Vern Krishna: Canada should soften tax rules on property transfers between family members

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More from Vern Krishna

Canadian tax law is unforgiving in how it treats property transfers between family members, such as spouses who are separating or divorcing. This strict-liability approach is bad public policy, Vern Krishna argues Getty Images/Thinkstock

Canadian family members transfer property among themselves for a lot of reasons. Perhaps they're doing some estate planning or maybe dividing property because of a matrimonial separation. No matter what the reason, these types of deals may trigger some important tax consequences. You need to be aware of the rules because the law can be unforgiving.

Canadians are presumed to know the complex maze of applicable tax rules and procedures. Even minor slip ups can lead to financial ruin for innocent spouses and common-law partners who get trapped by the rules, which the Canada Revenue Agency administers zealously, and insensitive to the taxpayer¹s costs or good faith.

The addition of unexpected tax burdens as a consequence of good faith transfers many years earlier is unfair to innocent spouses, and is bad public policy. At the very least, the law should permit the innocent spouse to put forward a good faith defence.

Here's how the CRA views things. When an individual transfers property to a person with whom he or she does not deal at arm's length, the transferor and the transferee may be held jointly and severally liable for any tax payable at the time by the transferor. The liability is limited to a maximum of the fair market value of the property transferred less the value of any consideration given.

For example, if an individual transfers his share (say, $200,000) of a jointly held matrimonial home to his spouse when he owes $100,000 in tax, the transferee spouse becomes liable for the $100,000. The liability attaches by virtue of retroactive reassessment. There is no time limit. It can apply many years later after the transfer, even after divorce or the death of the transferor. The recipient spouse (generally the wife or common-law partner) must establish the value of any consideration given in exchange.

“Transfer” is strictly interpreted to include any kind of transaction, including gifts, that involves the passage of property of one person to another. It doesn’t matter if the parties were acting in good faith at the time that they transferred the property. For example, contributions to a spousal registered retirement savings plan while the transferor owes tax renders the transferee liable, even after a divorce. The rule imposes strict liability. There is no due diligence defines.

The ultimate insult is that the CRA accrues interest on the outstanding tax bill from the date that the individual transferred the property, and not from the date of the subsequent reassessment for taxes. For example, a transfer of a home from husband to wife in 2014 may not be reassessed against her until 2020. Daily compound interest will accrue against the wife from 2014, even though she was unaware that her husband was a tax delinquent at the time of the transfer.

There is an exemption for property transfers between spouses or common-law partners who separate or divorce pursuant to a judicial order or written separation agreement as a consequence of matrimonial breakdown. However, courts interpret this exemption strictly and literally. Matrimonial lawyers must comply with every detail of the exempting provision in order to avoid exposing their clients to unexpected tax liabilities. The exemption does not apply to transfers of property prior to marriage breakdown, or to persons who have commenced to live separate and apart, but have not obtained a judicial order or entered into a written separation agreement. Thus, the transferee enjoys a certain amount of immunity from his or her spouse’s liability for unpaid taxes, but only in the very limited circumstances spelled out in the Income Tax Act.

For example, in *Carriere v. Canada*, 2006 DTC 3098 (TCC), the court found that a document evidencing a transfer of property to the taxpayer from her spouse referred only to the fact that they were separated. That was not enough to justify that the transfer was made under a “written separation agreement.” The court held that, “a written separation agreement must include, generally speaking, provisions in writing for the custody and support of children, alimony and property division made by couples who are usually seeking a divorce or legal separation.” In this case, the transfer was pursuant to a pure deed of gift. Thus, the taxpayer did not meet the conditions to claim the exemption. The tax bill of $5,283 on the date of the transfer had accumulated interest of $6,267 by the date of reassessment.

Although the innocent spouse can challenge the assessment on the basis of her husband[1]s defences already in place to reduce her vicarious tax liability, she cannot put up new defences and engage in retroactive tax planning such as carrying back later losses to reduce the amount of the assessment for the year of the transfer.

The tax rules make spouses (generally the wife or common-law partner) who engage in family transactions vulnerable to the maze of tax law and procedures, and all the more if they are unrepresented by counsel. As the Carriere case illustrates, the CRA is notoriously unsympathetic to unrepresented taxpayers, and the tax court will interpret the rules strictly, literally, and regardless of taxpayer’s good faith.