Know Your Enemy: Avoiding Tax Traps in Matrimonial Property Settlements

Prepared for: Legal Education Society of Alberta
Business Issues in Family Law Matters

Presented by:
H. Michael Dolson
Felesky Flynn LLP
Edmonton, Alberta

For presentation in:
Calgary, Alberta – January 17, 2018
Edmonton, Alberta – January 24, 2018

KNOW YOUR ENEMY: AVOIDING TAX TRAPS IN MATRIMONIAL PROPERTY SETTLEMENTS

I. INTRODUCTION

Matrimonial property divisions involving one or more shareholders of a Canadian-controlled private corporation ("**CCPC**")[1] can present both the opportunity for a tax-efficient property division and significant tax risks for both the transferor and transferee of property. The focus of this paper is on the tax risks, with the intention of allowing the reader to identify potential issues and protect their clients by seeking expert advice where warranted.

This paper is divided into five parts:

1. A review of the tax concepts of "relatedness", "affiliation" and arm's length dealings, which are critically important in applying the various income tax rules discussed in subsequent parts;
2. Tax issues associated with transfers of matrimonial property, including income attribution, derivative liability and shareholder benefits;
3. The proposed income splitting rules and the potential income tax consequences of distributing corporate property as a dividend or otherwise;
4. Potential income tax traps associated with capital gains deduction planning;
5. The increasingly delicate related-party butterfly reorganization and what to avoid in order to preserve the tax deferral.

Each of these topics could easily be the subject of a separate paper, so the discussion will necessarily be high-level. Many of the applicable income tax rules are inordinately complex or in a state of flux, so family law practitioners should not assume that the provisions discussed will operate exactly as described in any particular situation.

II. GROUP CONCEPTS IN THE INCOME TAX ACT

1. The Importance of Timing

Under subsection 12(1) of the *Divorce Act*, an order granting a divorce is effective on the 31st day after the day on which the order is issued (unless a court exercises its discretion to accelerate the effective date). In applying the tax concepts that are described below, it is important to identify

[1] Within the meaning in subsection 125(7) of the *Income Tax Act* (Canada), R.S.C. 1985, c. 1 (5th Supp.) (the "**Act**"). All statutory references contained herein are references to the Act unless otherwise noted.

whether an order granting a divorce has been issued at all, and whether or not the order is effective on the date that the tax concept becomes relevant.

It is also important to remember that the spouses remain married until the order granting the divorce becomes effective. Subject to certain exceptions, the relevant determination for income tax purposes is whether or not the spouses remain married, and not whether the spouses are living separate and apart, have experienced a marital breakdown, etc.

2. Relatedness and Affiliation

Many of the provisions of the Act that permit tax-deferred transfers of property turn on whether or not the transferor and transferee are either related or affiliated. The related party butterfly reorganization, in particular, can be jeopardized if an unrelated person is involved at certain times, of if parties to the transaction cease to be related at certain times.

Two individuals will be related if, at the particular time, they are connected by either blood or marriage.[2] Individuals are generally connected by blood if one is the child, parent or sibling of the other, while individuals are connected by marriage both to the individual to whom they are married and to individuals related by blood to the individual to whom they are married.[3] Individuals and corporations will be related if the individual "controls" the corporation,[4] if the individual is a member of a related group that controls the corporation, or if the individual is related to either the person who controls the corporation or any member of a related group that controls the corporation.[5]

Suppose that Brad and Angelina are married. Angelina is the sole shareholder of Opco. Brad and Angelina are related to one another by marriage, Angelina is related to Opco because she controls Opco, and Brad is related to Opco because he is related to Angelina (the person who controls Opco). If Brad and Angelina get divorced, then on the 31st day following the issuance of the order granting the divorce, Brad and Angelina will cease to be related to one another. Angelina will continue to be

---

[2] Paragraph 251(2)(a).

[3] Subsection 251(6). For income tax purposes, provisions involving marriage are equally applicable to "common-law partners" (as defined in subsection 248(1), generally encompassing persons who have cohabitated in a conjugal relationship for the 12-month period ending before the particular time or who cohabit in a conjugal relationship and are the parents of a child). Since the focus of this paper is on matrimonial property division and not on relationship breakdowns more generally, any reference to marriage in this paper also includes common-law partnerships.

[4] The word "control" is a reference to *de jure* control, being the right to appoint the majority of the board of directors by virtue of owning the majority of voting shares: *Duha Printers (Western) Ltd. v. R.*, [1998] 1 S.C.R. 795 (S.C.C.) at paras. 35-36, reversing 96 D.T.C. 6323 (F.C.A.), reversing 95 D.T.C. 828 (T.C.C.); *Buckerfield's Ltd. v. M.N.R.*, 64 D.T.C. 5301 (Can. Ex. Ct.) at para. 10.

[5] Paragraph 251(2)(b).

related to Opco, but Brad will cease to be related to Opco at the time that he ceases to be related to Angelina, as he is no longer related to Opco's controlling shareholder.

Affiliation is more restricted than relatedness. Individuals are affiliated with one another if, and only if, they are married to one another.[6] Individuals and corporations are affiliated if the individual controls the corporation, the individual is a member of an affiliated group that controls the corporation, or if the individual is the spouse of another individual who controls the corporation or is a member of an affiliated group that controls the corporation.[7]

Suppose that Khloé and Lamar are married, and that Khloé and her sister Kim both own 50% of the voting shares of Holdco. While they are married, Khloé and Lamar are related to and affiliated with one another, and Lamar is related to (but not affiliated with) Kim. Khloé and Kim are a related group that controls Holdco, and they are thus both related with Holdco. Lamar is related to Holdco because he is related to both Khloé and Kim, the members of the related group that controls Holdco. However, nobody is affiliated with Holdco, since Khloé and Kim are not affiliated with one another and since neither Khloé nor Kim exercises *de jure* control of Holdco.

Once the order granting Khloé and Lamar's divorce becomes effective, Lamar will cease to be related or affiliated with Khloé. Lamar will also cease to be related to Holdco. Nobody will become or cease to be affiliated with Holdco, as nobody was affiliated with Holdco while Khloé and Lamar were married.

3. Arm's Length Dealings

The application of many anti-avoidance rules and derivative liability provisions turns on whether or not two persons deal at arm's length. For income tax purposes, two persons are deemed not to deal at arm's length in one of three circumstances:

1. The persons are related to one another;
2. One person is a personal trust, and the other person is a beneficiary of the personal trust or a person who does not deal at arm's length with a beneficiary of the personal trust; or
3. The persons do not deal at arm's length as a question of fact.8

[6] Paragraph 251.1(1)(a).

[7] Paragraph 251.1(1)(b).

[8] Subsection 251(1).