Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Tax and estate planning considerations on relationship breakdown

A breakdown of your relationship can have a number of legal, tax and estate planning implications. This article provides you with an overview of typical matters that may arise as a result of a separation or divorce. It discusses the taxation of spousal and child support payments, as well as the tax implications of dividing up specific assets that you and your former spouse may own together. This article also identifies tips for developing and implementing a new estate plan post-relationship breakdown.

For tax purposes, a spouse includes a common-law partner. As such, any reference to a spouse in this article includes a common-law partner, except where specifically stated.

When are you considered to be separated?

For tax purposes, you're considered to be separated if you've been living separate and apart for at least 90 days as a result of a breakdown in the relationship and have not reconciled during this time. Although a common-law relationship is terminated once you've been separated for 90 days or more, a marriage is ended only through legal divorce, regardless of how long you've been separated.

Notifying the CRA about your change in marital status

After being separated for 90 consecutive days or immediately after a court-granted divorce, you should inform the Canada Revenue Agency (CRA) about the change in your marital status. You should notify the CRA by the end of the following month after your status changed. For example, if you obtain a court-granted divorce in March, you must inform the CRA about the change in your marital status by the end of April.

The CRA will determine whether you're entitled to certain benefits — such as the Goods and Services Tax/Harmonized Sales Tax (GST/HST) credit as well as the Canada child benefit — based on your new marital status, your adjusted family net income, and the number (and age) of

children who live with you. In addition, your new marital status may help when claiming other tax credits and deductions on your income tax return.

Support payments

Following a separation or divorce, support payments may need to be made to financially support your children or a former spouse. The tax implications of these payments differ, depending on whether they are being in made in support of your spouse or child.

Spousal support payments are generally taxable to the recipient and deductible to the payer, provided they are payable on a periodic basis (as opposed to a lump sum) and the timing of the payments is set out in a court order or written agreement.

Child support payments are generally neither taxable to the recipient nor deductible to the payer.

Lump-sum spousal or child support payments are generally neither taxable to the recipient nor deductible to the payer. However, exceptions do apply, for example, if periodic payments required by a court order or written agreement were overdue and one payment is made to bring them up to date.

Registering your court order or written agreement with the CRA

If your court order or written agreement includes a payment of spousal support, you must register it with the CRA. This will allow the CRA to verify the part of your payments that is spousal support and, if applicable, the part that is child support. You do not need to register your court order or written agreement if it requires child support payments only. Please verify the obligation to register your court order or written agreement with a qualified legal advisor.

Splitting assets

When there's a breakdown of your relationship, you and your former spouse may need to determine how to divide up your assets. Dividing your assets might involve transferring certain property to your former spouse as part of a written agreement or court order. The following sections describe the tax implications of splitting some commonly held assets with your former spouse:

Government pensions

If you separate or divorce, there would be no impact to your Old Age Security (OAS) pension. You can, however, divide the Canada Pension Plan (CPP) and/or Québec Pension Plan (QPP) contributions you and your spouse made during the time you lived together. You can also divide CPP/QPP contributions even if only one spouse contributed to CPP/QPP. Pension credit splitting may help one spouse qualify for benefits and can affect the amount of any current or future benefits under the CPP/QPP programs for both spouses. These retirement benefits are taxable to the recipient in the year they are received.

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CPP credit splitting

In common law provinces, pension credit splitting is referred to as "CPP credit splitting". Eligibility for CPP credit splitting varies depending on when you divorced or separated and whether you were married or living in a common-law relationship. Either you or your former spouse can request a CPP credit split by completing an application form and providing other required documentation. Note that a marriage contract or cohabitation agreement generally does not prevent a credit split, unless you entered the agreement before June 4, 1986, or you live in a province that allows couples to agree not to split CPP pension credits.

QPP partition

In Québec, pension credit splitting is called "partition of employment earnings between spouses." If you were married or in a civil union and obtained a judgment of divorce, legal separation or annulment in Québec, Retraite Québec automatically partitions the employment earnings on which you and your former spouse paid contributions to the QPP for the period of marriage or civil union. This automatic partition occurs unless you and your former spouse have expressly renounced such partition. If you obtained a judgment of divorce, legal separation or annulment outside of Québec, you or your former spouse must file an Application for Partition of Employment Earnings between Former Spouses should you want to partition your earnings. If you were de facto spouses at the breakdown of your union, partition is not automatic. You must file a joint application for partition to be carried out.

Transferring capital property

You can transfer capital property, such as securities in a non-registered account, to your former spouse at your adjusted cost base, if the transfer is in settlement of rights arising from the relationship breakdown. This is known as a tax-deferred rollover and you will not be subject to any tax consequences resulting from the transfer.

If desired, you have the option of electing out of this rollover so the property can be transferred at fair market

value, in which case, you would realize a capital gain or loss. This election would benefit you if, for example, you had unused capital losses available to offset any capital gains triggered on the transfer. The payment of taxes that may be incurred when transferring capital property in the settlement of marital rights is something you may wish to address and negotiate with your former spouse.

There are specific tax rules called the attribution rules that usually apply when you transfer property to your spouse — they're designed to prevent income splitting. According to these rules, income (interest and dividends) as well as capital gains and losses from property transferred to a spouse (or a trust of which the spouse is a beneficiary) will generally be attributed back to you and taxed in your hands.

These attribution rules will cease to apply following a divorce judgement and will also be suspended if you are living separate and apart from your spouse as a result of a relationship breakdown. While this suspension happens automatically on the attribution of income, a joint election is required to stop the attribution of capital gains and losses during the period that you and your spouse are living separate and apart. To learn more about these rules as well as the joint election, please refer to the article "Attribution rules on relationship breakdown".

Transferring registered plan assets

RRSPs and RRIFs

Some or all of the assets held in a registered retirement savings plan (RRSP) or registered retirement income fund (RRIF) can be directly transferred, using CRA Form T2220, on a tax-deferred basis from your RRSP or RRIF to your former spouse's RRSP or RRIF. The transfer must be pursuant to a court order or written separation agreement relating to a division of property in the settlement of rights arising out of a relationship breakdown. You must also be living separate and apart as a result of a relationship breakdown.

When your former spouse later withdraws money from their RRSP or RRIF, the full amount is taxable at their marginal tax rate. As such, it may be preferable to transfer RRSP assets where there's a significant difference between your and your former spouse's future marginal tax rates.

TFSAs

Tax-free savings account (TFSA) assets may also be transferred directly between spouses' TFSAs upon a relationship breakdown. If you transfer TFSA assets to your former spouse's TFSA, your contribution room would not be reinstated and your former spouse would not need contribution room to accept the transfer. Alternatively, you may withdraw assets from your TFSA and give these assets to your former spouse. In this case, the amount of the withdrawal will be added back to your contribution room in the following year. Your former spouse, however, will only be able to contribute these assets to their own TFSA if they have unused TFSA contribution room.

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FHSAs

If you experience a breakdown of your relationship, you may transfer funds directly from your first home savings account (FHSA) to your former spouse's FHSA, RRSP or RRIF. These transfers would not reinstate any FHSA contribution room for you and would not use any contribution room of your former spouse.

Registered pension plans and locked-in plans

Depending on the federal, provincial or territorial legislation that governs a registered pension plan (RPP), some or all of the pension benefits accumulated during a relationship may be divided in the event of a relationship breakdown. The options available will depend on the terms of the pension plan and the governing legislation. For example, the specific terms and legislation will determine whether a court order or settlement is required to transfer pension benefits; whether all or a part of the pension benefit can be transferred; or whether your former spouse must take the settlement as a pension, deferred annuity or lump-sum commuted value.

Depending on the legislation that governs an RPP, some or all of the pension benefits acquired during your relationship may be transferred to a locked-in plan for your former spouse on a tax-deferred basis. As well, subject to the governing pension plan legislation, assets held in a locked-in account may also be transferred on a tax-deferred basis to another locked-in plan on your relationship breakdown.

RESPs

Depending on your jurisdiction of residence, if you and your former spouse are joint subscribers of a registered education savings plan (RESP) for your child, it generally means you have an equal ownership interest in the RESP. As such, there may not be a requirement to separate the RESP assets upon relationship breakdown — you can remain as joint subscribers of a plan after your separation or divorce. In this case, if you remain as joint subscribers, it should be well-documented as to who

makes contributions after your relationship ends and who would be entitled to the contributions if they are not used by your child.

If, instead, you did want to separate the RESP assets, there are a few different possible outcomes. You can choose to open a new RESP with the same children as beneficiaries and transfer a portion or all of the assets from your current RESP to the new one. You can be the subscriber of one RESP and your former spouse can be the subscriber of the other. Transfers from one RESP to another can be done without tax implications when the transferring RESP and the receiving RESP have the same beneficiaries. However, when you have two RESPs for the same beneficiary, you need to be mindful as to which parent contributes first to their RESP in respect of a certain beneficiary. The parent who contributes first will receive the government grant, where applicable. You also need to be mindful of not going over each beneficiary's lifetime contribution limit of $50,000, between both RESPs.

You and your former spouse can also consider having separate RESPs for each child. For example, if you and your former spouse share two children, you can be the subscriber of one RESP for one child and your former spouse can be the subscriber of a separate RESP for your other child. There are no tax implications on transferring one RESP to another when a beneficiary of the receiving plan is a sibling of a beneficiary of the transferring plan, provided certain other conditions are met. This way, less coordination is required in terms of contribution room and government benefits. The main consideration with this alternative is that if the RESPs are opened as individual plans, and one child does not end up going to post-secondary school, it might not be possible to share the contributions, government benefits and income earned in the plan with the other child who will be going to post-secondary school. If, instead, the RESPs are opened as family plans, then it may be possible to add the child who will be going to post-secondary school onto the family plan and use the contributions, government benefits and income earned in the plan for them.

Where you and your former spouse are not joint subscribers but rather you are the sole subscriber of an RESP, you may wish to transfer the RESP assets to your former spouse on the breakdown of your relationship. In this case, your former spouse can become the subscriber of the RESP and assume the plan without any tax implications as a result of a court order or written separation agreement.

Transferring real estate assets

Your principal residence is often the largest asset to consider when a relationship breakdown occurs. If you and your former spouse owned more than one property during your marriage that you intend to keep post-separation, you'll both need to consider various tax matters, such as who can claim the principal residence exemption, as well as who will pay the resulting tax on the eventual sale of the property that can't be claimed as the principal residence.

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Imagine the following scenario. Harry and Winona are living separate and apart as a result of a breakdown in their marriage. Harry and Winona have jointly owned a house as well as a cottage since 1982. As part of a legal separation agreement, Harry's 50% interest in the house, presently owned jointly by both of them, is to be transferred to Winona; Winona's 50% interest in the cottage, presently owned jointly by both of them, is to be transferred to Harry.

The home is currently their principal residence and, subsequent to the transfer of Harry's interest in the house to Winona, it will become Winona's principal residence. The cottage will become Harry's principal residence subsequent to the transfer of Winona's interest.

First, unless Harry and Winona elect not to have the automatic rollover apply, these transfers can be carried out on a tax-deferred basis. The realization of accrued gains and losses is postponed until the recipient disposes of or is deemed to dispose of the property.

Second, provided Harry and Winona jointly elect, future gains or losses on the properties will accrue to the recipients as opposed to the transferors and will not be attributed back to the transferor. This joint election, signed by both spouses, can be made at any time following the relationship breakdown and will apply for the year the election is filed and every subsequent year.

Finally, assuming all of the necessary criteria are met to be able to designate the house and cottage as a principal residence, the principal residence exemption should be available for all years pre-separation and for all years post-separation.

When Winona disposes of the house, if she designates it as her principal residence for all of the years pre-

separation, then Harry will not be able to designate the cottage property as his principal residence for those same tax years. This is because for the years Harry and Winona were married, they, as a family unit, can only designate one property as their principal residence for each tax year. Once Harry and Winona have been living separate and apart throughout the year pursuant to a judicial separation agreement, they can each designate their own property as their principal residence, provided they meet the other relevant criteria. This means when Harry disposes of the cottage, he may not be able to shelter all of the gains realized on the disposition from tax.

Transferring corporate assets

If you and your former spouse are both shareholders of an incorporated business, subject to any terms or conditions set out in a shareholders' agreement, here are several options to consider with respect to dividing or transferring some value of your corporation:

Redeem shares

Perhaps the simplest option is for the corporation to redeem the shares held by one spouse. A redemption involves the company buying back all or a portion of the shares. In a private company situation, a redemption will likely result in a taxable deemed dividend to the spouse having their shares redeemed.

Purchase shares

Another option is for one spouse to purchase shares of the corporation from their former spouse. This option may be preferable if the shares are qualified small business corporation (QSBC) shares and the spouse selling their shares can claim the lifetime capital gains exemption (LCGE). By claiming the LCGE, the selling spouse may be able to reduce or eliminate the income tax otherwise payable on the disposition of the shares.

Related party butterfly

It may also be possible for you and your spouse to divide up your corporate assets through a transaction called a related-party butterfly. In general, a related-party butterfly divides up the assets owned by one corporation into two corporations. You'd essentially transfer some of the assets in the original corporation to another corporation owned by your former spouse on a tax-deferred basis. It may be possible to do this strategy even if one of you didn't initially own shares of the original corporation. Going forward, you and your former spouse would then each own your own corporation. Note that in order to use a related-party butterfly transaction, you must be considered to be a spouse or common-law partner under the federal Income Tax Act at the time of transfer. This means that you still must be married at the time (and not divorced) or if you are common law, separated for less than three months.

When you separate from your spouse, there are certain tax breaks that you will no longer be eligible for.

Benefits, tax deductions and tax credits

When you separate from your spouse, there are certain tax breaks that you will no longer be eligible for. For example, you won't be able to claim your spouse's donations or medical expenses on your tax return. You also won't be able to split pension income on your tax returns if you and your spouse were living separate and apart from each other due to a breakdown in your marriage or common-law relationship at the end of the tax year and for a period of 90 days.

As such, when you separate from your spouse, it's important to make the most of the financial benefits that are available to you and will help increase your cash flow. The following sections discuss some benefits, tax deductions and tax credits that you may be eligible to claim. To provide a distinction:

- A **benefit** provides you with an economic advantage, typically through the form of a payment from the government.
- A tax **deduction** reduces the amount of income that is subject to income tax.
- A tax **credit** reduces the amount of tax owing, usually by a set percentage.

In addition, many provinces and territories offer tax deductions or credits based on family net income, so it's important to speak with a qualified tax advisor in your province or territory of residence to help determine which tax incentives you're eligible for.

Benefits

Your potentially lower household income may mean an increase in the amount of certain benefits you are entitled to, such as the Guaranteed Income Supplement (GIS) or the Canada child benefit.

Guaranteed Income Supplement: The GIS is a monthly benefit paid to OAS recipients living in Canada. To receive this benefit, you must be receiving an OAS pension and your annual income cannot exceed a maximum annual threshold. To determine the annual threshold and possible GIS payments to which you may be entitled, please visit the Service Canada website.

Canada child benefit: The Canada child benefit is a tax-free monthly payment made to eligible families to help with the cost of raising children under 18 years of age. Generally, in order to get the Canada child benefit, you

must be the parent primarily responsible for the care and upbringing of your child. If you have shared custody, you will get 50% of what you would have received if you had full custody, and the amount is calculated based on your own adjusted family net income.

Tax deductions

Child care expenses: In most cases, the child care expense deduction is claimed by the lower-income spouse. However, in situations where you are separated or divorced and have shared custody, you and your former spouse may each claim a deduction for child care expenses in the year. Each of you may only claim child care expenses incurred for the period during the year that your child lived with you and only to the extent that the expenses were paid by you to enable you to engage in certain activities (such as work, carry on a business, carry on research, or attend secondary school).

Legal and accounting fees: As the recipient of support payments, you can deduct legal and accounting fees incurred to establish the right to support payments, to obtain an increase in support, to collect late support payments or to make child support non-taxable.

Legal and accounting fees are generally deductible in the year you incur them. You cannot carry them forward to be deducted in a future year. However, if the legal and accounting fees you incur in a year are higher than your income for that year, it is possible to create a non-capital loss which can then be carried back or forward for 20 years.

As the payer of support payments, you cannot deduct legal and accounting fees incurred to get a separation or divorce, or to negotiate or contest an application for support payments, or for the purpose of terminating or reducing the amount of support payments. You also cannot deduct legal and accounting fees incurred to establish child custody or visitation rights.

Tax credits

Spouse amount: You can generally claim the spouse amount if, at any time in the year, you supported your spouse and their net income on their return (or the amount that it would be if they filed a return) was less than the basic personal amount. In the year of separation, you may claim either the spousal amount or spousal support payments you paid, but not both.

Since spousal support payments can be claimed as a tax deduction rather than a tax credit, higher-income earners usually prefer to claim spousal support payments since the tax savings would be greater with a higher marginal tax rate.

Eligible dependant credit: The amount for an eligible dependant is a non-refundable tax credit designed for single adults who are not claiming the spouse amount and who are responsible for the financial care of a dependant, such as a child.

> The Canada child benefit is a tax-free monthly payment made to eligible families to help with the cost of raising children under 18 years of age.

Only one person can claim this credit for a particular dependant, even if both parents are eligible to claim this amount. Generally, if you're required to make child support payments to a current or former spouse for a child, you cannot claim an amount for an eligible dependant for that child. As such, if you are the only parent who makes child support payments for a child (and the other parent does not), you cannot claim an amount for an eligible dependant for that child. Only the parent who does not pay child support can claim the amount on their tax return.

If you and your current or former spouse share custody of a child throughout the year, and you each have a clearly established requirement under a court order or written agreement to make child support payments for that child, normally, neither of you would be able to claim the amount for an eligible dependant for that child. However, one of you may still be able to claim the amount, if you and the other parent agree who will make the claim. If you cannot agree, neither of you can claim the amount for that child.

Tuition credit: Where your child has unused tuition credits available for a particular year, they can choose to either carry forward the amount or transfer the credit (up to a maximum of $5,000) to a parent. Where your child chooses to transfer the unused portion of the tuition credit to a parent, and there has been a breakdown in your relationship, your child will have to choose one parent. You and your former spouse will have to agree who your child will transfer the credit to.

Estate Planning

Your Will

A Will is a legal document that takes effect upon your death. It outlines how you want your property distributed to your beneficiaries and appoints an executor (liquidator in Québec) to act on your behalf and carry out your wishes. Although a divorce does not revoke your Will, in some provinces and territories, divorce (and in some cases, separation) will revoke the benefits for your former spouse (i.e. cancel a gift to your former spouse) unless your Will provides otherwise.

In these same provinces and territories, if you have appointed your former spouse as executor/liquidator,

your divorce will revoke this appointment unless there is a contrary provision in your Will. For these reasons, it's a good idea to review your Will upon a relationship breakdown to ensure it reflects your current intentions and estate planning objectives.

Your power of attorney/protection mandate

A power of attorney/protection mandate is a document that empowers an individual to act on your behalf if you're unable to make decisions on your own. While a divorce or separation will not revoke a power of attorney/protection mandate, in certain jurisdictions a divorced spouse will lose any authority granted to them in an otherwise valid document.

In the case where a divorce does not revoke your prior appointment of a former spouse as attorney, it may be problematic if you do not want your former spouse making decisions on your behalf with respect to property and personal care. It may also be an issue if your former spouse is appointed but unwilling to act, and your alternate attorney, if any, is also unwilling to act. If you are incapable at that time and can't execute a new power of attorney/protection mandate due to a lack of capacity, it may then be necessary for someone to apply to court to become your court-appointed guardian, which is a costly and time-consuming process. As such, it's prudent to update your powers of attorney/protection mandate upon a relationship breakdown.

Your beneficiary designations

A divorce or separation has no impact on your beneficiary designations on registered plans and insurance policies. If you'd named your former spouse as beneficiary, they may be entitled to all or a portion of your life insurance policies and registered plans.

Before updating your beneficiary designations, it's important to review the terms of any separation agreement to determine whether you're allowed to a change a beneficiary designation. In some cases, there may be an express provision providing for how insurance, for example, is to be maintained and designated, including for child support purposes.

Conclusion

Going through a relationship breakdown is a time of transition in your life. It's also a crucial time to rethink your legal, financial and estate planning goals and priorities, both for the immediate future and the long term. As such, it's strongly encouraged to seek independent legal and tax advice if you're going through a breakdown in your relationship, to help you stay on course and ensure you have the utmost support and guidance throughout this transition.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

RBC Wealth Management

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