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Co-Editors: Pearl E. Schusheim* and Gena Katz**

MARRIAGE BREAKDOWN: A PRACTICAL REVIEW OF INCOME TAX CONSIDERATIONS

*Andrew Bateman****

A tax adviser often will, and in the author's view always should, actively participate in structuring a settlement in respect of the breakdown of a marriage or common-law relationship. The process of legally ending a marriage can give rise to a wide range of income tax considerations related to, among other things, (1) support payments, (2) property division, and (3) tax liability risks. The author provides a practical review of these topics and selected considerations that arise under the Income Tax Act.

KEYWORDS: DIVORCE ■ TAX LIABILITY ■ MATRIMONIAL PROPERTY ■ SPOUSE ■ SUPPORT ■ TRUSTS

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* Of Couzin Taylor LLP (allied with Ernst & Young LLP), Toronto.

** Of Ernst & Young LLP, Toronto.

*** Of Felesky Flynn LLP, Calgary. I would like to thank Rhoda Dobler of Dunphy Best Blocksom LLP and Scot Menzies of Widdowson Kachur Ostwald Menzies LLP for their assistance from a family law perspective in the preparation of this article.

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INTRODUCTION

A marriage breakdown requires the parties to address, among other things, support payments and division of property.[1] In the first section of this article, I review the technical requirements for the deductibility of support payments, including lump-sum payments made in respect of "retroactive" spousal support, and I consider the use of a trust arrangement to satisfy support obligations. In the second section, I provide a general review of matrimonial property division by considering examples, discussing selected ways to ensure tax efficiency, and examining planning techniques in the context of a division of property that is to occur over a period of time. In the third section, I review the often overlooked risk of unexpected tax liabilities (including section 160 liabilities) and the potential challenges that arise in addressing that risk.

SUPPORT PAYMENTS

When a marriage breaks down, one spouse often agrees or is required to make payments to the other for spousal and/or child support.[2] In this section, I review the technical income tax rules relevant to the deductibility of spousal support payments; the treatment of retroactive lump-sum spousal support payments for the purposes of the Act; and planning considerations, including the possible use of a trust in a support payment context.

1 Unless otherwise noted, a reference in this article to a "marriage," "spouse," or "former spouse" includes, for the purposes of the Income Tax Act, a reference to a "common law relationship," "common law partner," or "former common law partner," respectively. "Spouse" and "former spouse" are defined in subsection 252(3), and "common-law partner" and "common-law partnership" are defined in subsection 248(1) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"; unless otherwise stated, statutory references in this article are to the Act). Except in certain circumstances that have to do with the time at which common-law partners cease to be related, some of which are referred to herein, marriages and common-law relationships generally are subject to the same considerations under the Act.

2 Such requirements are governed under specific federal and provincial statutes. Federal: Divorce Act (RSC 1985, c. 3 (2d Supp.), as amended); Alberta: Family Law Act, SA 2003, c. F-4.5, as amended; British Columbia: Family Law Act, SBC 2011, c. 25, as amended; Saskatchewan: Family Maintenance Act, 1997, SS 1997, c. F-6.2, as amended; Ontario: Family Law Act, RSO 1990, c. F.3, as amended.

Deductibility of Spousal Support

For the purposes of the Act, if certain conditions are satisfied, spousal support payments are deductible in computing the income of a payer and are required to be included in the income of a recipient.[3] In contrast, child support payments generally are not deductible by the payer or included in the income of the recipient.[4] The net result is a degree of legislated income splitting to the extent of the spousal component of support payments. The deductibility of spousal support payments is often the subject of dispute, perhaps because of the strict technical requirements and a lack of involvement by tax advisers when support amounts are negotiated.

For a support amount paid to a spouse or former spouse to be deductible by the payer, the following conditions must be satisfied:[5]

1. The recipient must be the spouse or former spouse.[6]
2. The amount must be an "allowance" (that is, a predetermined sum of money paid to and for the benefit of the recipient).[7]
3. The amount must be "payable or receivable . . . on a periodic basis." Generally, payments are considered payable on a periodic basis when a specific sum of money is payable at regular intervals.[8]
4. The amount must be for the "maintenance" of the recipient. This determination requires a consideration of all of the relevant factors, including those discussed below under the heading "Retroactive Lump-Sum Payments."[9]

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3 Paragraphs 56(1)(b) and 60(b).

4 Child support payments were previously deductible by the payer and included in the recipient's income. Now, child support paid under orders or agreements that were made or varied after April 30, 1997 are no longer deductible to the payer. See subsection 56.1(4) for the definitions of "child support amount" and "commencement day."

5 Paragraph 60(b), subsection 60.1(4), and the definitions of "support amount" and "child support amount" in subsection 56.1(4).

6 Deductible support amounts also may be paid to a non-spouse parent of a child of whom the payer is a legal parent. The requirements for deductibility are similar to those that apply to spousal support payments, except that the payer and recipient need not have been married or in a common-law relationship (paragraph (b) of the definition of "spousal support" in subsection 56.1(4)).

7 *Gagnon v. The Queen*, [1986] 1 SCR 264, at paragraphs 21-29, and *Income Tax Folio* S1-F3-C3, "Support Payments," at paragraph 3.38. Note that in S1-F3-C3, at paragraphs 3.39 and 3.40, the CRA also accepts amounts adjusted or determined by formula in limited circumstances.

8 *P.T. Veliotis v. The Queen*, [1974] CTC 237 (FCTD). The periodic nature of a payment is not affected if the amount is not paid on time. Therefore, the payment of an amount in arrears, whether by lump sum or instalments, may still represent a deductible payment of spousal support (*The Queen v. Sills*, 85 DTC 5096 (FCA)). However, if an arrears amount is paid in a lump sum, the taxpayer bears "the onus of establishing that such periodic payments were embodied in the lump sum payment" (*Costello v. The Queen*, 2005 TCC 391). The CRA's position is that amounts paid to obtain a release from liability in respect of prior and future payments are not deductible to the payer (see S1-F3-C3, supra note 7, at paragraphs 3.43 and 3.46).

9 *S.J. McKimmon v. Canada*, [1990] 1 CTC 109 (FCA).

5. The recipient must have "discretion as to the use of the amount," subject to certain exceptions.[10]
6. The recipient and the payer must be "living separate and apart because of the breakdown of their marriage."[11]
7. The amount must be "receivable under an order of a competent tribunal or under a written agreement," and it must be specifically identified therein as "being solely for the support of a recipient."[12]

Retroactive Lump-Sum Payments

An issue that frequently arises is the deductibility of a lump-sum spousal support payment made under the terms of a court order or written separation agreement as spousal support for prior periods (sometimes referred to as "retroactive" spousal support).[13] Such payments are not specifically addressed in the Act. They give rise to two main questions in respect of deductibility by the payer (assuming that all other conditions set out above are otherwise satisfied): whether the lump-sum payment is "payable on a periodic basis," and whether it is made "for the maintenance" of the recipient.

"Payable on a Periodic Basis"

The Canada Revenue Agency (CRA) considers that, except in limited circumstances, a current lump-sum payment of spousal support in respect of prior periods will not satisfy the "periodic" requirement for deductibility.[14] Certain court decisions support that view.[15] However, other recent decisions have held that in certain circumstances a lump-sum payment may be deductible in the year of payment.[16] Those decisions

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10 *Larivière v. The Queen*, 2013 TCC 88, or *Fontaine v. Canada*, [1993] TCJ no. 587. The exceptions to this general rule are set out in subsections 60.1(2) and 56.1(2).

11 The Tax Court has held that persons living under the same roof can nonetheless be considered to be living separate and apart: *Kelner v. R*, [1996] 1 CTC 2687 (TCC); *MNR v. C.L. and F. Longchamps*, [1986] 2 CTC 2231 (TCC); and *Benson v. R*, [2003] 2 CTC 2431 (TCC). Legal parents of the same child, who never married or lived in a common-law relationship, need only be living separate and apart (that is, there is no requirement for a marriage breakdown).

12 Otherwise, the particular support amount would be considered a "child support amount" pursuant to the definition of that phrase in subsection 56.1(4), and consequently no deduction by the payer would be permitted under the Act.

13 These types of payments are not to be confused with periodic payments made prior to the effective time of the relevant written agreement or court order. Such payments are specifically addressed in subsections 56.1(3) and 60.1(3); if certain conditions are satisfied, the payments may be deductible by the payer and included in the income of the recipient.

14 S1-F3-C3, supra note 7, at paragraph 3.44.

15 *I.E. Burnes v. MNR*, [1983] CTC 2399 (TRB), and *Tossell v. Canada*, 2005 FCA 223.

16 *Bayliss v. The Queen*, 2007 TCC 387; *James v. The Queen*, 2013 TCC 164; and *Salzmann v. The Queen*, 2008 TCC 527. However, until the recent release of *Income Tax Folio* S1-F3-C3, the CRA does not appear to have accepted these decisions (see, for example, CRA document no. 2010-0375561I7, September 20, 2010).

were generally based on the principle that if a superior court issues an order stating that a legal obligation to pay spousal support existed in respect of a prior period, that legal obligation must be recognized as having existed at the prior time for the purposes of the Act (even if the order is retroactive).[17] On that basis, a subsequent payment of related spousal support is effectively a payment of "arrears" that generally will be deductible to the payer, provided that all other conditions for deductibility are satisfied. In the recently released *Income Tax Folio* S1-F3-C3, "Support Payments," at paragraph 3.44, the CRA appears to have changed its administrative position, and now accepts that lump-sum spousal support payments are deductible if "paid pursuant to a court order that establishes a clear obligation to pay retroactive periodic maintenance for a specific period prior to the date of the court order."

"For the Maintenance" of the Recipient

The question is whether the lump-sum payment—and, in particular, the prior-period payments that the lump sum purports to represent—is truly for the maintenance of the recipient, or whether it is a form of matrimonial property division for which the payer is seeking a deduction. Case law has held that all of the relevant factors should be considered in order to determine whether an amount is paid for the maintenance of the recipient. Such factors may include the following:

- The frequency of payments: Payments that are to be made weekly or monthly generally are regarded as allowances for maintenance. Longer periods may create uncertainty about the appropriate characterization of the payments. The Federal Court of Appeal stated in *McKimmon* that it would be "difficult to envisage payments made at intervals of greater than one year as being allowances for maintenance."[18]
- The relationship of payments to a recipient's living standards: The more substantial a payment is in relation to a taxpayer's annual income, the more likely it is that the payment will be characterized as representing a transfer of capital property. If the payment is no greater than what is required to maintain the recipient's standard of living, it is more likely to be considered an allowance for maintenance.[19]

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17 See paragraph 8 of *Bayliss*, supra note 16, where Bowie J referred to the decision in *Dale v. Canada*, [1997] 3 FC 235 (CA) and stated the following:

> It was held in that case that an order made by a Superior Court is not subject to collateral attack in subsequent proceedings, and when that order purports to operate retroactively that must be taken as effectively changing history. When Woods J. issued his order, one effect of it was to create a liability on the part of the appellant to pay accumulated arrears of spousal support from 2001 and 2002 in the total amount of $16,800.

18 *McKimmon*, supra note 9, at 112. The CRA considers amounts payable at intervals greater than one year as unlikely to qualify as an allowance for maintenance: S1-F3-C3, supra note 7, at paragraph 3.43.

19 *McKimmon*, supra note 9, at 112.

- Whether there is any indication (having regard to the relevant facts, including a current court order) that the payments were subject to interest in the event of late payment: A requirement to pay interest is a characteristic more commonly associated with the payment of a capital sum than with an allowance for maintenance.[20]
- Whether there is any indication that the payments could have been prepaid or were subject to an optional accelerated payment schedule: The presence of either factor suggests that the payments are of a capital nature and not an allowance for maintenance.[21]
- Whether the payments, if made as intended, would have allowed a significant degree of capital accumulation by the recipient within a short time: Although an allowance for maintenance may provide for some accumulation of capital, it is generally disbursed over a long period.[22]
- Whether there is any indication that the payments either were to continue indefinitely or were limited to a fixed term: Payments of a capital nature tend to be payable over a pre-set period, while allowances generally continue indefinitely.[23]
- Whether there was any indication that the payments could have been assigned to a new recipient, or that the obligation to make the payments could have survived the lifetime of either the payer or the recipient: Rights to property generally may be assigned to other persons and may form part of one's estate. Payments made as an allowance for maintenance generally are not assignable and terminate at death.[24]
- Whether, in respect of any of the payments, the payer is released from future obligations to pay maintenance: A payment in exchange for a release of all further liability may not be considered an allowance for maintenance.[25]

On the basis of these factors, if it is desired that a retroactive lump-sum spousal support payment be deductible, advisers and taxpayers should consider the following measures:

- A court order: A written agreement alone likely will not be effective, because persons generally cannot agree to alter the past by agreeing that payment obligations existed at prior times. The court order should be drafted in enough

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20 Ibid.

21 Ibid.

22 Ibid., at 112-13. It appears that most decisions that focus on this factor relate to situations that involve a lump-sum payment for arrears of spousal support.

23 Ibid., at 113.

24 Ibid.

25 Ibid., and *Scott v. The Queen*, 2009 TCC 115. See also the CRA's position in S1-F3-C3, supra note 7, at paragraph 3.44.

detail to bolster the likelihood that it will satisfy the deductibility requirements. For example, the order could state that (1) the lump-sum spousal support payment represents the payment of spousal support amounts for prior periods (ideally, the specific prior periods and amounts will be set out in or attached to the order), and (2) the liability to make spousal support payments in respect of those prior periods existed during those prior periods.

- Consideration of maintenance factors: The court order and any relevant agreements should reflect the factors (set out above) supporting the assertion that the prior payments were for the maintenance of the recipient.
- Larger future payments: Instead of making a lump-sum payment for past amounts, consider increasing the amounts of future spousal support payments by the amount of the prior due portion. Note that this alternative may cause the increased future payments to be subject to a higher marginal rate of tax in the hands of the recipient. Care must be taken to ensure that the increased payments will still be considered to be made "for the maintenance" of the recipient (as discussed above). Nonetheless, this approach may reduce the practical risk of the CRA adopting an adverse position in the course of an audit.

The Use of a Trust

A possible alternative to direct payments of spousal support involves the use of a trust to satisfy support obligations.[26] Although the trust structure adds some complexity, it may provide flexibility in achieving certain other objectives in a tax-efficient manner. In particular, a trust may be helpful if support payments are not otherwise deductible by a payer. Examples of such situations include the following.

- A payer may want to impose limitations on the recipient's use of the support amounts (for example, where addiction or mental illness is a factor). The direct payment of the amounts as spousal support may not be deductible by a payer if the recipient will not have full discretion with respect to the use of the funds.[27]
- A payer may prefer a clean break to the marriage and want to pay a one-time lump-sum amount in lieu of ongoing spousal support. Such a payment, if made directly, may not be deductible as spousal support because it will not be payable on a periodic basis.
- A payer may seek a tax-efficient way of paying support amounts to both a recipient spouse and the children of the marriage. The direct payment of child support by the payer spouse will not be deductible.

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26 Hilary E. Laidlaw and Sandra Mah, "Trust After Marriage: Using a Trust To Satisfy Support Obligations," Personal Tax Planning feature (2010) 58:1 *Canadian Tax Journal* 145-63.

27 The Act provides that support payments paid directly to third parties on behalf of a spouse will be deductible by the payer only in limited circumstances. See the detailed requirements in subsections 60.1(2) and 56.1(2).

- Spouses may want the support payments to be subject to a lower overall tax rate. This objective potentially can be accomplished by establishing a trust that (1) is resident in a low-tax province in Canada, (2) will earn investment income taxable in that province, and (3) will make tax-free distributions of capital to a recipient spouse in a high-tax province in satisfaction of support obligations. (For example, for 2014 the top marginal tax rate on eligible dividends is 19.3 percent in Alberta and 33.9 percent in Ontario.)[28]

The procedures for establishing a tax-efficient trust arrangement will depend on the circumstances. A detailed discussion is beyond the scope of this article; however, the following points summarize a high-level example of a possible method of establishing a trust for the purposes of placing restrictions on the use of support amounts by a recipient spouse.

- Assume that a valid inter vivos trust is settled with a gold coin by an individual who is precluded under the trust deed from becoming a trustee or beneficiary of the trust.[29]
- The payer spouse then sells a bundle of publicly traded marketable securities to the trust for fair market value (FMV) consideration consisting of a demand promissory note (possibly non-interest-bearing).[30] The anticipated stream of dividend payments exceeds the anticipated support requirements of the recipient spouse and the interest (if any) payable on the note. (In cases where the trust does not restrict the recipient spouse's entitlement to income, provided that a divorce has not been finalized, it may be possible for the payer spouse to transfer the property to a spousal trust on a tax-deferred basis.)[31]
- The property is transferred to the trust while the spouses are either divorced or living separate and apart because of a breakdown of their marriage (such that spousal attribution of income either should not apply or should be suspended).[32] Note that future gains realized by the trust on a disposition of the

28 Careful consideration should be given to the application of provincial general anti-avoidance rules.

29 This restriction is intended to strengthen the position that the various attribution rules of the Act do not apply in respect of this initial transfer.

30 Other types of income-producing property could be transferred to the trust, such as preferred shares of a private corporation with a fixed dividend rate. Alternatively, one may consider loaning funds to the trust at the applicable prescribed interest rate and having the trust acquire income-producing property. However, it is important to ensure that the property transferred or acquired or the loan made does not result in unintended adverse consequences (for example, the application of the kiddie tax rules in section 120.4 if there are minor beneficiaries of the relevant trust).

31 Subsection 73(1).

32 Subsection 74.1(1) and paragraph 74.5(3)(a).

property can be attributed to the payer spouse unless the divorce is finalized or a joint election is made for such an attribution not to apply.[33]

- The recipient spouse is the income beneficiary of the trust while he or she is alive, and no person is entitled to the capital of the trust. On the death of the recipient, the adult children of the marriage become the income and capital beneficiaries of the trust.[34] However, at all times until the promissory note is repaid, the trust has an obligation to repay the principal amount to the payer spouse.
- Restrictions on the use of funds by the recipient spouse may take different forms. For example, the trustee may be required to distribute a fixed portion of the annual income of the trust to the recipient and may be given discretion to distribute the remaining portion of income. Perhaps more likely, the trust deed can specify that, prior to the distribution of a specified portion of annual income, the recipient must provide written direction to pay that portion to a third party for a permitted purpose.[35]
- The terms of the separation agreement or court order confirm that the trust arrangement satisfies the relevant legal obligations for the payment of spousal support. Appropriate contractual guarantees and security could be obtained by the recipient spouse.

The general tax consequences of the steps taken in the example above are as follows. The payer spouse will not include an amount in income in respect of the investments or claim a deduction in respect of support amounts paid. The recipient spouse generally will be required to include annual distributions of trust income in computing personal income (ideally at low marginal tax rates).[36] The trust generally is entitled to a deduction in respect of such annual distributions of income.[37] Thus, the net outcome may be a deduction-inclusion result similar to that of a direct payment of spousal support by a payer spouse.[38]

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33 Section 74.2 and paragraph 74.5(3)(b).

34 If minor children are to be included as beneficiaries, it is important to carefully consider the kiddie tax and attribution rules in the Act.

35 There is a technical risk that payments made to third parties on behalf of a beneficiary are not deductible by the trust (see subsections 104(6) and 106(24)). However, provided that a beneficiary executes a written direction to make such payments to particular third parties, there should be strong arguments that such payments are deductible by the trust: *Howard Langer Family Trust v. MNR*, [1992] 1 CTC 2119, at 2123-24 (TCC), and *Alan W. Cockeram and E. Anne Cockeram Trustees of the Cockeram Family Trust v. The Queen*, 2004 TCC 307, at paragraph 19.

36 Subsection 104(13).

37 Subsection 104(6).

38 Depending on the circumstances, and particularly if an arrangement is primarily tax-motivated, careful consideration should be given to the possible application of the general anti-avoidance rule (GAAR) in section 245.

DIVISION OF MATRIMONIAL PROPERTY

Overview

A division of matrimonial property can be structured in a number of ways. The final division may be agreed upon by the parties, determined in a collaborative dispute resolution process (arbitration or mediation), or mandated by a court. Regardless of the method used, there are many areas of potential disagreement, including the following.

1. *Classifying assets.* This process involves determining what assets are to be shared. Depending on the applicable provincial legislation, the assets may be shared equally, shared on some non-equal basis, or exempt from division.
2. *Valuing assets.* Certain assets (for example, shares of private corporations or interests in a discretionary trust) can be difficult to value because of the nature of the property interest.[39] It may also be difficult to determine an after-tax value of certain property (for example, funds held in a registered retirement savings plan [RRSP]).[40]
3. *Selecting the assets to distribute.* The spouses must agree on which particular assets will be retained by or distributed to each of them.
4. *Distributing liabilities.* The spouses must agree on how existing liabilities (such as outstanding mortgages) are to be satisfied or shared.

The tax adviser should be aware of the most contentious matters in each divorce situation. Once those matters are resolved, the adviser may find that the spouses are more receptive to a collaborative approach to the division of matrimonial property.

A Routine Division of Property

Consider the following example, which for illustrative purposes we will consider a routine division of matrimonial property. Assume that the principal assets and liabilities of a husband (H) are as follows:

- the matrimonial home, which has an estimated FMV of $1 million and an adjusted cost base (ACB) substantially lower than that amount;
- $750,000 held in an RRSP,
- $200,000 in cash, and
- $200,000 in short-term debt.
- Net: $1.75 million.

39 CRA document nos. 2004-0062291E5, March 30, 2004, and 2003-0181465, April 3, 2003.

40 The taxation of funds held in an RRSP depends on various factors, including the timing and manner in which the funds are ultimately withdrawn.

The principal assets of the wife (W) of H are as follows:

- $200,000 held in an RRSP, and
- $50,000 in cash.
- Net: $250,000.

Assume that H is required to make an equalization payment of $750,000 to W, and that the payment may be accomplished by a transfer of any combination of the assets shown above, subject to the parties agreeing on after-tax FMVs for the assets. (For simplicity, assume that the amounts shown above represent agreed-upon after-tax FMVs.)[41]

The following list sets out a number of tax-efficient ways to achieve the division.

1. H can transfer his $750,000 RRSP to W. This transfer potentially can be completed on a rollover basis under subsection 146(16).
2. H can transfer the $1 million home to W, and W can transfer her $200,000 RRSP and $50,000 cash to H. This transfer potentially can be completed on a tax-deferred basis by transferring the RRSP proceeds to H's RRSP[42] and by transferring the home to W using a spousal rollover.[43] Alternatively, the home can be transferred on a taxable basis, and H can claim the principal-residence exemption to shelter the resulting gain.
3. H can agree to transfer $750,000 (and possibly more) of property to W over a period of time. This method may be preferred if an immediate transfer of assets is not practical or desirable (in such circumstances, the parties may agree on a higher amount for the ultimate quantum of property to be transferred). Such transfers can potentially be completed on a tax-deferred basis, provided that the property to be transferred is capital property and the transfers are clearly documented as being in settlement of rights arising out of the marriage.[44]

A number of issues (discussed below) are relevant when one is considering these various methods of effecting a division of property.

Spousal Rollover

Property can be transferred on a tax-deferred basis if (1) the transferor is an individual other than a trust, (2) both the transferor and the transferee are resident in

41 For example, the after-tax FMV of the funds held in an RRSP depends on various factors, including the projected timing of withdrawals from the RRSP and the tax payable in respect thereof.

42 Subsection 146(16).

43 Subsection 73(1).

44 Subsection 73(1) and paragraph 73(1.01)(b).

Canada at the time of the transfer, (3) the property transferred is capital property of the transferor, (4) the transferor has not elected out of the rollover provision,[45] and (5) the property is transferred to (a) a spouse, (b) a former spouse in settlement of rights arising out of the marriage, or (c) certain types of trusts (including a spousal trust, although in that case the transfer must be completed before the divorce is final).[46]

Provided that the conditions above are satisfied, a particular property generally can be transferred on a tax-deferred basis with the recipient "inheriting" the former tax cost of the property to the transferor. However, taxpayers and advisers should be aware of the following points in respect of these tax-deferred transfers:

1. *Property other than capital property.* It is important to ensure that the property to be transferred is capital property at the time of transfer. A common example of property that could be mistaken for capital property, and that spouses may believe could be subject to subsection 73(1), is an interest in real property that constitutes inventory (for example, an interest in bare land, a house, a condominium, or other real property that is under development for resale).
2. *Resident in Canada.* A separation or divorce may affect the residence of one or both spouses.[47]
3. *Former spouses.* A transfer between former spouses must be in settlement of rights arising out of their marriage. Therefore, it is advisable that any such transfer be described in a court order or other written agreement as being made in settlement of such rights. This point is particularly important for common-law partners, since their relationship status is deemed to end for the purposes of the Act after 90 days of living separate and apart because of the relationship breakdown.[48]

45 The opening words of subsection 73(1) allow the transferor to elect out of the application of the provision. It is important to note that there is no specific form on which the taxpayer can elect out of the provision. The CRA indicates that the transferor normally makes the election by reporting the disposition on a taxable basis in its filed tax return. See *Interpretation Bulletin* IT-325R2 (Archived), "Property Transfers After Separation, Divorce and Annulment," January 7, 1994, at paragraph 6. It is prudent for the adviser to ensure that the separation agreement specifies how each party will report the transaction for tax purposes.

46 Subsections 73(1) and 73(1.01).

47 In particular, if one spouse has any ties to a foreign country, it is important to ensure that any changes in lifestyle or living arrangements do not affect the application of any treaty tiebreaker rules so as to cause that spouse to be a non-resident of Canada for the purposes of the Act.

48 Pursuant to the definition of "common-law partners" in subsection 248(1), two individuals will cease to be common-law partners once they have been "living separate and apart . . . for a period of at least 90 days . . . because of a breakdown of their conjugal relationship." The CRA considers this part of the provision to mean a continuous period of at least 90 days: CRA document no. 2004-0069021E5, July 28, 2004. Therefore, any transfer under subsection 73(1) made after that 90-day period must be adequately documented to show that it is in settlement of rights arising from the former common-law partnership.

4. *Losses.* If losses are inherent in property to be transferred, a transferor may consider triggering those losses by electing out of subsection 73(1) and ensuring that the various stop-loss rules of the Act do not apply. For example, the superficial-loss rules may apply unless the divorce is finalized before the date that is 30 days after the transfer.[49]
5. *Valuation.* As a practical matter, when one is valuing property to be transferred, it is important that the recipient consider the future taxes on a disposition of that property (and that the transferor take into account any losses that may have been forgone).

Principal Residence

Often, a family residence is a married couple's most valuable asset. A transfer of the residence upon marriage breakdown may therefore be of primary concern. The two main options available for such a transfer are (1) the transfer of all of the ownership interest in the residence to one spouse on a tax-deferred basis, and (2) the transfer of the ownership interest to one spouse on a taxable basis, with the transferor spouse utilizing the principal-residence exemption to shelter any gain realized.

Under the first option, when the home is ultimately sold by the recipient spouse, it will generally qualify as the principal residence of that spouse in respect of the years of ownership prior to the transfer (provided that the home otherwise qualified as a principal residence of the transferor for those years).[50]

Under the second option, if the residence is transferred on a taxable basis (before or after the divorce is finalized), provided that the requirements of the principal-residence exemption are satisfied, there should be no resulting gain to the transferor spouse.[51] If there is any uncertainty about whether a residence will meet all requirements of the exemption during the married years, further consideration is warranted. From the recipient spouse's point of view, it may be preferable if the property is transferred on a taxable basis so that the transferor spouse claims the principal residence exemption on his or her own account. From the transferor spouse's point of view, a tax-deferred transfer may be preferable to avoid that uncertainty. As a compromise, the property can be transferred in either manner, with the parties agreeing to share any ultimate tax liability in respect of a future reassessment that successfully denies all or part of a principal-residence exemption.

One of the requirements of the "principal residence" definition is that only one property be designated a principal residence by a married couple for a taxation year.[52] Where spouses are, throughout a taxation year, separated and living apart from each other pursuant to a judicial separation or written separation agreement,

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49 See the definition of "superficial loss" in section 54 and paragraph 251.1(1)(a).

50 Subsection 40(4). Absent this rule, the residence may not otherwise qualify as a principal residence of the recipient for years preceding the divorce.

51 Paragraph 40(2)(b).

52 See paragraph (c) of the definition of "principal residence" in section 54.

each spouse may designate his or her own principal residence for that year. As a general practice, it may be helpful at the time of separation or divorce to complete a designation of the principal residence during the years of marriage prior to the separation (regardless of whether the residence is to be transferred on a taxable basis).[53]

This point is particularly important if multiple residences could qualify for the exemption during the time of marriage. The designation provides the spouses with an opportunity to agree on an optimal use of the principal-residence exemption for all residences (which generally involves, for each taxation year, determining the residences that might qualify as a principal residence and designating the qualifying residence with the largest increase in value). The spouses may then agree on the manner of sharing the inherent tax liabilities related to non-designated residences during the applicable years. Absent an agreed-upon designation in these circumstances, when one spouse designates one of the homes as a principal residence for a year of the marriage, the other spouse is precluded from designating any other qualifying residence for that year.

RRSP Transfers

Funds may need to be transferred from the RRSP or RRIF (registered retirement income fund) of one spouse to that of another on a tax-deferred basis as part of a matrimonial property division.[54] Such a transfer can be completed before or after the divorce is final. The key requirements are that (1) the parties be living separate and apart, (2) the transfer be made pursuant to a court order or written separation agreement, and (3) the transfer be related to a division of property in settlement of rights arising out of or on the breakdown of the marriage.[55] With respect to the last requirement, it is important to ensure that the transfer is not made for some other purpose. For example, it could be the case that RRSP funds are transferred in lieu of spousal support, which may not qualify.[56]

Spousal Attribution

It is important to understand the potential application of the spousal attribution rules.[57] In particular, subsection 74.1(1) provides for the attribution of income and losses between spouses, and subsection 74.2(1) provides for the attribution of certain

53 CRA form T2091(IND), “Designation of a Property as a Principal Residence by an Individual (Other than a Personal Trust).”

54 Subsection 146(16) and paragraph 146(16)(b).

55 The CRA requires that form T2220, “Transfer from an RRSP or a RRIF to Another RRSP or RRIF on Breakdown of Marriage or Common-Law Partnership,” be completed but not filed.

56 CRA document no. 2006-0199271E5, August 23, 2006.

57 Advisers should also ensure that other rules are not inadvertently triggered on a matrimonial division, including the attribution rules in subsections 74.4(2) and 75(2) and the kiddie tax rules in section 120.4.

gains and losses from a disposition of property. These provisions generally apply when, among other things, property is loaned or transferred between spouses for less than FMV consideration.[58]

Once a divorce is finalized, the spousal attribution rules cease to apply in respect of any loans or transfers previously made between the spouses.[59] For common-law partners, the rules cease to apply when the relationship is deemed to end for the purposes of the Act (that is, after 90 days of living separate and apart because of the relationship breakdown).[60]

Attribution also may be suspended before the divorce is final, during any period when the spouses are "living separate and apart as a result of marriage breakdown."[61] It is important to note that such a suspension is automatic for the attribution of income and losses from property but requires a joint election to be made for the attribution of gains and losses from a disposition of property.[62] If the spouses reconcile and resume cohabitation, the attribution rules will apply again as of that time.

A Complex Division of Property

The following example illustrates a more complex division of matrimonial property. Assume that H and W each own 50 percent of the outstanding shares of Familyco, which is a Canadian-controlled private corporation[63] and a small business corporation[64] for the purposes of the Act. The shares of Familyco have an aggregate FMV of $2 million and a nominal ACB. Familyco owns a mix of business assets with an aggregate FMV of $2 million.

Assume that under the agreed-upon division of matrimonial property, W will continue to own the shares of Familyco (so that W can direct the business operations) and that H will receive a transfer of $1 million (by payment or transfer of any combination of cash or property).

This division of property might proceed in a number of ways. At a high level, these include the following.

1. H transfers his shares to W, and W transfers $1 million of cash or property to H.

58 Many cases have considered the application of these rules during marriage. See, for example, *Muio v. The Queen*, 2007 TCC 536; *Overs v. The Queen*, 2006 TCC 26; and *St-Pierre c. La Reine*, 2007 TCC 90; aff'd. 2008 CAF 204.

59 Those provisions require the transferor to be the current spouse or common-law partner of the recipient.

60 Supra note 48.

61 Subsection 74.5(3). Note that there is no 90-day requirement in respect of common-law partners. The CRA commented on this point in document no. 2012-0438021E5, April 25, 2012.

62 Paragraph 74.5(3)(b).

63 As defined in subsection 248(1) with reference to subsection 125(7).

64 As defined in subsection 248(1).

2. Familyco redeems the shares owned by H with a payment of $1 million.
3. A divisive reorganization is completed whereby, for example, W will own shares of a corporation that owns the key business assets of Familyco, and H will own shares of a corporation that owns $1 million of cash or property.

The tax concepts and consequences of the alternatives described above are very complicated, and I do not address them in detail here. However, the following discussion summarizes some of the considerations associated with each choice.

Transfer of Shares

A transfer of shares gives rise to a number of potential tax considerations:

1. *Taxable or tax-deferred.* There are multiple ways to complete a transfer of shares. In the example given above, the shares can be transferred from H to W on a tax-deferred basis under subsection 73(1). Alternatively, H can elect out of this rollover, transfer the shares on a taxable basis, and potentially claim a capital gains deduction, if applicable, in respect of a disposition of QSBC (qualified small business corporation) shares to reduce any resulting gain.[65] Or, if H is to receive payment for the shares over time, he can potentially claim a capital gains reserve in respect of the remaining amounts payable after the year in which the shares are transferred.[66]
2. *Interest deductibility.* If W borrows funds to pay H as consideration for the shares, she may be able to deduct the interest paid. W should ensure that the relevant conditions for deductibility are satisfied.[67]
3. *Stop-loss rules.* If the ACB of the shares to H exceeds the FMV thereof, and if H elects out of a subsection 73(1) rollover, H should consider the application of the various stop-loss rules in the Act. In that situation, the superficial-loss rules may apply to deny the loss to H and add that amount to the cost of the shares acquired by W unless the divorce is finalized before the date that is 30 days after the transfer.[68]
4. *The potential section 84.1 trap.* W may prefer to form a holding corporation (Holdco) to own W's shares and to acquire the shares owned by H. That strategy potentially allows $1 million to first be paid by Familyco to Holdco as a tax-free intercorporate dividend, subject to subsection 55(2) and other restrictions under the Act. Those funds, which will have been subject only to corporate-level taxation, can then be transferred to H as consideration for

65 See the definition of that expression in subsection 110.6(1) and the deduction in subsection 110.6(2.1).

66 Subparagraph 40(1)(a)(iii).

67 Paragraph 20(1)(c).

68 See subparagraph 40(2)(g)(i), paragraph 53(1)(f), and the definition of "superficial loss" in section 54.

the shares acquired. The resulting capital gain to H can potentially be reduced by H's available capital gains exemption. In that case, however, section 84.1 may apply to deem the $1 million capital gain to be a taxable dividend received by H (presumably a non-eligible dividend), which will result in significant additional tax payable by H and will preclude his use of the capital gains exemption.[69] This rule applies before divorce, since H and Holdco are related for the purposes of the Act. After the divorce, while it may be more likely that H and Holdco will be at arm's length, care must be exercised: section 84.1 can still apply if H and Holdco are considered factually not to deal at arm's length.[70]

Redemption of Shares

A redemption of H's shares of Familyco will generally result in a payment to H by Familyco using corporate funds and a cancellation of those shares (that is, W will be the sole remaining shareholder of Familyco). The redemption generally will result in a taxable deemed dividend to H.[71] Although the tax payable on a dividend is generally higher than the tax payable on capital gains, this planning may be desirable in certain circumstances (for example, if Familyco is able to designate the dividend as a non-taxable capital dividend). Consideration also should be given to the potential interest deductibility to Familyco of any funds borrowed to complete the redemption.

Divisive Reorganization

A divisive reorganization can potentially be completed on a tax-deferred basis either as a non-arm's-length reorganization under paragraph 55(3)(a) or as a pro rata distribution under paragraph 55(3)(b). The former option is potentially available to H and W, provided that the reorganization is completed before the divorce is final. The latter option is more complicated, and may not be available in these circumstances if all active business assets must ultimately be owned or controlled by W. In general, any divisive reorganization is complex and will require the payment of substantial valuation, legal, and accounting fees.

Potential Alternatives: Transfers over Time

It is not always possible for spouses to agree on a division of matrimonial property in the short term—for example, when an immediate division would interfere with an ongoing business, or when the valuation of certain assets is expected to increase substantially. In such circumstances, the following two options can be considered:

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69 Section 84.1.

70 Section 84.1 does not apply to arm's-length transactions. After the divorce is final, former spouses cease to be related; in certain circumstances, however, they may still be considered not to deal at arm's length factually. See, for example, CRA document no. 1999-0008625, February 1, 2000.

71 Subsection 84(3).

1. *A wasting freeze.* This planning involves a tax-deferred exchange by H of his shares of Familyco for non-voting, redeemable preferred shares. The share attributes will provide for a fixed dividend rate (H should obtain any desired guarantees and additional security). The redemption of the shares can result in taxable deemed dividends to H (as discussed above); however, such dividends may be taxed at lower marginal rates since the redemptions will occur over time.
2. *A spousal trust.* This planning may be helpful when shares are owned by one spouse. On the facts in the example, if W had owned all of the shares of Familyco, certain shares (for example, a class of non-voting common shares or redeemable non-voting preferred shares) can be transferred on a tax-deferred basis by W to a spousal trust before the divorce is final.[72] H could be entitled to all of the income of the trust during his lifetime, the income being the dividends paid on the shares held by the trust (this arrangement would require certain conditions with respect to the payment of dividends, either embedded in the share terms or otherwise). H would not be entitled to receive any capital of the trust, and the capital beneficiaries would be restricted to children of the marriage after the death of H. Thus, over time, dividends can be paid on the shares held by the spousal trust, and such amounts can then be distributed to H and taxed as dividends[73] (and, as above, if the amounts are paid over time, lower marginal tax rates can provide a benefit).

The use of a trust has a number of possible advantages:

- Additional control can be exercised over the ultimate distribution of the capital of the trust (for example, on the death of H, the shares could be distributed only to the children of the marriage).
- Tax can be deferred on a disposition of the shares until the death of H.
- Control and ownership of the shares can be given to agreed-upon trustees and ultimately to the children of the marriage.
- A trust relationship may provide an opportunity for other beneficial planning (such as a charitable remainder trust).

TAX LIABILITY AND RISK ISSUES

Another important aspect of structuring a settlement is the limitation of future exposure to tax-related liabilities and other risks. It is prudent for a tax adviser—particularly an adviser who has extensive knowledge of a family's past dealings—to carefully consider the various types of risks.

72 There is some uncertainty about whether a spousal trust will remain such after a divorce is final. That said, the wording of subsections 73(1) and 73(1.01) is relevant to the time at which property is transferred to a spousal trust, and the CRA has stated that in its view the trust's status will continue after a divorce is final. See CRA document no. 2012-0473661E5, March 22, 2013.

73 Provided that the required designations are completed under subsection 104(19).

Types of Risks

Most commonly, a spouse is directly exposed to a previous tax liability (including a liability for related interest and penalties)—for example,

- joint and several liability of both spouses for one spouse's personal tax liability (see the discussion of section 160 below);
- if a family trust was utilized, joint and several liability in respect of the liabilities of that trust;[74]
- if spouses were shareholders and directors of a family-owned corporation, joint and several liability in respect of the corporation's failure to properly withhold, collect, and remit GST (goods and services tax) or employee source deductions;[75]
- if spouses were involved in the winding up of a family corporation, joint and several liability in respect of liabilities of the corporation;[76]
- if spouses were directors or officers of a family corporation, joint and several liability in respect of penalties for offences of the corporation under the Act;[77] and
- unanticipated tax liabilities related to support payments and matrimonial property division in respect of the marriage breakdown.

A more subtle risk is a possible increased exposure to audit, assessment, reassessment, or other enforcement action by the CRA. After divorce, a spouse typically has little or no knowledge or control of a former spouse's tax circumstances. For example, assume that one spouse has a potential tax liability that arose during marriage. That liability may be known or unknown at the time of marriage breakdown. After the divorce is final, the CRA conducts an audit of the other spouse (now the former spouse). In the course of that audit, information is provided to the CRA (intentionally or inadvertently) that leads to an audit of the first spouse and ultimately a successful assessment of a tax liability.[78] (Advisers should be aware of the CRA's offshore tax informant program, which offers cash rewards for information leading to the collection of taxes in respect of international tax-avoidance transactions.)[79]

A further risk is the intentional or inadvertent waiver of solicitor-client privilege with respect to legal tax advice. Such a waiver can occur by virtue of the divorce

74 See section 159.

75 See sections 227.1 and 323 of the Excise Tax Act, RSC 1985, c. E-15, as amended.

76 Supra note 73.

77 Section 242. Note the broad drafting of the offence provisions in sections 238 and 239 (for example, paragraph 239(1)(d), which imposes liability on a person who "wilfully, in any manner, [has] evaded or attempted to evade compliance with [the] Act").

78 The CRA has broad authority to ask and require taxpayers to provide information and documents (subsections 231.1(1) and 231.2(1)).

79 This program was announced in the 2013 federal budget. Details are available at Canada Revenue Agency, "Offshore Tax Informant Program," www.cra-arc.gc.ca/otip/.

process itself—for example, a spouse could waive privilege by disclosing privileged information to third-party advisers who are not providing legal advice. A waiver can also occur after divorce in the course of an audit of the former spouse, as described in the example above.

Addressing Risk Issues

Advisers must give careful consideration to protecting their clients from tax liabilities. For risks related to a direct exposure to liabilities, detailed indemnity provisions should be set out in the separation or divorce agreement. If one spouse is a potential collection risk (for example, because he or she plans to leave Canada or has personal financial difficulties), consideration should be given to obtaining appropriate security.

With respect to the risk of increased exposure to an audit, assessment, reassessment, or enforcement action, one possibility is to consider a voluntary disclosure prior to the time of divorce.[80] Spouses can take the opportunity to cooperate with the CRA, potentially reducing or eliminating exposure to penalties and some interest. A second possibility, particularly if an audit or tax dispute is already in progress, is to reach an agreement on the joint conduct of the parties—for example, the parties could agree that one of them will communicate with the CRA on all relevant matters, subject to the prior review of such communications by the other party's lawyer.

Section 160 Liability

One of the most potentially damaging tax liabilities arises under section 160, which provides that spouses may be jointly and severally liable for the tax debt of one of the spouses. In the context of a marriage breakdown, the conditions relevant to the application of section 160 may be summarized as follows.

1. One spouse (the tax debtor spouse) has a liability under the Act in respect of a taxation year during the marriage.
2. During or after that taxation year, the tax debtor spouse directly or indirectly transfers property to the other spouse (the recipient spouse).
3. The FMV of the property at the time of transfer exceeds the FMV of the consideration (if any) received in exchange for the transfer.

If the conditions above are satisfied, the recipient spouse becomes jointly and severally liable with the tax debtor spouse for an amount equal to the lesser of the tax liability and the amount by which the FMV of the property transferred exceeds the FMV of the consideration received. (An exception for property transferred in the course of a matrimonial property division is discussed below.)

Although the conditions set out above may seem relatively straightforward, the following example illustrates the potential dangers of this provision on a marriage breakdown. Assume that in 2009, a husband (H) participates in a transaction for

80 This may also be an ideal time to obtain a rectification order, if applicable.

estate-planning purposes. In 2010, H transfers the ownership of a family cottage to his wife (W) for no consideration. The approximate FMV of the property transferred is $750,000. In 2011, H and W separate and are divorced, and no material amount of additional property is transferred to W at that time under the matrimonial property settlement. In 2012, H is reassessed in respect of the estate-planning transaction; the resulting liability (including taxes, interest, and penalties) is $800,000. The CRA faces difficulties in collecting from H because of his personal financial situation.

In the example, pursuant to subsection 160(1), W is jointly and severally liable with H for $750,000 of his tax liability (that is, the FMV of the transferred family cottage, since W provided no consideration). Unfortunately, that liability represents the majority of the property obtained by W under the matrimonial property division. Such a result may seem extreme, but the technical risk is real (and, in my experience, the CRA may adopt a highly technical approach in enforcement actions under section 160).

Problems arise under section 160 because of the provision's broad application. In particular,

1. there is no requirement or condition for any element of intention to avoid tax;
2. the types of property transfers that may occur for less than FMV consideration during marriage can take many forms, including cash gifts, transfers of cars, and mortgage payments made by one spouse that partially benefit the other spouse;[81]
3. the tax liability of the tax debtor spouse may not be determined until a reassessment is issued a number of years after the divorce;
4. there is no time limit for the CRA to issue an assessment under section 160;
5. once complete, a transfer that triggers section 160 cannot be cured (in fact, a return of the property to the transferor may leave the recipient spouse with joint and several liability but without property to satisfy the liability); and
6. cascading applications of section 160 can occur if there are multiple non-arm's-length transfers of the same property.

The obvious possible defences are (1) that the timing requirements in respect of the tax liability and the relevant transfer were not met, (2) that the FMV of the property transferred was lower than the CRA asserts, and (3) that the recipient spouse provided valuable consideration.[82] In addition, the recipient spouse has the option of challenging the underlying assessment.

81 Such transfers could also include transfers by a related corporation that is a tax debtor (and not by the tax debtor spouse) in the form of, for example, dividends.

82 Depending on the circumstances, it has been argued that such consideration consists of, among other things, a loan payable (that is, that the property was transferred as proceeds of a loan to be repaid) or the settlement of rights arising under a constructive trust. These arguments have had divided results in the relevant case law. In any event, if there is insufficient documentation or other persuasive factors to support such arguments, there is a material risk that they will not succeed.

An exception to this joint and several liability arises under subsection 160(4). The key requirements of the exception are that the transfer of property be made between spouses who are separated and living apart as a result of the marriage breakdown at the time of transfer, and that the property be transferred pursuant to a court order or written separation agreement. If the transfer is to be documented in a separate agreement, it is prudent to have the applicable court order or written separation agreement expressly require that the transfer occur.

In some cases, spouses may begin transferring properties to one another as a form of self-help before the finalization of a separation agreement. Such transfers should be avoided to protect against the risk of a tax liability extending to a spouse as a result of a division of matrimonial property. The most conservative approach is to complete all transfers in accordance with subsection 160(4): as noted above, the spouses should be living apart, and the transfers should be specified in a court order or written separation agreement.

Also as noted above, there is no cure for a tax liability that extends to a spouse as a result of transfers of property prior to marital breakdown. The adviser should determine whether it can be argued that the recipient spouse provided adequate consideration in respect of the transfer, and, where possible, prepare documentation that acknowledges the payment. If the risk is viewed as material, another strategy may be to negotiate appropriate indemnities and security in respect of the divorce settlement (although there is a risk that doing so could highlight the issue).[83] Security could take the form of, for example, a secured interest in real property, funds held in trust, or a letter of credit provided by a bank, each of which could be established for a negotiated period of time[84] and each of which could be used by a spouse if an amount ultimately becomes payable under section 160.

CONCLUSION

A marriage breakdown generally gives rise to a range of tax considerations, most commonly related to support payments, property division, and tax liability risks. To achieve the best outcome for a client, it is important for the tax adviser to be aware of the potential settlement objectives and to discuss with the client and his or her family law counsel the possible alternatives and the associated tax risks and opportunities.

In particular, it is important to review the technical requirements for the deductibility of spousal support, especially retroactive spousal support payments. In the right circumstances, a trust arrangement may be a useful alternative method of satisfying support obligations tax-efficiently.

83 Care should be taken to ensure that the provision of security is not itself another transfer of property to which section 160 could apply.

84 In such circumstances, it is difficult to determine the appropriate term of such security. As noted above, there is no time limit for the CRA to issue an assessment under section 160; and with respect to the underlying tax liability, the CRA may be able to reassess beyond the applicable normal reassessment period pursuant to subsection 152(4).

Matrimonial property divisions, whether routine or complex, can be completed in a number of ways. A tax adviser should carefully consider the implications of the various methods in consultation with the client and his or her family law counsel. To maximize overall tax efficiency, a collaborative approach by all interested parties will often be required.

Finally, a tax adviser should be aware that a marriage breakdown can result in increased exposure to tax liabilities, including liabilities arising from a future audit, assessment, reassessment, or other enforcement action. In each case, the liability risks should be reviewed and consideration given to the available protective measures.