Income
A Family Law Perspective

Presentation to 2017 IDFA National Conference

November 14, 2017

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Topics to be covered

- Brief review of Income as per the Federal Child Support Guidelines
- Discussion of pre-tax corporate income where fiscal year end differs from Calendar year
- Case-Impact on income where fiscal year differs from calendar year
- Case-Purchase of building – impact on Pre-Tax Corporate income inclusion
- Case-Dividends and Inter Company loans – using after tax income to determine accessibility to pre-tax corporate income
- Areas/Issues of interest
  - Pre-tax corporate income and multi-year considerations
  - The Gross-up
  - The Gross down
  - Shareholder Loans and income
  - Capital Dividends and income
  - Double Counting

Calculation Of Annual Income

S16. Subject to Sections 17 to 20, a spouse's annual income is determined using the sources of income set out under the heading "Total income" in the T1 General form issued by the Canada Revenue Agency and is adjusted in accordance with Schedule III

- Start with total income – Line 150
- Adjust in accordance with Schedule III of the Guidelines
- Other potential adjustments

Calculation Of Annual Income

Shareholder, Director or Officer

18. (1) Where a spouse is a shareholder, director or officer of a corporation and the court is of the opinion that the amount of the spouse's annual income as determined under Section16 does not fairly reflect all the money available to the spouse for the payment of child support, the Court may consider the situations described in Section 17 and determine the spouse's annual income to include

(*a*) all or part of the pre-tax income of the corporation, and of any corporation that is related to that corporation, for the most recent taxation year; or

(*b*) an amount commensurate with the services that the spouse provides to the corporation, provided that the amount does not exceed the corporation's pre-tax income

Adjustment to corporation's pre-tax income

18. (2) In determining the pre-tax income of a corporation for the purposes of subsection (1), all amounts paid by the corporation as salaries, wages or management fees, or other payments or benefits, to or on behalf of persons with whom the corporation does not deal at arm's length must be added to the pre-tax income, unless the spouse establishes that the payments were reasonable in the circumstances

Calculation Of Annual Income

Pre-tax Corporate Income

- Included in income or not?
- Is it an all or nothing proposition?
- If included, in what year should it be included?

Calculation Of Annual Income

Included or Not? – Factors to Consider

- History (has pre-tax corporate income been removed from the company previously?)
- Has the same income already been included for support purposes in a prior year?
- Nature of the business
- Third party obligations
  - Bank covenants
  - Mortgage covenants
- Assess balance sheet
- Other

Off Calendar Year End

To Which Calendar Year Should The Pre-Tax Corporate Income Be Allocated

Choices for allocation (assuming income should be included):

- All to the calendar year in which the fiscal year ends (Scenario 1)
- All to the calendar year that substantially all of the income was earned (by months) (Scenario 2)
- Pro-rate by number of months in the fiscal year falling in the calendar year (Scenario 3)
- Allocate to calendar year based on actual revenues & expenses for each period (Scenario 4)

For illustration purposes assume pre-tax corporate income for year ended February 28, 2017 was $120,000

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
February 28, 2017 Pre-tax corporate income	$120,000	$120,000	$120,000	$ 120,000
Allocation:				
2017 Calendar Year	$120,000		$ 20,000	$ 5,000
2016 Calendar Year		$120,000	$100,000	$ 115,000

Scenarios:

1. Calendar Year
2. Fiscal year end (primarily)
3. Pro-rated
4. Actual

Guidelines – 18(i)(a) – all or part of the pre-tax income of the corporation, and of any corporation that is related to that corporation, FOR THE MOST RECENT TAXATION YEAR (emphasis added)

Example: February 28 Year End

- The Valuation Date (“V-Day”) is September 27, 2016
- Mr. Roofer is a carpenter involved in construction work of varying types and duration focusing mainly on rough carpentry and the framing of new homes
- All of Mr. Roofer’s work is done through his company ABC Roofing Inc.
- The year end of the company is February 28
- All (or primarily all) of the revenues earned by the company up to the date of separation related to one contract (between the company and “Z Homes”)
- This agreement ended prior to the date of separation (the subdivision being worked on had been completed) with the exception of the follow up work that was required
- Mr. Roofer (that is, his company) does not get paid for the follow up work that is required and is obligated to bear the costs in relation to same
- Mr. Roofer injured himself just before separation (he fell off of a roof in June 2016) and was unable to return to work until March 2017

Example: February 28 Year End

	February 28 2017 (12 Months)	Before V-Day March 1 2016 to September 27 2016 (7 Months)	After V-Day September 2 2016 to February 28 2017 (5 Months)
Sales	828,020		
Direct costs	692,774		
Gross profit	135,246		
Expenses	112,895		
Income before income taxes	22,351		

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Example: February 28 Year End

	February 28 2017 (12 Months)	2016 to September 27 2016 (7 Months)	2016 to February 28 2017 (5 Months)	
Sales	828,020	828,020	0	
Direct costs	692,774	635,222	57,552	1
Gross profit	135,246	192,798	-57,552	
Expenses	112,895	32,871	80,024	
Income (loss) before income taxes	22,351	159,927	-137,576	

1 - Represents costs paid to third parties to cover warranty obligations.

Example: February 28 Year End

- Possible double counting of income for purposes of equalization and support if utilize the February 28, 2017 pre-tax corporate income (since the company suffered a loss from September 28, 2016 to February 28, 2017) as reflecting the income earned by the company for the year ended February 28, 2017 as Mr. Roofer's income earned post-separation for purposes of support would result in double counting of that income – if the book value is representative of the fair market value of the company at that date, then it is likely that through the equalization process, Mrs. Roofer will receive her share thereof
- Implicit assumption that the level of income earned prior to the date of separation is representative of the level of income earned after the date of separation (as noted, in this case, Mr. Roofer actually injured himself before the V-Day and was not able to return to work until after the fiscal year end)

Result:

At a case conference, the judge agreed with us that it would not be fair in the circumstances to treat February 28, 2017 income as income for support purposes. However, the judge noted that since Mr. Roofer had already returned to work in March 2017, it was reasonable to assume that he would earn some income in 2017. She recommended 50% of the February 28, 2017 income as 2017 income.

Purchase Of Building (Previously Being Rented)

Example: Support Matter Between Mr. Peele (Now Remarried To Ms. Stone) And Ms. Brock

- Prior to April 2015 (and prior to her marriage to Mr. Peele) Ms. Stone owned an office condominium unit
- On or about February/March 2013, Mr. Peele's company (the "Company") sublet its former premises and began occupying/renting the office condominium from Ms. Stone, who was Mr. Peele's girlfriend at the time. Rent was determined by a third party at fair market value
- The condominium unit which was smaller than the space in which the Company previously operated was also a better space (more efficient, modern space, kitchen and bathroom facilities, located in the downtown core, etc.)
- Note that the Company had to move its premises several times during its existence as leases expired and landlords attempted to increase rent significantly

Example: Support Matter Between Mr. Peele And Ms. Brock

- Mr. Peele felt it made economic sense to purchase the condominium from Ms. Stone as opposed to renting space, and, in or about April 2015, the Company purchased the condominium unit from Ms. Stone at fair market value based on an arms length appraisal from a qualified appraiser
- Ms. Stone reported the sale of the unit on her tax return and paid income tax thereon (about $50,000)
- The Company was having a very good year in fiscal 2015 and used the cash generated by operations to primarily fund the purchase of the condominium unit

Example: Support Matter Between Mr. Peele And Ms. Brock

- The income report prepared by the other experts, considered the purchase of the condominium in 2015 as discretionary in nature
- As a result the other experts allocated all of the significant pre-tax corporate income of the Company to Mr. Peele in 2015, even though, as a result of the purchase of the condominium, it did not appear that the 2015 pre-tax corporate income was accessible by him in that year
- As a result of the purchase of the condominium, the Company's occupancy costs before and after the acquisition of the building were as follows:

	2013	2014	2015
Rent expense	$ 41,960	$ 45,378	$ 16,582
Occupancy costs			
Condominium fees	N/A	N/A	$ 4,304
Property taxes	N/A	N/A	$ 2,044
Insurance	N/A	N/A	$ 2,328
Repairs and maintenance	N/A	N/A	$ 2,696
Total	N/A	N/A	$ 11,372
Total rent expense and occupancy costs	$ 41,960	$ 45,378	$ 27,954

Example: Support Matter Between Mr. Peele And Ms. Brock

- Occupancy costs were reduced about $17,400 in 2015 (thereby increasing pre-tax corporate income)
- It was expected that the Company would realize occupancy cost savings of approximately $25,000 to $30,000 in 2016 and subsequent years compared to 2014, as the cost of ownership was much less than the cost of tenancy
- If adding this 2015 Corporate Income to Mr. Peele's income (as if the condominium was not acquired and the money used to acquire same was available to be distributed) we suggested that one should take into account/consider/adjust for the decreased expenses of the Company in subsequent years by virtue of the acquisition as not to do so would be akin to "having your cake and eating it too"

Example: Support Matter Between Mr. Peele And Ms. Brock

- If the Corporate pre-tax income of the Company for 2015 is attributed to Mr. Peele (as if the condominium was not purchased), then for the 2015 and subsequent years, the increased income of the Company by virtue of the acquisition the building ($17,400 in 2015 and approximately $25,000 - $30,000 in 2016 and subsequent years) would have to be ignored. Failure to do so would result in higher income for Mr. Peele in 2015 (and subsequent years)
- The rationale was that it would not be possible to realize higher income post acquisition of the condominium UNLESS the property was acquired

Result

At a case conference, the judge said that for child support she agreed with our view that the purchase of the condominium should be considered as a barrier to accessing pre-tax corporate income in 2015 (as the children would benefit from the higher income (less expenses) in subsequent years).

However, since spousal support was going to be terminated in the near future, for spousal support purposes the judge indicated that she would ignore the purchase of the condominium.

Dividends And Intercompany Loans – Using After Tax Numbers To Determine Accessibility To Pre-Tax Numbers

- Consider the case of Mr. Blue and Mrs. Green
- Mr. Blue is the sole shareholder of Parent Limited (“Parent”) (essentially a holding company) which owns 100% of The Eccentric Company (“Eccentric”). The balance sheets and statements of income and retained earnings (deficit) are set out on Schedules 2 and 3 (Slides 30 and 31) enclosed herein
- As can be seen on the schedules, in 2016, Eccentric paid a dividend to Parent (and Parent paid a dividend to Mr. Blue). You will also see that there is an intercompany loan between Parent and Eccentric

Dividends And Intercompany Loans

Calculation Of The Income Of Mr. Blue

- Summary Schedule (Schedule 1, Slide 26)

Calculation Of Adjusted pre-tax corporate income Of Parent

- Mr. Blue owns, and effectively controls, the company. For purposes herein, we have concluded that the income from this company could have been attributable to Mr. Blue
- In arriving at the adjusted pre-tax corporate income of Parent, we commenced our calculation with the company's pre-tax corporate income as reflected on the fiscal 2016 financial statements of the company (income of $515,596) (Schedule 1-2, Note 8, Slide 28)
- We then made certain adjustments to this figure as noted below
- Dividend from Eccentric
  - We deducted the dividend paid by Eccentric to Parent ($473,000) so as to avoid double counting (as discussed below, we have included a portion of the adjusted pre-tax corporate income of Eccentric). The result is that Parent (on its own) earned $42,596 of pre-tax corporate income.

Dividends And Intercompany Loans

Calculation Of Adjusted Pre-tax Corporate Income Of Parent

- Share of adjusted pre-tax corporate income from shareholdings
  - Parent owns 100% of the common shares of Eccentric. For purposes herein, we have included the accessible income of Eccentric attributable to Parent for 2016 of $426,653 (as discussed below)
- As a result, we arrive at adjusted pre-tax corporate income from Parent of $469,249 (Schedule 1-2, Note 8, Slide 28), which we have included in determining Mr. Blue's 2016 income

Dividends And Intercompany Loans

Calculation Of Adjusted Pre-tax Corporate Income Of Eccentric

- As previously noted for purposes herein, we have assumed that all of the adjusted pre-tax corporate income could have been attributable to Parent (as evidenced in part by the dividend paid on the common shares in fiscal 2016)
- In arriving at the adjusted pre-tax corporate income of Eccentric, we commenced our calculation with the company's pre-tax corporate income as reflected on the fiscal 2016 financial statements (income of $555,249) (Schedule 1-2, Note 9, Slide 28). In assessing the accessibility to this income, we noted that the company paid dividends to Parent on its common shares of $473,000 (Schedule 3) (this equates to 99.77% of Eccentric's after tax income; $473,000/$478,911 (Schedule 3))

Dividends And Intercompany Loans

Calculation Of Adjusted Pre-tax Corporate Income Of Eccentric

- If we stopped the analysis here, we would have included at least 99.77% of the pre-tax corporate income of Eccentric in determining Mr. Blue's income
- However, we also noted that, the "Due to related company – Parent Limited" balance increased by approximately $105,000 from the prior year (Schedule 2, Note 1, Slide 30). This meant that some of the dividend paid to Parent was loaned back to Eccentric. Therefore, only $368,000 net ($473,000 - $105,000) was actually paid out by Eccentric to Parent in relation to its common share dividends declared. As dividends are paid out of a company's after tax income, the net amount actually paid by Eccentric to Parent represented 76.84% ($368,000/$478,911) of Eccentric's after tax income

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Dividends And Intercompany Loans

Calculation Of Adjusted Pre-tax Corporate Income Of Eccentric

- Accordingly, in calculating the income of Eccentric accessible by Parent, we have multiplied the pre-tax corporate income ($555,249) by 76.84% resulting in $426,653 of pre-tax corporate income
- As a result, we arrive at adjusted pre-tax corporate income accessible from Eccentric by Parent of $426,653 (Schedule 1-2, Note 9, Slide 28)
- Adding this to $42,596 of the Parent's own pre-tax corporate income results in total pre-tax corporate income attributed to Mr. Blue of $469,249
- This is the LOWEST possible amount of pre-tax corporate income that could be attributed to Mr. Blue in that year

Green (Kelly) And Blue (Peter)
Calculation Of The Income Of Mr. Peter Blue
For The Year Ended December 31, 2016

Schedule 1

Summary Schedule

Line 150 (Note 1)	385,433
Adjustments:	
Dividend - eligible; taxable to actual (Note 3 and 5)	(99)
Capital loss (Note 1 and 4)	(770)
Carrying charges & interest (Note 3 and 7)	(357)
Parent Limited:	
Eliminate dividend (taxable amount of dividends - other than eligible) (Note 6 and 11)	(216,250)
Eliminate dividend (taxable amount of dividends - eligible) (Note 6 and 11)	(52,510)
Add: Pre-tax corporate income (Note 8)	469,249
Calculation of income of Mr. Blue	584,696
Rounded	585,000

See notes on the following pages.

Green (Kelly) And Blue (Peter)
Calculation Of The Income Of Mr. Peter Blue
For The Year Ended December 31, 2016

Schedule 1-1

Notes To Summary Schedule

1. Details of Line 150 of Mr. Blue's 2016 personal income tax return is as follows:

Employment income (from The Eccentric Company Ltd.)	116,480
Taxable amount of dividends - eligible (from arms length sources)	340
Taxable amount of dividends - eligible (from Parent Limited)	52,170
Taxable amount of dividends - other than eligible (from Parent Limited)	216,250
Interest and other investment income	133
Other income	60
Total income (Line 150)	385,433
Total capital losses (do not appear in Line 150)	770

2. Based on the information/documentation provided, we are unaware of any taxable benefits included in Mr. Blue's employment income.

3. As reflected on Schedule 4 of Mr. Blue's 2016 personal income tax return.

4. As reflected on Schedule 3 of Mr. Blue's 2016 personal income tax return.

5. Adjustment per Schedule III, paragraph 5 of the Federal Child Support Guidelines; adjust taxable amount of dividends from taxable Canadian corporations to the actual amount received.

6. As noted above, Mr. Blue reflected taxable dividends - eligible of $52,170 in his Line 150 income for 2016 (actual dividend of $37,000) and taxable dividends - other than eligible of $216,250 in his Line 150 income for 2016 (actual dividend of $173,000) (total actual dividends of $210,000). The financial statements of Parent Limited reflect a dividend of $210,000 to Mr. Blue during the fiscal year ended 2016.
For purposes herein, the dividend is being eliminated from the calculation of Mr. Blue's income (see note 11).

7. Adjustment per Schedule III, paragraph 8 of the Federal Child Support Guidelines; deduct carrying charges and interest expenses paid and deductible for tax purposes.

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Green (Kelly) And Blue (Peter)
Calculation Of The Income Of Mr. Peter Blue
For The Year Ended December 31, 2016

Schedule 1-2

Notes To Summary Schedule

8. Calculation of adjusted pre-tax corporate income of Parent Limited (for the fiscal year ended May 31, 2016):

Parent Limited *	
pre-tax corporate income (Schedule 3, Slide 29)	515,596
Less: Dividend from The Eccentric Company Ltd. (Schedule 3, Slide 29)	(473,000)
	42,596
Add: Parent Limited's share of adjusted pre-tax corporate income of:	
The Eccentric Company Ltd. (as calculated) (Note 9)	426,653
Total adjusted pre-tax corporate income (Note 10)	469,249

* As the company has a non-calendar fiscal year end (fiscal year ended May 31), we have treated the fiscal year income as being earned in the current calendar year; that is, the income for the fiscal year ended May 31, 2016 has been treated as income in the 2016 calendar year. We note that the financial information for the year ended May 31, 2017 is not yet available.

9. Calculation of adjusted pre-tax corporate income of The Eccentric Company Ltd. (for the fiscal year ended May 31, 2016):

	$
The Eccentric Company Ltd.**	
pre-tax corporate income (Schedule 3, Slide 29)	555,249
% of pre-tax corporate income accessible by Parent Limited (Note 10)	76.84%
pre-tax corporate income accessible	426,653

** As the company has a non-calendar fiscal year end (fiscal year ended May 31), we have treated the fiscal year income as being earned in the current calendar year; that is, the income for the fiscal year ended May 31, 2016 has been treated as income in the 2016 calendar year. We note that the financial information for the year ended May 31, 2017 is not yet available.

Green (Kelly) And Blue (Peter)

Schedule 1-3

Calculation Of The Income Of Mr. Peter Blue

For The Year Ended December 31, 2016

Notes To Summary Schedule

10. We have reviewed the balance sheet of Parent Limited and it is our view that all of the adjusted pre-tax corporate income of Parent Limited (as calculated) for the fiscal year ended May 31, 2016, was accessible by the shareholders.

    In assessing the accessibility to the pre-tax corporate income of The Eccentric Company Ltd. for the fiscal year ended May 31, 2016, we noted that the company paid dividends to Parent Limited on its common shares of $473,000 (Schedule 3); however, the "Due to related company – Parent Limited" balance increased by approximately $105,000 from the prior year (Schedule 2, Note 1). Therefore, only $368,000 net ($473,000 - $105,000) was paid out to the common shareholders. As dividends are paid out of a company's after tax income, the dividend paid by The Eccentric Company Ltd. to Parent Limited represented 76.84% ($368,000/$478,911) of The Eccentric Company Ltd.'s after tax income.

11. As we have included the accessible adjusted pre-tax corporate income of Parent Limited, we have eliminated the dividend received by Mr. Blue from Parent Limited so as to avoid double counting.

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Green (Kelly) And Blue (Peter)
Calculation Of The Income Of Mr. Peter Blue
For The Year Ended December 31, 2016

Schedule 2

The Eccentric Company Ltd. And The Parent Limited
Extracts Of The Unaudited Balance Sheets
As At May 31, 2016

	Eccentric Company	Parent Limited
Assets		
Current		
Cash	94,581	680,572
Accounts receivable and accrued revenue/inventories/short-term investments	1,448,339	193,463
Due from The Eccentric Company Ltd.	0	926,039
	1,542,920	1,800,074
Investment in shares of The Eccentric Company Ltd.	0	10
Deferred finance charges/equipment	33,081	0
Investment in rental properties	0	541,510
	1,576,001	2,341,594
Liabilities		
Current		
Accounts payable/income taxes payable	598,100	12,695
Accrued management salary	52,000	0
Due to related company - Parent Limited (Note 1)	926,039	0
	1,576,139	12,695
Shareholders' equity (deficit)		
Share capital	30	210
Retained earnings (deficit)	(168)	2,328,689
	(138)	2,328,899
	1,576,001	2,341,594

Note:

1. We understand that the "Due to related company - Parent Limited" balance was $821,039 as at May 31, 2015.

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Green (Kelly) And Blue (Peter)
Calculation Of The Income Of Mr. Peter Blue
For The Year Ended December 31, 2016

Schedule 3

The Eccentric Company Ltd. And The Parent Limited
Extracts Of The Unaudited Statements Of Income And Retained Earnings (Deficit)
For The Year Ended May 31, 2016

	Eccentric Company	Parent Limited
Revenue		
Sales	5,453,147	
Investment income		
Dividend income from The Eccentric Company		473,000
Dividend income		24,756
Other investment income		41,000
Total		538,756
Cost of sales	4,421,281	
Gross profit	1,031,866	
Expenses	476,617	23,160
Earnings before income taxes	555,249	515,596
Income taxes	76,338	10,854
Net income for the year	478,911	504,742
Retained earnings, beginning of year	(6,079)	2,031,088
Net income (above)	478,911	504,742
Refundable dividend taxes recovered	0	4,384
Less: Dividend paid on common shares	(473,000)	(210,000)
Less: Refundable dividend taxes paid	0	(1,525)
Retained earnings (deficit), end of year	(168)	2,328,689

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Pre-tax Corporate Income And Capital Investment

- Capital investment (i.e. buying equipment or machinery) will reduce ‘the money available to the spouse’ as it will have been spent but with only a limited deduction to the pre-tax corporate income – this is only relevant where the business needs its capital for operations. If it has excess cash or marketable securities those assets are available for distribution
- Is it reasonable for a capital investment to reduce income per the Guidelines? There are several items to consider:
  - Is the investment for purposes of maintaining the existing corporate earnings or for growth? If for growth, has the valuation of the underlying entity reflected this?
  - What is the expected duration of support? Will any growth in future earnings be shared or are the earnings being depressed during the period of support with the expected growth to occur once support has ceased?
  - What is the past history of the company with respect to acquisition of fixed assets?

Pre-tax Corporate Income And Multi-Year Considerations

- Example 1 – all pre-tax corporate income can be distributed :

Year	Pre-tax corporate income	Additional cash available	Cumulative cash available	Cumulative notional distribution
2014	$300,000	$300,000	$ 300,000	$ 300,000
2015	$200,000	$200,000	$ 500,000	$ 500,000
2016	$400,000	$400,000	$ 900,000	$ 900,000
2017	$100,000	$100,000	$1,000,000	$1,000,000

- Each year enough cash has accumulated in order to pay out the income earned

Pre-tax Corporate Income And Multi-Year Considerations

- Example 2 – insufficient cash available for distribution:

Year	Pre-tax corporate income	Additional cash available	Cumulative cash available	Cumulative notional distribution
2014	$ 300,000	$ 300,000	$ 300,000	$ 300,000
2015	$ 200,000	$ 100,000	$ 400,000	$ 400,000
2016	$ 400,000	$ 300,000	$ 700,000	$ 700,000
2017	$ 100,000	$ 300,000	$ 1,000,000	$ 1,000,000
	$ 1,000,000	$ 1,000,000		

*assumes no distributions (i.e. dividends) were paid

- In 2015 even though there is more cumulative cash than earnings (i.e. $400,000 compared to $200,000) there is not enough cash to support a $200,000 income inclusion in that year. Consider that $300,000 of the $400,000 cumulative cash available was already “notionally” paid out in 2014 and imputed in calculating income, the same $300,000 cannot be recycled again in 2015. Therefore we look to the change in cash ($100,000) to see how much is really available this year – *shortfall of $100,000*
- In 2016 the same thing has happened; $400,000 was earned but only an additional $300,000 of cash became available - *shortfall of another $100,000*
- In 2017 $100,000 was earned but $300,000 became available – *excess of $200,000!*
  - Time to consider a catch-up of previous years shortfalls

The Gross Up

- Pursuant to Section 19 of the *Federal Child Support Guidelines*:

  19. (1) The Court may impute such amount of income to a spouse as it considers appropriate in the circumstances, which circumstances include the following:

  (*a*) the spouse is intentionally under-employed or unemployed, other than where the under-employment or unemployment is required by the needs of a child of the marriage or any child under the age of majority or by the reasonable educational or health needs of the spouse;

  (*b*) the spouse is exempt from paying federal or provincial income tax;

  (*c*) the spouse lives in a country that has effective rates of income tax that are significantly lower than those in Canada;

  (*d*) it appears that income has been diverted which would affect the level of child support to be determined under these Guidelines;

  (*e*) the spouse's property is not reasonably utilized to generate income;

  (*f*) the spouse has failed to provide income information when under a legal obligation to do so;

  (*g*) the spouse unreasonably deducts expenses from income;

  (*h*) the spouse derives a significant portion of income from dividends, capital gains or other sources that are taxed at a lower rate than employment or business income or that are exempt from tax; and

  (*i*) the spouse is a beneficiary under a trust and is or will be in receipt of income or other benefits from the trust.

The Gross Up

- Occurs in situations where a preferential tax rate (which would include a zero tax rate (the write off of personal/discretionary expenses)) is received by the individual due to the type of income (for example, investment income) earned
- Examples:
  a) "Regular" gross up – personal or discretionary expenses – Sarafinchin
  b) Gross up on lower taxed income – dividend income or capital gains
  c) Foreign jurisdiction – for example, earning US taxed income
  d) Spouse/kids – income splitting

Example – Gross Up On Personal Or Discretionary Expenses

- Assume Ms. Carr has personal or discretionary expenses that have been written off through her company, Quin Inc.

		2016	2015
Total discretionary expenses	A	20,000	18,000
Gross up thereon:			
Assume a marginal tax rate of	B	40.00%	40.00%
Income (before tax) required to pay discretionary expenses	C = A/(1 - B)	33,333	30,000
Less: discretionary expenses	A	20,000	18,000
Gross-up on expenses	C - A	13,333	12,000

Example – Gross Up On Lower Taxed Income

- Dividends and capital gains are taxed at different (lower) rates than employment income
- The purpose of the gross up is to place an individual in an equivalent after-tax position had they not received this preferential (lower) rate of tax on their income
- What does “a significant portion” (19(1)(h)) mean?
- Assume for the year 2016 Mr. Lavine’s Line 150 income is comprised of dividends and investment income

Example – Gross Up On Lower Taxed Income

		2016		
		Scenario 1	Scenario 2	Imputed Income
Line 150 income		$ 75,359	$ 75,359	
Adjustments:				
Taxable dividends to actual - eligible	(Note 1)	(10,043)		
Elimination of dividends	(Note 2)		(34,537)	
Replacement income	(Note 3)		31,378	
		65,316	72,200	6,884
Taxes per tax return/adjusted tax return		(6,081)	(12,965)	
Net after-tax cash position		59,235	59,235	

Notes:

1. Taxable dividends were adjusted to actual dividends to reflect the actual cash received by Mr. Lavine.
2. For purposes herein, we have considered the tax benefit as a result of earning dividend income that is taxed at a lower rate than, for example, investment income (Scenario 2).
3. There were no capital gains in this example. Had there been significant capital gains an adjustment would be required.

Example – Gross Up On US Taxed Income

- Assume Ms. Gray earns income in the state of New York, USA
- Based on the comparison of the actual income taxes payable by Ms. Gray (in New York) in comparison with the income taxes that she would have to pay on that same income if earned Ontario, Canada
- The difference in the taxes paid by Ms. Gray creates the base for the gross up amount
- For example,

		2013
Taxes paid in New York (converted to $CDN)	A	2,000
Taxes that would be payable in Ontario	B	5,000
Tax savings	C = B- A	3,000
Effective additional income (using a 40% marginal rate)		5,000

Example – Gross Up – Spouse/Kids (Income Splitting)

- Assume Mr. Hodge earns $500,000 of income in his company, $25,000 of which he pays to his second wife, Mrs. Hodge, as a notional salary and that Mrs. Hodge earns no income of her own effectively creating an income splitting situation
- By doing so, Mr. Hodge is being taxed at a lower marginal rate, creating a tax savings

The gross up due to differential in tax rates from income splitting is calculated as follows:

		2012
Mrs. Hodge's notional salary		25,000
Total calculated tax thereon	A	3,744
Tax that would be paid assuming a 50% rate	B	12,500
Total notional tax savings	C = B - A	8,756
Grossed up total	D = C/(1 - 50%)	17,512

The Gross Down

Example: Mr. Fox

- Consider the following scenario:
  - Mr. Fox is the sole shareholder of Terrain Investments Inc. (“Terrain”). During the period under review, Terrain earned income from Cool Holdings (“Cool”) a real estate joint venture in which it holds a 33 1/3% minority interest
  - Revenue reflected on the financial statements of Terrain from Cool (i.e. income for accounting purposes) is different from (in excess of) the actual cash distributions received by Terrain in the year, as the controlling joint venture interest has determined that monies need to be retained by the joint venture to fund upcoming capital requirements
  - Accordingly, Terrain is required to pay income tax on monies that it does not actually receive (as a result of a decision by the controlling joint venturer)

The Gross Down

- In this situation, the reported income significantly exceeds the cash distributions received and accordingly, the income received from Cool is at a disadvantageous rate (that is, more tax is paid compared to that of employment income upon which tax is generally paid on monies received)
- As such, an argument could be made to reduce Terrain’s income to a lower amount to reflect the actual after-tax income received in relation to its investment in Cool, as opposed to its taxable income
- If this were to occur, then total income per the *Guidelines,* would be reduced

The Gross Down

- Before the gross-down, Mr. Fox's calculated income would be as follows:

	Memo $	$
Total income - Line 150		135,709
Adjustments		
Social benefit repayment		(6,368)
Dividends		
Deduct taxable dividends (eligible)		(18,418)
Add actual dividends (Guidelines Sch. III, para. 5)		13,063
Rental Income		
Net rental income	54,775	-
Actual cash received	37,219	-
Net business income		
Deduct as reported on income tax return		(34,641)
Add adjusted net professional income		53,301
Income attributable from Terrain	152,519	152,519
Actual Cash Received from Terrain	60,403	
Income of Mr. Fox pursuant to the Federal Child Support Guidelines, As Adjusted		295,175
Rounded		295,000

The Gross Down

	$	
Cash received in respect of Cool (by Terrain)	60,483	
Cash received from rental properties held directly (Slide 44)	37,219	
Total cash received relating to real estate	97,702	(A)
Taxable income from Cool (held by Terrain)	152,519	
Taxable rental income reported (Slide 44)	54,775	
Income subject to tax	207,294	(B)
Tax rate – est – 40%	40.00%	
Actual taxes payable by Mr. Fox on real estate income	82,918	(C)
Actual after tax proceeds retained	14,784	(A-C)
Gross-up amount	9,757	
Equivalent pre-tax income	24,541	(D)
Possible deduction from income	182,753	(B-D)
Rounded	183,000	

The Gross Down

- After the gross-down, Mr. Fox's calculated income is as follows:

	$
Income of Mr. Fox pursuant to the Federal Child Support Guidelines, Rounded (Slide 44)	295,000
Potential adjustment for Gross Down (Slide 45)	(183,000)
Potential Adjusted Income, Rounded	**112,000**

- The calculations demonstrate the reduction of income from Cool and rental properties for the purposes of reflecting the actual after-tax income received (grossed up to a pre-tax amount) by Mr. Fox, as opposed to that reported for tax purposes

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Shareholder Loans – Income or not?

- In order to answer the question, must relate shareholder loans to pre-tax corporate income
- Examples:

	Scenario 1	Scenario 2
Pre-tax corporate income	$ 200,000	$ 200,000
After-tax corporate income	$ 170,000	$ 170,000
Net loan drawn by shareholder in the year	$ 170,000	$ 0

Under Scenario 1, the drawing of the after tax income by way of shareholder loan confirms that the pre-tax corporate income was available to the shareholder

Under Scenario 2, a "normal" analysis must be done in relation to determining whether all or part of the pre-tax corporate income should be included in income

Is a Capital Dividend Income?

- If capital dividend arose before V-day, then is drawing the capital dividend after V-day income?
- Simple approach – Mr. Smith received a $1,000,000 tax free capital dividend in 2016 from his company – therefore his grossed up income should be about $2,150,000 (using 53.53% tax rate)
- Is this correct? Is it fair?
- Need to look at:
  1) Timing of creation of capital dividend account (pre or post V-day)
  2) Pre-tax corporate income (may be indication that pre-tax corporate income could have been drawn)

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Employee Stock Options & Restricted Share Units (RSUs) Double Counting

- Executives at public companies are often granted stock-based compensation in the form of options and RSUs (also referred to as phantom shares)
- Upon separation these assets will form a part of net family property (NFP)
    - Stock options are usually valued using the Black-Scholes formula less discounts for vesting risk (if unvested) and early exercise risk
    - RSUs are usually valued at their intrinsic value less discounts for vesting risk and price risk
- At some point following the date of separation when these assets are realized on, they will be included for tax purposes in Line 150 (total income) and this will form part of income pursuant to the Federal Child Support Guidelines
- Double counting (also known as double dipping) may occur when a spouse shares in the value of these assets upon separation and then shares in the same assets again in the form of spousal support (double counting is permitted for purposes of child support)

Employee Stock Options & RSUs
Double Counting

- In order to avoid double counting, the discounted value (before tax) which was included in NFP at separation needs to be backed out of Line 150 income when the assets are realized on
- The growth (and possibly the loss) in the value of the assets between separation and the eventual realization should still be included in income
- Example:
  - V-day (2015) discounted value of RSUs: $200,000, before tax
  - RSUs vest in 2016 and result in taxable income of $325,000 at that time
  - Total line 150 income in 2015: $600,000 (including salary, RSU income and other income)
  - Line 150 adjusted for RSUs: $400,000 ($600,000 - $200,000)
(for spousal support purposes) OR has the asset been valued and all $325,000 should be excluded?

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Employee Stock Options & RSUs
Double Counting

- One of the differences between RSUs and Stock Options is that at the V-day one can predict the date when RSUs will mature and provide a taxable benefit. Stock Options may have a predictable vesting date (the earliest date they can be exercised) but the exercise date will be at the discretion of the option holder
- When one requests a valuation of either RSUs or Options at the V-Day it is a relatively simple matter for the valuator to include a schedule of maximum deductions from future income to avoid double counting for spousal support purposes
    - RSU income schedules will have a fixed date
    - Options income schedules will be variable depending on the exercise date

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About Crowe Soberman LLP

Crowe Soberman has built its reputation in Ontario working with mid-sized businesses and high-net-worth individuals. Our size allows us to focus on building close relationships with our clients to learn about their aspirations and objectives and then work with them to maximize their growth potential and achieve their financial goals.

We work with many private and family-owned businesses, professional service firms, not-for-profit organizations and individuals. We also work with larger, multi-national companies, both public and private.

Our goal is to work with clients as part of their strategic advisory team. Partners are the prime business advisors who work closely with individuals, owners or managers to understand the business objectives. Our business model allows partners and senior professionals to have a very hands-on approach.

Service Areas

- Audit & Advisory
- Business Valuation
- Claims Valuation
- Corporate Recovery & Turnaround
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- International Tax
- Dispute & Litigation Support
- Management Services
- Media Services
- Mergers & Acquisitions
- Personal Insolvency
- Sports & Entertainment
- SuRE Services for Family Business
- Tax