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Tax implications of separation or divorce for a business owner-manager

According to government statistics, upwards of 40% of marriages end in divorce before the 30th wedding anniversary. While no one anticipates this sort of "exit strategy," a separation or divorce is the fate of many relationships—and can have a significant impact on one's business and operations.

If you are breaking up with your partner or spouse, and one or both of you own a private company, you should carefully consider your options before moving forward with a plan for the business. The approach and timing for dividing the company and/or its assets can have significant long-term tax implications for you, your former partner, and your business.

What is a Spouse or Common-Law Partner for Tax Purposes?

The definitions of a spouse or common-law partner for tax purposes, as well as the length of time required to dissolve a formal partnership, need to be kept in mind throughout the process of separating business assets.

Under Canadian tax law, your spouse is a person to whom you are legally married. A marriage is ended only through legal divorce, regardless of the length or distance of your separation. This means that even if you have been separated from your spouse for years and live on opposite sides of the country, you are still not considered to be at "arm's length" for tax purposes until a divorce is finalized.

In contrast, a common-law partner is someone to whom you are not legally married, but with whom you are living in a conjugal relationship and with whom at least one of three situations applies:

1. You have been in a relationship lasting at least twelve continuous months, with no separation periods of more than 90 days during that time.
2. They are the parent of your child, either by birth or adoption.
3. They have custody and control of your child, and your child is wholly dependent on that person for support.

Ending a common-law partnership is much easier and faster than ending a marriage. A common-law partnership is deemed to be terminated once partners have been separated for 90 days or more.

It is often best to reach out to a tax professional before a formal separation or divorce, if possible, as the most tax-effective way of dividing your assets may require you to be separated, divorced, or still legally with your former partner. If you are getting out of a common-law relationship, the 90 day rule may mean that you are racing against the clock when it comes to splitting your business assets. This time restriction may also limit your available planning alternatives.

Key Tax Rules

When conducting tax planning for the division of business assets during or following a marital breakdown, there are three tax areas which business owners need to be especially cognizant:

1. **Spousal Transfer Rollover:** If assets are transferred between non-arm's length individuals, the transaction is deemed to occur at fair market value (FMV), regardless of the amount actually paid for the assets. For example, if you were to sell $100,000 worth of shares to your brother for $50,000, you would still be considered to have sold the shares for their FMV of $100,000. However, spouses get to disregard this rule; assets transferred between spouses and common-law partners are transferred at cost, often referred to as a spousal rollover.Following the breakdown of your relationship, you can only transfer on a rollover basis provided that the transfer results from a settlement. Otherwise, this rollover rule will no longer apply, potentially resulting in a larger capital gains tax impact on the transfer of assets.
2. **Spousal Attribution Rules:** Under spousal attribution rules, when one spouse or common-law partner transfers property to the other for less than FMV, the income or gains from that property will continue to be taxable to the transferor. For example, if you were to give your spouse $100,000 in stock assets as a gift, the dividends on those stocks would be yours; they would not need to appear on your spouse's tax return. This spousal attribution ends the moment a common-law relationship ends or when your divorce is finalized. Attribution is also suspended when spouses or common-law partners are living apart as a result of the breakdown of the relationship.
3. **Capital Gains Exemptions:** Normally, in situations where a corporation is buying your shares and those shares qualify for the capital gains exemption, you will have a capital gain and can claim your lifetime capital gains exemption. However, when the purchasing corporation is non-arm's length and the proceeds exceed the paid-up capital of the shares, the excess could be deemed a dividend and not a capital gain. Spouses are non-arm's length, as are the corporations that they control. Even after a divorce or end of a common-law relationship, some former partners may still be non-arm's length. This can impact situations when a corporation controlled by one former partner buys shares of a corporation controlled by the other, which can include the division of asset strategy.

With situations that touch on one or more of these three areas, timing is critical, as is the legal status of the relationship when the business separation plan is enacted.

Understanding Butterfly Transactions

One common way of managing a business through a divorce or separation is dividing corporate assets with the use of a butterfly transaction. This is basically splitting the assets of one corporation into two corporations (which may or may not include the original business entity), one owned by each partner, without incurring income taxes. There are generally two ways to achieve a butterfly transaction:

1. **The Related-Party Butterfly,** or "easy" butterfly, applies only to non-arm's length parties and thus must be completed while a couple is still considered "together" for tax purposes. The appeal of this approach is its flexibility. The couple gets to decide which assets are allocated to which of the two resulting companies. For example, partners can choose to split corporate assets so that passive assets, such as an investment portfolio, go to one company (and thus one partner), while the active business assets stay or go to another corporation.
2. **The Divisive Butterfly** applies where owners are arm's length parties. This can be much more complicated and is considerably less flexible, as there are specific rules dictating that each company must receive pro-rata shares of business and non-business assets. Understandably, deciding this division can become contentious, especially following a difficult divorce.

Finding the Right Plan for Division

There are many approaches to dividing a business depending on your needs and desires, and those of your former partner. The plan to achieve an optimal outcome will look very different depending on whether one or both parties own shares, are active in the business activities, want to continue with the current business, and more.

Proper tax support during your separation or divorce can not only deliver an optimal tax outcome, but also limit damage and disruption to your business during a difficult time. For more information on dividing your business assets, including specific examples of division strategies, please see our Private Company Tax Webinar—June 2016, or contact your BDO advisor for personal support.

The information in this publication is current as of July 27, 2016.

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