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Having just filed their tax returns, Canadians will breath a sigh of relief and enjoy the Stanley Cup playoffs without worrying that the taxman will seize their television sets. Others, however, will just be receiving assessments for their ex-spouse's tax bills. It was bad enough when he left with the TV, but really too much when the tax collector comes to you for his taxes years after divorce. Unlike the United States, Canada does not have joint tax returns for spouses and common-law partners. However, even though individuals are responsible for their own income, they may be liable for their spouse's taxes. Tax law is a potential minefield for family lawyers, particularly those who studiously avoided tax in law school.

Wife Can Be Liable for Spouse's Tax Bill

Date: May 19, 2010

Vern Krishna

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The law reports are replete with cases of matrimonial settlements and hidden boomerangs for divorced "spouses"—usually women—who settled without considering the tax implications of their property transactions. Such settlements can trigger liability claims against lawyers and accountants.

When an individual transfers property to his spouse or common law partner—whether by sale for inadequate consideration, gift or settlement—both the transferor and the recipient are jointly and severally liable for any income tax payable in the year of the transfer. The liability attaches as of the beginning of the year in which the transaction occurs.

The rule is one of absolute liability. Due diligence is not a defence. The parties do not have to have any intention to defeat CRA's claim. Indeed, the parties do not even have to know that a tax liability exists. The liability will usually arise many years later as a result of a reassessment and be retroactive to the year of transfer. There is no time limit on the CRA's claim.

There is some good news. The recipient spouse's liability is limited to the lesser of the transferor's tax liabilities outstanding at the date of the transfer and the difference between the fair market value of the property and the amount that she paid. For example, assume that, upon divorce, a man with income tax debts of $400,000 gives up his half-interest in the family home—which has a fair market value of $1- million—to his wife as part of the property settlement. The wife is potentially liable for her former husband's tax bill of $400,000 if he defaults on his taxes, for example, by going bankrupt or skipping town. She also becomes liable for any additional taxes that might be owing by her husband to the end of the year in which he transfers the property to her. She cannot, however, be liable for more than $500,000.

The rule also applies to children who receive payments from parents—for example, school or summer camp fees, and amounts paid for a child's wedding. If the transfer occurs through a series of family members, all of them become liable.

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Corporate dividends are also caught. For example, assume that a married couple each own 50% of a family company that pays them dividends instead of salary. The couple divorce and go their separate ways. The corporation is later reassessed and cannot pay its taxes. The shareholders become liable for the corporate taxes to the extent of the dividends.

All property transfers have tax implications. Two cases illustrate the types of difficulties that can arise. In the first, an individual transferred the family residence to his wife when they separated. Even though the family residence had never been an income-producing property, the wife was held liable for her husband's unpaid income tax as of the date of the transfer of the home.

In the second case, an individual helped pay for a home purchased by his wife by contributing toward the down payment and making mortgage payments thereafter. He also paid off his wife's bank loans. At the time the taxpayer made these payments, he had a tax liability of nearly $65,000. The parties separated many years later. The wife was held liable with her husband for payment of his earlier taxes because he had repaid her loans at the bank.

The statutory language is so broad that a housewife who receives housekeeping money from her husband becomes liable for his unpaid taxes to the extent of any shortfall in consideration flowing from her to him. Contribution for the expenses of marriage is not consideration. Not only is she liable for his unpaid taxes as of the date he gives her the money, she also becomes liable for his taxes on income he will earn later in the same year.

An individual's liability to pay her husband's outstanding taxes can continue for a considerable period. There is no limitation period. Payments made by the husband after he transfers property to his wife go first toward reducing his personal tax liability. Only after he has discharged all his personal tax liability will further payments by him go toward reducing her joint liability. Thus, a woman may find her home foreclosed to satisfy her husband's tax bills, of which she was unaware at the time of their separation.

Thus, although Canada does not have "joint returns", we do have joint liability for property transfers between spouses. To be sure, the transferee spouse can challenge the CRA assessment even if the transferor did not initially do so. Such actions are, however, burdened with their own litigation costs and may not be economic.

Paying tax is painful, but even more so when the path of the law is beset with hidden leg traps.

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