THE CANADIAN BAR ASSOCIATION
L'ASSOCIATION DU BARREAU CANADIEN

October 13, 2010

Via email: Flaherty.J@parl.gc.ca; Ashfield.K@parl.gc.ca

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance
House of Commons
Ottawa, ON K1A 0A6

The Honourable Keith Ashfield
Minister for National Revenue
555 MacKenzie Avenue, 7th Floor
Ottawa, ON K1A 0L5

Dear Ministers:

Re: Tax Issues for Family Lawyers

I am writing on behalf of the Canadian Bar Association's National Family Law Section (CBA Section) to outline some concerns our members have raised about certain provisions of the *Income Tax Act* (ITA), as well as the administrative application of that Act by Canada Revenue Agency (CRA). The CBA Section consists of family law specialists from all regions of Canada, and our clients represent the full range of individuals impacted by family breakdown.

In 2009, we asked all 1500 Section members to relay any tax related issues they had come across in practice. This informal survey elicited many responses, and some key issues and concerns emerged. In this letter, we summarize those issues and concerns, with additional detail.

Issue #1: Proving Separation for Income Tax Purposes

Under the ITA, the taxpayer is required to provide proof of separation including:

1. where the taxpayer claims the deduction for child care expenses and earns a higher income than his or her former spouse: section 63(2).
2. where the taxpayer claims the Canada Child Tax Benefit (CCTB) based on the taxpayer's income alone, rather than including his or her former spouse's income: section 122.62(6).

Under both sections, separation is defined as "living separate and apart" for a period of at least 90 days.[1]

[1] For the purposes of claiming the child care deduction the period of 90 days must begin in the year that the deduction is claimed. For the purposes of claiming the CCTB the period of 90 days must begin in the first month from which the benefit is claimed.

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One of the issues with proving separation for income tax purposes is that CRA's definition of "living separate and apart" differs from that used in the family law context, and requires that the former spouses live in separate residences.[2] Proof that former spouses are living in separate residences can be provided by way of, for example, utility bills that show different addresses for each spouse.

This can present a problem for taxpayers. For instance, mailing addresses may not yet have been changed (and in some instances, there are costs to doing so). CRA will not accept a separation agreement stating the date of separation as conclusive proof.[3] Letters from independent third parties are also not considered conclusive proof of separation, but merely one factor for CRA to consider when looking at the taxpayer's overall circumstances.[4] Further, it can be difficult for one spouse to obtain copies of a former spouse's bills to prove separate residences. This problem is exacerbated when a former spouse files a tax return using a different date of separation. CRA will not always disclose why it has rejected a particular date of separation, but this may be because different dates were provided by the two spouses.

As of May 2009, CRA policy regarding proof of separation for the purposes of the CCTB states:

> The CRA recognized that, in the context of a breakdown of the marriage or relationship, it was often difficult to obtain the other spouse's or common-law partner's information in support of the benefit recipient's claim. For that reason, the CRA simplified the review process, and benefit recipients can now assess their situation and provide all required documents in one simple step. With this new process, benefit recipients who worry that the CRA will not receive their former spouse's information may immediately submit two letters from independent third parties to show that they live at a residential address different from their former spouse.[5]

Recommendation

The Canadian Bar Association National Family Law Section recommends that CRA take action to alleviate problems for separated spouses in proving that they are separated, including that:

the definition of "date of separation" be amended to conform with the Divorce Act and related provincial family law legislation to include two spouses who are living separate and apart but under the same roof,

separation be defined consistently for income tax purposes and for family law purposes,

a date of separation in a separation agreement should be considered conclusive proof that a taxpayer and former spouse are living separate and apart,

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2 The "Frequently asked questions about marital status" section of the CRA website states: "If you continue to live together in the same household, we will not consider separation to have occurred. An exception to this may occur when separate living quarters are self-contained in the same household." See: http://www.cra-arc.gc.ca/bnfts/mrtl/sprtd-eng.html [as of Oct. 1, 2010]

3 An Alberta respondent to our survey attempted to prove that her client was separated by providing a copy of a Statement of Claim for divorce to the CRA; the CRA did not accept this as adequate proof.

4 Phone enquiry to the Universal Child Care Benefit/Canada Child Tax Benefit division of the CRA, February 8, 2010.

5 Minister of National Revenue, *News Release*, May12 2009.

an affidavit stating that an individual is living separate and apart from a former spouse should be accepted by CRA if separated parties have not yet signed a separation agreement or obtained a court order, and

only where there is a conflict should utility bills and other types of independent proof as to the date of separation be required.

Issue #2: Deduction of Legal Fees

Section 18(1)(a) of the ITA allows a taxpayer to deduct from business or property income those expenses made or incurred for the purpose of gaining or producing income from the business or property. The case law has established a two part inquiry for determining whether a legal expense related to support has been incurred for the purpose of gaining or producing income from business or property:

1. is the claim in regard to which the expenses were incurred a claim to income to which the taxpayer was entitled?

2. were the legal expenses properly incurred in order to obtain payment of that income?[6]

The first part of this test excludes the deduction of legal expenses for payers and payees attempting to establish a right to support in the first place.

CRA's current position is found in an October 10, 2002 *Technical News Release*. Legal fees relating to the following types of procedures are deductible by the recipient of support in the year the fees are paid:

- Obtain an order for child or spousal support.
- Enforce an existing order for child or spousal support.
- Vary an existing order for child or spousal support.
- Defend a reduction of child or spousal support.

Legal expenses paid (and deducted from income) must be reduced for any legal costs awarded by the court that are received by the recipient spouse.[7]

Non-deductible family law legal expenses relating to, or on account of capital, or personal or living expenses include the following:

- establishing the right to spousal support amounts, either by way of a support order or through the negotiation of a separation agreement or the costs;[8]
- obtaining a divorce;[9]

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6 *Evans v. Minister of National Revenue*, 1960 CarswellNat 289 (S.C.C.) at para. 21.

7 *Interpretation Bulletin on Legal and Accounting Fees* (IT-99R5 dated December 11, 1998 with revisions made December 5, 2000).

8 IT-99R5 at para. 17.

9 *Ibid*.

- seeking to obtain an increase in spousal or child support;[10]
- seeking to make child support non-taxable;[11]
- in connection with receipt of a lump sum payment which cannot be identified as being payment in respect of a number of periodic payments of support amounts that were in arrears;[12]
- defending against an increase in child support;[13]
- obtaining custody or access.[14]

Support payers are never allowed to deduct legal fees. A payer's legal fees can be compared to the fees incurred when hiring a tax consultant for one's business. If the latter is a deductible business expense, then why not the former? The response in the CRA's *Interpretation Bulletin* is: "[f]rom the payer's standpoint, legal costs incurred in negotiating or contesting an application for support payments are not deductible since these costs are personal or living expenses. Similarly, legal costs incurred for the purpose of terminating or reducing the amount of support payments are not deductible since success in such an action does not produce income from a business or property."[15]

Further, the rationale that recipients should receive a deduction on account of paying legal fees to obtain taxable income is not valid as legal fees may also be deducted by payers in pursuing a claim for non-taxable child support.

It is difficult to explain to clients that support recipients may be permitted to deduct legal expenses but that support payers are never allowed to do so. In *Bergeron c. R.*, Justice Archambault stated: "I consider it totally unfair that both spouses are not treated the same for tax purposes." He proposed eliminating the possibility of support recipients deducting their legal expenses as well, as support in this context is not income from a business or property.

Recommendation

The Canadian Bar Association National Family Law Section recommends amendments to CRA policies to allow legal expenses incurred to contest a claim for support to be deducted. Greater clarity is also required as to what constitutes sufficient evidence to prove the deductibility of legal fees.

Issue #3: Provision of Receipts

In the past, payers could document the support they paid by providing a copy of their executed separation agreement. Subsequently, CRA requested that payers prove the spousal support paid by also providing copies of cancelled cheques. This is impossible for payers that pay by way of direct deposit, and CRA has in some cases refused banking records to prove support payments.

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10 *Ibid*.

11 *Ibid*.

12 IT-99R5 at para. 20.

13 *Bergeron c. R.*, 1999 CarswellNat 1899 (T.C.C.).

14 IT-99R5 at para. 21.

15 IT-99R5 at para. 21.

More recently, CRA has asked for further proof of spousal support paid, specifically receipts signed by the recipient spouse. Family lawyers regularly advise payer clients to maintain records of spousal support payments. However, CRA has, on occasion, insisted that payers provide a receipt from the recipient spouse acknowledging the spousal support received. There are several problems with this requirement. First, the demand for receipts is not applied uniformly, consistently or predictably. Second, there appears to be no basis in the ITA (or Regulations or Interpretation Bulletins) requiring that receipts be provided. Third, it is unreasonable to expect that, in an average conflict separation, the recipient spouse will voluntarily provide a receipt for support paid each year.

Finally, it is hard to understand why more evidence is required beyond a signed separation agreement and the recipient spouse claiming the support received in an income tax return. If spouses would collude to avoid taxes by claiming payments that were never made (and go so far as to include or deduct those payments on their respective income tax returns), surely requiring a receipt would not address the problem.

Recommendation:

The Canadian Bar Association National Family Law Section recommends replacing the requirement that support payers provide receipts from the recipient spouse with a requirement to provide a copy of the separation agreement and, if requested, proof of payment, such as cancelled cheques or bank records in the case of direct deposit.

Issue #4: Proof of Child Support Payments

CBA Section members have reported that clients are being denied a deduction for spousal support payments in cases where the client cannot "prove" that child support was paid pursuant to the *Child Support Guidelines.*

While we agree that child support dollars should be deemed to be the "first dollars paid," this issue has proven to be particularly problematic in situations of shared or split custody where child support payable pursuant to the *Child Support Guidelines* is not readily ascertainable.

Recommendation:

The Canadian Bar Association National Family Law Section recommends that CRA accept a signed separation agreement as providing details of child support obligations. Where those obligations are met, spousal support payers should receive full deductions for spousal support paid.

Issue #5: Spousal Support Arrears

Spousal support is deductible and taxable in the year paid. When a support payer accumulates significant arrears (perhaps over a course of years) and then pays the arrears in a lump sum, the recipient incurs a significant tax liability in that year (and the payer gets a significant deduction), which reduces the net value of support received.

The tax treatment of spousal support actually encourages payers who know their income will increase significantly in the future to accumulate arrears and pay off those arrears later, when income is higher. This allows the payer to shelter income that would otherwise be subject to a higher rate of tax.

Recommendation:

The Canadian Bar Association National Family Law Section recommends that the Income Tax Act be amended to make spousal support arrears taxable and deductible in the year for which the arrears are owed.

While we acknowledge that this recommendation would also require recipient spouses to re-file their tax returns for previous years upon receiving payments of arrears, it is important to remedy a tax incentive to be delinquent in paying spousal support.

Issue #6: Splitting Pension Benefits and Attribution Rules

When parties separate and one spouse is a member of a pension plan, an actuary will generally be retained to determine the plan's value. Assuming that a spouse's pension is the only asset of the parties, the owner of the pension would owe the other spouse half its value as an equalization payment. The obvious problem is that the lump sum owed is not liquid.

The solution would be to divide the benefits flowing from the pension only if and when they are paid, as opposed to financing a lump sum payment based on its value at the valuation date.

Generally, provincial pension benefits legislation provides terms under which a portion of the pension benefits of a plan member may be paid to a spouse or former spouse pursuant to a domestic contract, written separation agreement or court order relating to a division of property pursuant to the breakdown of a marriage. For income tax purposes, the portion of pension benefits received by each spouse or former spouse as permitted under the pension benefits legislation of the province is included in the income of that person as a pension benefit pursuant to section 56(1)(a)(i) of the ITA.

The ITA does accommodate splitting pension benefits between spouses or former spouses. Simply put, any pension benefit received by a spouse will be included in income in the year received, with appropriate information slips to each spouse provided by the pension plan administrator.

Although the ITA appears to be user friendly with respect to the taxation of pension receipts, the attribution rules in the ITA – specifically section 56(2), Indirect Payments and section 56(4), Transfer of Rights to Income – are unclear as to whether a pension payment received by one spouse could be attributed back to the other.

Also, in cases involving pensions subject to legislation that does not permit division of benefits between separating or divorced spouses, application of the ITA provisions could lead to the pension plan member having to pay income tax on the non-member's share, including any interest and penalties that may be applicable. Overall, there is a lack of clarity surrounding taxation resulting from division of pension payments. Separating and divorcing spouses cannot adequately anticipate tax consequences in the same way as with other provisions, for example, a transfer of RRSPs or transfer of a matrimonial home.

It is unclear why the ITA attribution rules exclude only retirement pension payments assigned by the taxpayer under a provincial pension plan. Also unclear is why the ITA taxes pensions divided between parties if that pension is administered by provincial legislation but not, for example, by federal legislation or through other arrangements not regulated by a province.

In our view, all types of pension and retirement plans where the benefits are divided between the parties as they agree should be taxable in each party's hands in the year they are received. For

example, benefits paid by a company that exceed the maximum amounts permitted by the ITA from a registered plan are commonly referred to as Supplemental Executive Retirement Plans (SERPs). Payments from a SERP requires that the full amount be taxed in the member spouse's hands. It seems impossible to divide a SERP between separating or divorcing parties in a tax effective manner. Upon a distribution from the plan, the member will likely include all of the distribution as income, although a portion, possibly 50%, has been paid directly to a spouse or former spouse.

Where the division of pension benefits is administered by the pension administrator, the income tax consequences will be known to each recipient as the administrator makes the appropriate withholdings and issues the necessary information slips to permit filing of individual personal income tax returns. However, where the plan administrator refuses to assist, for example, in a division of a SERP or where agreements or orders were made prior to the effective date of specific pension division legislation, then usually the member pays a portion of the pension benefit to the non-member spouse. In these situations, any withholdings pertain to the member only. This causes an unnecessary accounting to deal with the withholdings applicable to the non-member's share.

In these cases, further agreement between the parties will be required to ensure that the member spouse will pay the pension entitlement on a pre-tax basis to the non-member spouse, although the member has received an after-tax amount. We anticipate resistance when the member is required to transfer to the non-member spouse a payment based on an after-tax receipt. In our view, this would be an impediment to settlement. In either of the situations outlined, one or the other spouse will be short changed, resulting in inevitable conflict.

The pension member could apply to reduce withholdings concerning the amount to be paid to that member's former spouse. A member might simply apply to CRA to permit the pension plan administrator to reduce the tax withholdings based on the amount to be paid to the non-member spouse, similar to when parties arrange for payment of spousal support and the withholdings made by an employer. This procedure can be somewhat awkward and confusing, requiring renewal either on an annual or biannual basis and thus increasing the administrative burden on the parties. While CRA has the discretion to approve, it does not always do so.

Ideally, the member spouse could allocate some portion of the withholdings to a former spouse more directly. As long as CRA receives the income tax on that portion of the pension received by each party, it should not be an issue.

If the non-member spouse does not pay the required income tax on pension receipts transferred from the member spouse, CRA may expect the member to pay all taxes. This would be unfair. Changes to the ITA similar to those 1990s amendments relating to transfers of property pursuant to a marriage breakdown where the transferor owed personal income tax should be considered. Under current rules, CRA cannot look to the transferee of property for the unpaid taxes of the transferor. In our view, this should be extended to all transfers of pension benefits.

Recommendation:

The Canadian Bar Association National Family Law Section recommends that, to avoid uncertainty in division of pensions in marriage breakdown:

(a) the ITA provide clear and precise rules about the income tax consequences of the transfer of pension benefits

(b) payments to a non-member spouse from a registered or supplemental pension, either directly from the member or the plan administrator, should be taxable to the non-member regardless of how the division is implemented

(c) any payments to a non-member spouse should not be included in the member's income

(d) where income tax withholdings have been made from a member's pension relating to a non-member share, the ITA should permit a mechanism for the member spouse to direct that a portion of the tax withheld relating to the non-member share be credited to that person, and

(e) Information bulletin IT-499R dated January 17, 1992 should be amended to clearly describe any changes so that taxpayers are certain about their entitlements with respect to the income tax treatment of divided pension benefits.

Issue #7: Application of Canada Child Tax Benefit

Among the most frequent comments received from our informal survey concerned the manner in which CRA applies the CCTB for separated and divorced parents who share parenting of their children in a generally equal manner.[16] In these situations, CRA provides for sharing the benefit on a six month rotating basis. The "frequently asked questions" section of the CRA website about shared eligibility for the CCTB states:

> Shared eligibility exists where a child lives more or less equally with two separate individuals (whether 4 days with one, and 3 days with the other, on a one week on, one week off basis or some other similar rotation), and each individual is primarily responsible for the child's care and upbringing when the child resides with them. The Canada Child Tax Benefit (CCTB) legislation only allows eligibility to one "eligible individual" in a month. To address this problem, the Canada Revenue Agency (CRA) developed a shared eligibility policy that would recognize that there could be two eligible individuals for the same child. It was therefore decided to allow eligibility for the child (or children) to each individual on a 6-month on, 6-month off rotation, both for the CCTB and for the child component of the goods and services/harmonized sales tax (GST/HST) credit.[17]

Currently, federal legislation applicable everywhere but Quebec prevents CRA from having two recipients eligible for the CCTB in the same month. CRA's position is that it is easier administratively not to rotate benefits between recipients monthly, and so the policy is that the CCTB rotates on a six month basis.

CRA is only bound by orders from the Federal Court, so even if a family court order says that one parent receives the CCTB throughout the year, CRA need not heed it and can provide that benefits rotate. This usually results in the government paying less overall for the CCTB than if the lower wage earner was permitted the full amount of the CCTB throughout the year pursuant to an agreement or court order. For half the year, the higher wage earner receives the CCTB based upon

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16 We note that a Finance Canada consultation recently released in August 2010 addresses the Canada Child Tax Benefit and the Universal Child Care Benefit in shared custody situations. See: http://www.fin.gc.ca/drleg-apl/ita-lir10-eng.asp

17 *Supra* note 2.

that higher wage earner's salary, so the total payment received by the family will be less.[18] The fact that these arrangements were previously allowed makes the situation more difficult for those who relied on receiving the full amount of the CCTB year round.

This arrangement can cause household budgetary problems because the additional money is only received for half the year, and the overall family income for children is lower because of the global amount of the CCTB paid. In Quebec, CRA takes the amount payable yearly to each individual and apportions the payment to both parents on a monthly basis, which addresses the consistent budgeting issue for residents of that province. There should be a user friendly, simple approach for parties to share the CCTB as they decide, provided that there is no "double dipping".

Recommendation:

The Canadian Bar Association National Family Law Section recommends the CCTB be provided as parties elect, or as outlined in a separation agreement or a court order. Where payment is agreed or ordered to be shared, parties should be permitted to elect to be paid on a regular monthly basis.

We trust that the CBA Section's comments will be helpful. We would be happy to discuss them with you at your convenience.

Yours truly,

(original signed by Gaylene Schellenberg for Anu Osborne)

Anu Osborne
Chair, National Family Law Section

cc. The Honourable Robert Nicholson, P.C., M.P.
Minister of Justice and Attorney General of Canada
Via email: Nicholson.R@parl.gc.ca

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[18] CRA's interpretation of the equity of this arrangement, as stated on the CRA website: "By letting individuals pick and choose who between them will be the eligible individual, the CRA is not being fair to all of its other benefit recipients. If a child lived with one individual only, that individual would be the eligible individual (assuming all of the other eligibility criteria have been met) without regard to that person's family income. If a child resides with two individuals, and they are both responsible for that child's care and upbringing, it is most fair and equitable if both share benefit eligibility for that child, regardless of the amount of the benefit, if any, that each will receive. It is entirely possible in a situation of shared eligibility, that one individual will receive no benefits at all during their six-month rotation, due to their high family income."