

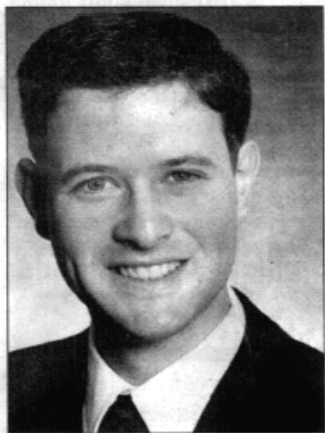
Taxpayers should look carefully at the treatment of child support payments

By Michael Friedman and Sandy Andreou

Few matters generate as much emotion and debate as the negotiation of child support payments on the dissolution of a marriage. Disagreements over the length of a spouse's payment obligations, the amount of support to be provided and the basis upon which support payments may be altered frequently raise the ire of former spouses and result in protracted litigation.

Until 1997, individuals were generally entitled to claim a tax deduction in respect of child support payments made in a year, while recipients of child support were generally required to recognize such payments as taxable income (the so-called "deduction/inclusion regime").

Yet, the rules governing the taxation of child support were drastically altered following the decision of the Supreme Court of Canada in



Michael Friedman

The Queen v. Thibaudeau ([1995] 2 S.C.R. 627). In *Thibaudeau*, the taxpayer, Suzanne Thibaudeau, objected to paying income tax on child support payments received from her ex-husband on the grounds that the deduction/inclusion regime violated her equality rights under the *Canadian Charter of Rights and Freedoms*. Although

the Supreme Court overturned the lower court ruling which had previously allowed *Thibaudeau's* appeal, the federal government heeded public sentiment and amended the *Income Tax Act* (Canada) (the "Tax Act") to provide that, subject to certain grandfathering rules, child support payments would no longer be tax deductible to the payer or treated as taxable income in the hands of the recipient (the "New Child Support Regime").

Child support payments now fall under the New Child Support Regime if the agreement or order pursuant to which the payments are made has a "commencement day". The Tax Act provides that any agreement or order made after April 1997 is considered to have a "commencement day". The statute also provides that any agreement or order made prior to May 1997 will have a "commencement day" where: (i) the agreement or order is varied after April 1997 to

change the amount of child support payable; or (ii) a subsequent agreement or order is made after April 1997, the effect of which is to change the total amount of child support payable.

Since the introduction of the New Child Support Regime, much tax litigation has focused on whether a "commencement day"

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has arisen as a result of particular changes to the child support arrangements between former spouses. Unfortunately, the decisions that have been rendered by the Tax Court of Canada have been highly fact-specific and frequently contradictory. In fact, until recently, it was extremely difficult to draw a uniform set of principles from the prevailing case law that could be used to determine when a change to pre-existing child support payment obligations may result in the establishment of a "commencement day" and, thus, change the taxable status of child support payments made, or received, by a particular taxpayer.

However, over the past nine months, the Federal Court of Appeal has rendered two key decisions that have adopted a purposive approach to determining when a change to the amount of child support payable under an order or agreement may result in the creation of a "commencement

day". In December 2004, the Federal Court of Appeal was called upon to determine whether a court order made after April 1997, which simply ratified the terms of a previous agreement governing the payment of child support, created a "commencement day". In dismissing the taxpayer's appeal, the Federal Court of Appeal criticized the awkward drafting of the legislation that enacted the New Child Support Regime and indicated that the new rules were meant to capture orders and agreements that created new payment obligations and that "obligations created under the old regime will

remain subject to the old provisions" (*Kennedy v. The Queen*, [2004] F.C.J. No. 2122). Similarly, the Federal Court of Appeal recently held that changes to the quantum of ongoing child support payments that arose pursuant to a court order made prior to May 1997 did not result in a "commencement day" for tax purposes (*Coombes v. The Queen*, [2005] F.C.J. No. 874).

The new interpretive principles enunciated by the Federal Court of Appeal should be of great interest to any individual that is party to a settlement agreement, or is bound by an order respecting the payment of child support, made prior to May 1997. The Federal Court of Appeal has arguably affirmed that the New Child Support Regime is designed to capture substantive changes to agreements and orders respecting the payment of child support and not mere supplements that do not alter the amount of child support payable under the

original order or agreement. Procedural variances that the courts may have previously held created a "commencement day" may be treated differently in light of the recent pronouncements of the Federal Court of Appeal. Moreover, given the continuing uncertainty over the availability of retroactive child support adjustments, the recent judgments of the Federal Court of Appeal may become increasingly significant in the years to come.

Taxpayers that have paid or received child support for more than eight years would be well advised to examine whether the historical tax treatment of their child support payments or receipts has been justified. Similarly, taxpayers should continue to remain diligent to ensure that any new agreement or court order relating to the right to receive, or the obligation to pay, child support will not trigger unexpected changes to the way in which such payments are treated for income tax purposes.

Michael Friedman is a tax lawyer and Sandy Andreou is a student-at-law with the law firm of McMillan Binch Mendelsohn LLP in Toronto, Ontario.



Sandy Andreou