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Marmer Penner Newsletter

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Spousal Support - The Tax Haven Next Door

There are unique tax planning opportunities when support payments cross the Canada-U.S. border: This newsletter will examine two of these.

Readers may recall that child support was non-taxable in the United States during the era when all child support was still taxable to the recipient in Canada. Where child support payments are made by one spouse in Canada and received by another spouse in the United States, the combination of the mechanisms of the Income Tax Act, Internal Revenue Code and the Canada-U.S. Tax Convention serve to permit a deduction to the Canadian payer and no taxable inclusion to the U.S. recipient.

Where family law practitioners find their clients in such a situation, the need to structure child support payments so that they may be deductible to the Canadian payer becomes even more advantageous. Readers should also note that having passed the April 30, 1997 deadline does not necessarily preclude the parties' ability to enter into a pre-May 1, 1997 child support agreement.

After December 31, 1998, no new opportunities will be available to take advantage of this cross-border "loophole" to permit a deduction of child support with no corresponding inclusion in income to the recipient. However, agreements in existence prior to May 1, 1997 can presumably continue to benefit from the loophole.

Just as this opportunity to benefit from cross-border tax rules regarding child support is closing, another opens regarding spousal support.

In the absence of any special elections, spousal support is deductible to the payer and taxable to the recipient in both Canada and the United States. However, the Internal Revenue Code contains a provision permitting spouses to "designate that payments otherwise qualifying as alimony or separate maintenance payments shall be non-deductible by the payer and excludable from gross income by the recipient". The provision allows parties to elect non-alimony treatment simply by

designating such payments as such in the qualifying divorce or separation instrument.

A qualifying divorce or separation instrument is defined in the Internal Revenue Code as:

(a) A decree of divorce or separate maintenance or a written instrument incident to such a decree;

(b) A written separation agreement; or,

(c) A decree (not described in (a) above) requiring a spouse to make payment for the support or maintenance of the other spouse.

A copy of the instrument containing the designation of payments as non-alimony or separate maintenance payments must be attached to the recipient's tax return filed for each year in which the designation applies. It appears that failure to file the return on a timely basis or failure to file the copy of the instrument with the original return could result in the disallowance of the designation and result in the U.S. taxation of the alimony payments.

The election to treat the alimony or separate maintenance payments as non-deductible and excludable from income by the payee applies for U.S. income tax purposes only. As a result, it has no bearing on the deductibility of support to the payer in Canada.

Consider the following example:

Homer and Marge separate. Marge decides to reside in the warmer climate of Florida and becomes a U.S. resident, obligating her to file a U.S. tax return only. Homer remains in Canada. Homer and Marge agree that Homer will pay monthly spousal support of $5,000 and include the election to exclude the support from Marge's income for U.S. tax purposes. Homer has no U.S. source income. Marge will receive $60,000 in non-taxable support. Homer will be able to deduct the support for Canadian tax purposes and effectively pay about $30,000 in after-tax dollars. The savings of $30,000 are borne entirely by Revenue Canada which permits the deduction but is not able to tax the related income.

As indicated above, the designation made by the spouses prohibits the payer from deducting any payments as alimony or maintenance on any U.S. income tax return. Accordingly, if the payer is required to file a U.S. personal income tax return, there may be a tax cost to the payer notwithstanding that the payer resides in Canada. Where the payer has no obligation to file a U.S. personal income tax return, the tax savings from such an election can be significant.

This newsletter is intended to highlight areas where professional assistance may be required. It is not intended to substitute for proper tax planning. The professionals at Marmer Penner will be pleased to assist you with any matters that arise.