive norm, the tax burden is shifted onto the recipient spouse under the section. In the event that the recipient spouse disposes of the property, they are liable to pay not only the taxes incurred during the period following the divorce, but they must also pay taxes on all of the capital gains accrued during the actual marriage itself, during which the property was a joint property between the married couple.

An argument may be made that such a rollover provision allows the recipient spouse to defer any tax liability with respect to capital gains made on the property if they do not dispose of the property, as the recipient spouse will only bear tax consequences on the transferred capital property in the event that they sell it. However, even though the recipient spouse may not sell or dispose of the property during their lifetime, upon their death paragraph 70(5)(a) of the *Income Tax Act* deems all capital property to be disposed of immediately before an individual’s death at fair market value. Thus, the recipient spouse, or following death, their estate will be liable to pay taxes on the transferred capital property.

Alternatively, it may be contended that the taxation scheme applied to capital property within subsection 73(1) is fair as the section provides an option to elect out of the rollover, thus allowing the sharing of the tax burden between the transferor and recipient spouse. However, it is of interest to note that the electing out option can, in practice, only be exercised by the transferor spouse in their own tax return for the year. That is, no forms are required to elect out of the section 73 rollover. The transferor will not be subjected to any tax liability incurred with respect to the transferred capital property unless he or she so
provides in their tax return. The ultimate control of the application of the rollover provision, and consequently, the placement of the tax burden, lies with the transferor. Thus, it is ironic to note that section 73 places the fate of the tax consequences within in the transferor’s hands while simultaneously placing the tax burden on the recipient as the default presumption.

It may be asserted that the tax consequences surrounding transferred capital property should be included within a court order or written agreement and thus may be easily enforceable through the court system by the recipient spouse in the instance of non-compliance by the transferor spouse in not making the appropriate election in their tax return. However, it has been observed that “the court system is an expensive and frequently inefficient means of resolving differences”.297 Thus, it is of importance to remember that such enforcement through the court system may not be a viable option for the recipient spouse after taking into consideration the social realities surrounding marital dissolution, especially the financial impact of divorce.

Aside from the application of subsection 73(1) to capital property that is transferred as a result of a settlement following the breakdown of marriage, another issue that warrants closer examination is whether income tax liabilities on accruing capital gains and losses are taken into consideration during the division process. More specifically, the provincial legislation governing the division of property aims to provide an equal distribution of property between the former spouses through various methods; however, it is important to consider whether tax consequences, such as accrued capital gains or losses on property, are accounted for during the division process. As has been observed, the ability of the family

297 Freeman, supra note 35 at 79.
law system to take into account the tax consequences resulting from the inclusion/deduction system for support payments has been questioned by some judges of the Supreme Court of Canada.\textsuperscript{298} Such hesitancy may be expanded towards the family law system’s capability to account for capital gains or losses in the division process.

Failure to take into account the accrual of capital gains and losses while dividing property may result in serious injustice. For example, two paintings with equal value may easily be allocated between the former spouses as an equal division. However, the fairness of such a division may be questioned where one of the paintings has a lower adjusted cost base, resulting in a higher accrued capital gain, than the other painting. A heavier imbalance in the division process may result where one of the paintings has accrued a capital gain while the other has a capital loss associated with it.

\textbf{4.4 PENSIONS}

\textbf{4.4.1 Background}

As pensions are one of the largest assets that a family owns,\textsuperscript{299} many questions surround the fate of these assets upon marital breakdown. Are pensions subjected to division? If so, what mechanisms are available to effect such a division? Are pre-marriage contributions vulnerable to the claim of division on the breakdown of marriage? What is the tax treatment accorded to the division of pensions upon marital dissolution? Because of the complexity of pension plans, individuals are often mystified by the intricacies of pensions.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{298} The family law’s system to take into account the tax consequences surrounding support payments was questioned by both Justices McLachlin and L’Heureux-Dubé in the \textit{Thibaudeau} decision.
\item \textsuperscript{299} Statistics Canada, \textit{Assets and Debts Held by Family Units, Including Employer-Sponsored Registered Pension Plans, By Provinces}, online: Statistics Canada <http://www.statcan.ca/english/Pgdb/famj99t.htm>.
\end{itemize}
\end{footnotesize}
and the tax issues surrounding them. Thus, an attempt is made within this section to provide some clarity with respect to pensions and their treatment on marital dissolution.

In considering the various types of pensions available to Canadians, it can be observed that a three tier system exists, with federal public pension plans occupying the first and second levels of the hierarchy, Old Age Security (OAS) and Canada Pension Plan (CPP) respectively.300 The third tier consists of private pension plans. With respect to the federal public pension plans, the majority of Canadians qualify to receive benefits from the Old Age Security program, which constitutes Canada’s largest public pension program.301 The Canada Pension Plan is the other federal public pension plan, which pays benefits to Canadian residents, 65 years of age and older.302 The benefits paid out by the CPP will depend directly on the amount of contributions individuals have made during their working years.

Private pension plans are programs which allow individuals to receive contractual pension income over payments from statutory public pension plans. Registered pension plans (RPPs), registered retirement savings plans (RRSPs), and deferred profit sharing plans (DPSPs) all fall under the umbrella of private pension plans.303 RPP’s can be further


302 Social Development Canada, Retirement Pension, supra note 300.

categorized into defined benefit plans or defined contribution plans. In the former plan, an individual will receive a pre-determined or defined pension payment. In defined contribution plans, the pension income is not pre-determined; rather, the plan stipulates the amount of contributions and who is responsible for making these contributions.

4.4.2 Division and Tax Consequences Arising Upon Marital Dissolution

4.4.2.1 Federal Public Pensions

The only federal public pension plan that is subject to division upon marital dissolution is CPP, which is regulated by the Canada Pension Plan Act. In the event of marital dissolution or the breakup of a common law couple, the Canada Pension Plan provides for credit splitting of CPP pension credit. Of particular importance in determining the split of CPP credits are the duration of the marriage or common-law relationship, and the differential between the earnings of the spouses or common-law partners. Any CPP credits accrued during the period of cohabitation of the couple is

304 CCH Canadian Limited, supra note 258 at para. 15,925.


306 The contributions you pay over the years while you remain in the work force will ultimately become your Canada Pension Plan pension credits. The amount of CPP credits received is directly proportional to the benefit derived from CPP. Same-sex common law couples also qualify for credit splitting if their relationship has ended after July 31, 2000.

While the Canada Pension Plan does allow for the splitting of credit upon the breakdown of a marriage or common-law relationship, such a division will not occur in certain circumstances. Section 55.1(8), Canada Pension Plan Act. CPP earnings will not be subjected to division in the following circumstances: (a) an individual’s pensionable earnings in a year are $7,000 or less (as of 2005); (b) for the period where one of the individuals in the couple is younger than 18 or older than 70; (c) an individual is a beneficiary of a retirement pension or provincial pension plan; (d) where an individual is disabled.

307 If it is determined that both of the individuals in the marriage or common-law relationship had equal pensionable earnings, then utilizing the credit split method will be superfluous as no exchange in credits will occur.
subject to division between the spouses or common-law partners. That is, only those pensionable earnings that have accrued during the time the couple has lived together will be subjected to division.

As the credit splitting mechanism re-distributes the CPP credits earned throughout the duration of the marriage or common-law relationship, each of the former spouses’ pension credits is maintained separately. Thus, on retirement, each individual will receive their CPP entitlement, as calculated from their own credits. Each individual will only be liable to pay tax upon receipt of the CPP benefit.

4.4.2.2 Provincial Private Pensions

Provincial private pension plans are also subject to division upon the breakdown of a marriage. As pensions are major assets, they are subject to division as legislated under the applicable provincial legislation. However, unlike other assets, the division of pensions is particularly complicated, as the process of appraising value requires specialized expertise, and the application of accounting rules. Appraisal is further exacerbated by the fact that pensions are generally locked in; therefore assigning accurate values to assets becomes difficult.

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308 *Canada Pension Plan Act*, supra note 305 at s. 55.1(4).

309 Social Development Canada, *Canada Pension Plan (CPP) – Credit Splitting Upon Divorce or Separation*, online: Social Development Canada <http://www.sdc.gc.ca/asp/gateway.asp?hr=en/isp/pub/factsheets/credit.shtml&hs=cpr>. Individuals will still be considered to be cohabiting if they are living apart from each other due to illness or work.


311 Hendrickson, supra note 242 at 249.

312 The valuation of pensions or methods used to determine the appropriate portion to be paid to the non-member spouse will not be discussed as it is beyond the scope of this thesis.
As pension division legislation varies among provinces, Barbara Hendrickson notes that methods used for dividing pension at the source can be classified into three categories, referred to as “transfer”, “separate pension”, and “benefit split”. The first method, transfer, involves transferring a valued portion out of an unmatured pension into another locked-in retirement plan. An alternative method of pension division is to establish a pension for each spouse within the same plan, otherwise known as separate pension. Finally, the benefit split method is utilized to split the payments arising from the pension upon its maturing.

If a pension plan has matured prior to marital breakup, irrespective of whether it is a defined contribution plan or a defined benefit plan, pension division will take place via the benefit split method, resulting in appropriately apportioned payments allocated to both of the former spouses. In the utilization of the benefit split method to divide a pension, the plan administrator’s duties include division of each monthly payment, individual withholding for each of the former spouses, and finally payments of the appropriate pension amounts to each of the parties separately.

While the division of pension for matured plans is relatively straightforward, the method utilized to split unmatured pensions varies, depending upon the type of plan in question. Where there is an unmatured defined benefit plan, the non-member spouse becomes a limited member of the plan, and two options exist with respect to division upon

313 Hendrickson, supra note 242 at 249.
marital dissolution.\textsuperscript{315} The first option involves the creation of separate plans for each spouse within the pension.\textsuperscript{316} In this situation, the separate pension will be created when the member spouse retires. Alternatively, when the member spouse is eligible to retire, and thus to receive payments from their pension plan, the non-member spouse’s share accumulated throughout the marriage can be transferred to another retirement savings vehicle.\textsuperscript{317}

On the other hand, if the individual has not retired and is a member of a defined contribution plan, the unmatured pension will be divided immediately through the transferring of the non-member spouse’s share of contributions and accumulated earnings within the plan into another retirement savings instrument.\textsuperscript{318} In such a situation, the transferred amount will generally be locked-in, such that the non-member spouse is limited to using the funds in the form of a life income.

If the benefit split method is utilized, the member-spouse’s monthly payments arising from the pension will be divided in accordance with the separation agreement or court order between the member-spouse and the non-member spouse. In such a case, each individual will be liable to pay tax on the amount received from the pension.\textsuperscript{319} Likewise, with the creation of a separate plan for the former spouse within the pension, both the member and non-member spouses will receive their own payments out of their own pension plans and must pay tax upon receipt. Even in the instance where the onus of splitting the pension

\textsuperscript{315} Ibid. at c. 2.

\textsuperscript{316} Family Relations Act, supra note 243 at s.74(b).

\textsuperscript{317} Ibid. at s.74(a).

\textsuperscript{318} Ibid. at s.73; BC Law Institute, supra note 314 at c. 3.

\textsuperscript{319} Income Tax Act, supra note 2 at s.56(1)(a)(i)(C).
payment is placed on the member-spouse and thus the plan administrator pays out a single cheque to the member spouse, CRA takes the position that both of the former spouses would be liable to pay the taxes for the portion received by each of them.\textsuperscript{320}

The transfer method requires closer attention as this technique deals with the division of pensions outside of the sphere of the plan itself whereas both the benefit split and separate pension methods are regulated, to some degree, by the actual pension plan. Several specific criteria must be met for the transfer method to be an effective rollover for pension division.\textsuperscript{321} First, the transfer method is only effective if transfer is made between specific plans.\textsuperscript{322} For example, a non-member spouse’s entitlement to benefits from their former spouse’s RPP can only make use of the transfer method if the transfer occurs from the RPP to the non-member’s RPP, RRSP or RRIF.\textsuperscript{323} Furthermore, the payment must be made pursuant to a court order or agreement made for the purposes of property division upon the breakdown of marriage or a common-law relationship. Moreover, the transfer has to be made in a single payment and “not as a part of a series of payments”.\textsuperscript{324} If all of the above conditions are met, when the amount is transferred from the transferor’s plan to their former spouse’s pension plan, the transferred amount will not be included in the transferor’s income.\textsuperscript{325} Similarly, the


\textsuperscript{321} Hendrickson, supra note 242 at 249. The transfer method can be effected through the use of the T2151 form from CRA.

\textsuperscript{322} Income Tax Act, supra note 2 at s.146.3(14)(b). With respect to DPSPs, a transfer can only be made from an individual’s DPSP to a former spouse’s or common-law partner’s RPP, RRSP or DPSP according to s147(19)(d) of the Income Tax Act. Similarly, payments out of an RRIF can only be transferred to the former spouse’s RRIF or RRSP.

\textsuperscript{323} Ibid. at ss.147.3(5), 147(19)(b)(ii)(B), 146.3(14)(a).

\textsuperscript{324} Ibid. at ss.147.3(5), 147(19)(a), for RPPs, DPSPs respectively.

\textsuperscript{325} Ibid. at ss.147.3(9), 147(20). This applies to both RPPs and DPSP.
former spouse who is in receipt of the transferred amount will not bear any tax liability with respect to the transferred amount until the amount is withdrawn.\textsuperscript{326}

The \textit{Income Tax Act} also stipulates methods for RRSP division via the transfer method.\textsuperscript{327} It will be noticed that the requirements to establish an effective RRSP transfer are more onerous as opposed to a transfer from an RPP or DPSP. In addition to having the amount be transferred to a former spouse under a court order or agreement with respect to property division upon marital dissolution, the \textit{Income Tax Act} also requires that the former spouses to be living separate and apart. Furthermore, amounts being transferred out of an RRSP can only be put into the former spouse’s RRSP or RRIF.\textsuperscript{328} If these requirements are adhered to, the transferred amount will not be included in the transferor’s income for the year and will be taxed to the recipient when such payment is withdrawn from their RRSP.\textsuperscript{329}

The importance of obtaining a court order or separation agreement pertaining to the division of property upon the breakdown of marriage or a common-law relationship cannot be over-emphasized. That is, if an individual is to assign some of their pension payment to another individual but no court order or agreement was in place mandating the division of pension benefits, then the transferor may be liable to pay tax on their entire pension, regardless of whether or not a portion was assigned to a former spouse.

\begin{footnotesize}
\textsuperscript{326} \textit{Ibid.} at s.56(1)(a).

\textsuperscript{327} \textit{Ibid.} at s.146(16)(b).

\textsuperscript{328} Hendrickson, \textit{supra} note 242 at 249. It is important to note that if an amount is transferred to the former spouse or common-law partner’s RRSP, this will not interfere with their RRSP contribution limit.

\textsuperscript{329} \textit{Income Tax Act, supra} note 2 at s.146(8).
\end{footnotesize}
4.4.2.3 Evaluation of Taxation of Pensions

The general rule for the taxation of pensions is that the recipient will be taxed on withdrawals, regardless of whether the individual was the original plan member or received the pension benefit through a property settlement on the breakdown of marriage. While the methods utilized to divide pensions upon marital dissolution vary from province to province, it can be observed that the tax treatment accorded to divided pensions remains consistent regardless of the mechanism employed to effect the division. In fact, the tax consequences with respect to pension division on the breakdown of a marriage remain uniform irrespective of whether the pension is a provincial private plan or a federal public plan.

4.5 CONCLUSION

Upon the breakdown of marriage, an issue of concern to the parties is the division of matrimonial property. Of particular importance is the division of pensions as benefits arising out of pension plans consist of a significant portion of the family unit’s total value of assets. While the legislation governing property division varies from province to province, the tax treatment accorded to such property is applied in a uniform manner.

Although the taxation scheme applied to divided pensions is equitable, in contrast, the tax treatment accorded to transferred capital property does not take into account the social realities surrounding divorce for several reasons. First, as discussed in previous chapters, the recipient spouse is more likely in financial need as compared to the transferor spouse. Despite the financial disadvantage suffered by the recipient spouse, the rollover provision indirectly bestows a preferential treatment to the transferor. The default presumption contained within subsection 73(1) is that the recipient spouse will bear the tax burden. The
recipient spouse is further disadvantaged in the sense that the only method of providing that the transferor be liable for any accrued capital gains on the property is for the transferor to make such an election on their income tax return. Therefore, if the transferor disobeys a court order or written agreement to this effect by not making the appropriate election on their tax return, the recipient spouse has little control in this regard.

In an attempt to remedy this problem, it is suggested that the CRA devise a form for the electing out of the subsection 73(1) rollover, which would require the signatures of both spouses. In the event that the transferor refused to sign the form, the recipient spouse could submit the incomplete form to CRA along with a copy of the court order or written document as proof that the transferor be liable for the taxes accrued on the transferred property. By having a separate form for the electing out option, the control for exercising this option no longer lies with the transferor spouse. Thus the control accorded to the transferor spouse under the current regime in section 73(1) is shifted equally to both spouses, placing the recipient spouse in a less vulnerable situation to the perils of the transferor.

Furthermore, the tax legislation applied to property division does not take into account social realities surrounding divorce as too much responsibility is shifted on the family law system. That is, the hidden tax consequences associated with capital property, such as accrued capital gains and losses, may often be overlooked by the divorcing parties themselves or their legal counsel, usually family law or general practitioners, and no remedy is provided within the tax legislation to accommodate for any inequitable division that might result. It is of significance to emphasize that such problems should not simply be brushed aside as a “family law” problem. Rather, accountability should be taken from both a family
law and tax perspective such that feasible solutions may be identified. For example, CRA may work in conjunction with legal institutions to create an awareness of the inequity that arises with respect to property division as a result of hidden capital gains and losses. The parting of such knowledge would help to prevent future disputes, thereby easing the burden on both the tax law and family law systems.
CHAPTER 5

CONCLUSION

The breakdown of a marriage can have long lasting effects on the parties involved, both emotionally and financially. From a financial perspective, many tax consequences arise upon marital dissolution. The purpose of this thesis was to investigate the taxation treatment accorded to the breakdown of marriage in an attempt to identify weaknesses in the tax legislation and to provide appropriate recommendations to the legislation. Such a study is of particular significance when considering the increased prevalence of divorce.

Accompanying the increasing divorce rate is the rise in the level of the many detrimental consequences and social realities surrounding marital breakdown. The impact of divorce has long lasting effects on both the former spouses as well as children within the family. Emotional, psychological, and physical issues are associated with the breakdown of marriage. Additionally, of significance is the economic plight suffered subsequent to the divorce process. All of these issues not only adversely affect the individuals involved, but also indirectly have an effect on society at large as an onerous burden is placed on various social programs funded by the government.

As divorce is a topic that requires attention from both the spheres of tax and family law, it is important to understand the interplay between these two areas of law. In an attempt to assess the harmony, or lack thereof, between family law and tax law, an analysis of the
legislative policy objectives underlying each of these areas was conducted. This study revealed a disparity between these areas of law with respect to the divorce process. That is, it can be observed that policy objectives underlying family law specifically address, at a great length, various issues arising out of divorce. On the other hand, the policies utilized in the drafting of taxation legislation are broad in application, reflecting the Income Tax Act's wide scope, and thus do not accord particular prominence to the divorce process. Therefore, it can be concluded that a lack of harmony exists between tax law and family law with respect to divorce.

The discrepancies that exist in the treatment of marriage breakdown between the arenas of taxation and family law ultimately result in adverse implications for individuals undergoing the divorce process. Consequently, an analysis of the tax consequences arising upon marital dissolution was undertaken in an attempt to determine whether our tax legislation requires further amendments to adequately reflect the social realities surrounding families and the breakdown of marriage, concepts which seem to have been better accounted for within the realm of family law. In this process, the taxation provisions related to spousal support payments, child support payments and the division of property were subjected to an in-depth analysis.

In chapter two, it was seen that the inclusion/deduction taxation system applied to spousal support payments does not take into account the financial consequences surrounding divorce, as the tax burden arising from the support payment is ultimately shifted to the recipient spouse while simultaneously benefiting the payor spouse with a deduction. Thus, with the current taxation treatment accorded to spousal support payments, the recipient
spouse is not able to benefit from the entirety of their support payments. This taxation treatment seems unacceptable when considering the fact that spousal support payments are granted in an attempt to provide relief to economic hardships arising out of divorce.

The discord between the realms of taxation and family law is further apparent when considering spousal support. While family law expressly promotes economic self-sufficiency as one of the objectives to consider in the granting of spousal support payments, tax legislation clearly provides that spousal support payments must be made in the form of periodic payments to qualify under the inclusion/deduction system. In preventing any lump sum forms of payments from qualifying under this special tax treatment, payor spouses may be more inclined to provide support payments on a periodic basis, which indirectly results in the encouragement of some form of economic dependence between the former spouses.

The taxation system’s lack of taking into account social realities surrounding divorce is further exemplified when considering the tax provision governing child support payments, as seen in chapter three. The inclusion/deduction system no longer applies to the taxation of child support payments; however, the system still requires payments of child support to be made in full before permitting the payor spouse to claim any deduction available with respect to spousal support. While such a safeguard seems to benefit the recipient spouse, upon closer analysis, it can be seen that the payor spouse may withhold payments of child support for years and still be eligible to claim the full amount of the deduction available, cumulatively, in the event that they pay the total amount in arrears. Once again, the tax system’s prejudicial treatment towards the recipient spouse and advantageous treatment accorded to the payor spouse become blatantly apparent.
The fourth chapter details the taxation scheme applied to the division of property. It was seen that the tax legislation provides the option for rolling over property that has been transferred as part of a settlement in the breakdown of marriage, thereby deferring any accrued tax consequences until the recipient spouse disposes of the property. Despite the fact that the provision allows both the option of having the rollover apply, or the alternative of electing out of the rollover, it is argued that the tax provisions related to the division of property do not adequately take into consideration the social realities surrounding the breakdown of marriage. This is due to the fact that power regarding the utilization of the rollover provision is placed in the hands of the transferor spouse, who generally tends to be in a stronger financial position than the recipient spouse, while the default effect of the legislation is that the tax on the transferred item be placed on the recipient spouse. Thus, it can be seen that the structure of the tax legislation governing the transfer of capital property ignores the financial plight suffered as a consequence of divorce, especially by recipient spouses.

Through examining the legislation governing the taxation of spousal support, child support and the transfer of capital property, it is blatantly clear that the current tax legislation does not adequately take into account many of the social realities surrounding divorce. The arena of family law expressly recognizes that any economic disadvantages or hardships arising as a consequence of the divorce should be taken into consideration, and that the breakdown of marriage should be settled equitably between the two spouses. Thus, it can be seen that one of family law's main objectives is the promotion of equity. The family law system strives to prevent the burden of marital dissolution from falling disproportionately on
one of the spouses by advocating for fairness with respect to spousal and child support payments, as well as within the context of the provincial family legislation, which governs division of property.

In stark contrast, it can be seen that the tax system gives added advantage to the payor spouse while simultaneously disadvantaging the recipient spouse. This is evident in considering the fact that the inclusion/deduction system places the tax burden on the recipient spouse, who is generally the lower-income earner. A similar result ensues when considering the fact that child support payments may be made in arrears by the payor spouse without impacting the eligibility of the payor spouse to collect the cumulative value of the deduction provided for spousal support payments. The notion that prominence is accorded to the payor spouse by the tax system is also supported when considering the taxation scheme applied to the division of property. That is, the transferor spouse has the flexibility to utilize or elect out of the rollover provision, putting the recipient spouse at the mercy of the transferor spouse. Such treatment seems to overlook the economic hardship suffered by the recipient spouse, as well as the numerous issues faced by children, who generally tend to be in the care of the recipient spouse.

Therefore, it can clearly be seen that the tax provisions governing marital dissolution do not adequately take into consideration many of the social realities surrounding divorce. As previously acknowledged, in attempting to provide solutions to the various problems within the tax legislation, many conflicting policy objectives will have to be addressed. Furthermore, in amending the tax legislation, it will be imperative to not only focus on the short term loss of revenue for the government in providing tax benefits or incentives to
divorcing couples, but to take into account the long-term impact of the various consequences arising out of marital dissolution. This also includes taking into account the burden placed on various other government social institutions in determining the opportunity cost of providing additional tax benefits to individuals undergoing the divorce process, especially for recipient spouses. Such long-term impacts include the burden placed on society through the welfare and health care systems as well as child welfare agencies. In addition, the financial difficulties suffered by divorced individuals, especially recipient spouses, may turn into a vicious cycle, resulting in generations being destined to the same economic plight, with more weight being placed on the government.

A great deal of work still remains to be done in this area to find viable solutions which take into consideration the social realities suffered by divorced individuals. However, one thing remains clear for sure: taxation law and family law will be required to work hand-in-hand in order to find the most appropriate solutions to this problem.
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APPENDIX 1: SUPPORT DEDUCTION FORMULA


60. There may be deducted in computing a taxpayer's income for a taxation year such of the following amounts as are

(b) the total of all amounts each of which is an amount determined by the formula

\[ A - (B + C) \]

where

A is the total of all amounts each of which is a support amount paid after 1996 and before the end of the year by the taxpayer to a particular person, where the taxpayer and the particular person were living separate and apart at the time the amount was paid,

B is the total of all amounts each of which is a child support amount that became payable by the taxpayer to the particular person under an agreement or order on or after its commencement day and before the end of the year in respect of a period that began on or after its commencement day, and

C is the total of all amounts each of which is a support amount paid by the taxpayer to the particular person after 1996 and deductible in computing the taxpayer’s income for a preceding taxation year;