TAB 1

Determination of Income for Family Law

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Marmer Penner Inc.
Business Valuations and Litigation Accountants

Valuation and Income Calculations For Family Law Lawyers

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Introduction

In the simplest of worlds, spouses would be T4-ed employees with no unreported income or allowable expenses. Income determination would then be no more difficult than reading one line on a tax return. But it is not that way.

Businesses and shareholders can arrange their affairs to minimize income tax or for other goals, one of which can be to reduce personal income for support purposes. Today's accountants can be very creative. That is why today's investigative accountants and business valuators must be familiar with the tricks of the trade.

Optimal Utilization of Assets

Before we delve into the world of forensic accounting and unreported income, let's deal with less nefarious ways to minimize income. We have all heard the term Asset Allocation. Most often it is used in connection with risk minimization in investment management. However, asset allocation or asset mix can also affect income for support purposes.

Consider Ian the investor, who has a $1,000,000 portfolio. Prior to separation, three quarters of the portfolio was invested in a mix of triple A corporate and government bonds yielding about 6% or $45,000 per annum. The remaining $250,000 was invested in equities, some of which paid dividends. The average dividend yield was 2%, so Ian earned $5,000 in dividend income for a total of $50,000. In addition, Ian realized some capital appreciation on his equities, however, these were only realized when sold. After separation, Ian moved all of his bond portfolio into equities so he now earned about a 2% yield on the entire $1,000,000. That reduced his annual income from $50,000 to $20,000. It may seem apparent that Ian reallocated his assets in order to reduce his support obligation. However, in the last ten years when we have experienced low interest rates and high stock market returns, it is difficult arguing that Ian was acting in this manner solely to defeat his spouse.

Reallocating economic resources is not limited only to investments. For many spouses, the greatest economic asset is themselves. Some spouses choose to under-employ this economic asset in order to minimize support obligations. The role of a business valuator and forensic accountant is called upon in these circumstances to shed light where the income minimization is intentional. In some cases, medical practitioners cite government cutbacks and clawbacks as a reason for lower income. A comparison of revenues to prior years and government limits is required. A further comparison to other similar practitioners in the same geographic area is also warranted. Finally a review of the professional expenses may indicate that inflated expenses, not minimized revenue is the actual culprit.

Where partnerships are involved, the forensic accountant may wish to look more carefully where the spouse's income drops but the partner's income rises. Once again, it may be that the separated spouse has reallocated clients or profit sharing in a temporary manner to reduce income. Where partners agree to act in concert for mutual benefit, some of the transferred income may be repaid in cash to the separated partner. A review of insurance record and patient appointment books may indicate that a dentist, for example, continues to service his usual patients while allowing a partner to report the income as his for accounting and income tax purposes.

Does this mean that only the self-employed or investors can shift economic assets to reduce their income? Not any more. A common and tax efficient form of employee remuneration is the use of employee stock options. A stock option is the right to purchase a security at a predetermined fixed price. Where the value of the security has risen above the fixed price, exercising the option provides a gain to the option holder. In a recent case, a senior bank executive magnanimously offered to his employer to reduce his salary significantly in exchange for enhanced stock option benefits. If a company's stock price failed to rise, his gamble would not pay off. If the stock price rose sufficiently, his gamble would leave him ahead of where his base salary would have otherwise left him. To the shareholders, this created a sense of confidence in the corporation's future since the senior executive was betting a fortune on the company's growth. What was unknown to most was that the executive was embroiled in a matrimonial dispute. The "salary for option" swap also provided the bonus of income manipulation for support purposes. The timing of income from stock options is discretionary. In most cases, employee stock options are issued with long exercise period, such as ten years. Accordingly an employee whose children are teenagers will benefit from shifting current income into stock option income which will likely be exercised after the children are beyond the age at which support is still required.

In all these examples, the first clue to income manipulation is a sudden drop in total income after separation.

Expense Manipulation

For the self-employed, income minimization can take other forms. One of the simplest forms involves payments to non-arm's length parties. It is not uncommon to see management fees or salaries paid to family members or friends in order to reduce business income. The forensic accountant should review the cash disbursements and T4 summaries of a business and note the names of recipients who may be non-arm's length parties. These services should be questioned and compared with previous years for reasonableness. When reviewing the last three years' income, don't forget to look for payments to a family trust or a corporation controlled by family trust for the benefit of minor children. Although the 1999 federal budget did away with this type of income splitting, the effect remained relevant for three more years where the Guidelines permit an averaging of the last three years' income. It should be noted that although the budget eliminated the income tax advantages of income splitting through a family trust, the business owner may still continue to make payments to a family trust in order to reduce the business income. Under the new rules, any amounts paid to the minor children as dividends will be taxed at the high rate. However, if the income is not paid out to the children, then the payment of management fees to a trust or a holding company will still achieve reduced business income for the support payer. It will also still result in lower taxes as the corporate tax rate can be as low as 18% which is much lower than the 46% that might be paid if reported as personal income in Ontario.

Next on the list of income reducing techniques is the practice of paying personal expenses through a business by treating them as business expenses. The most abused expenses tend to be entertainment, travel and automobile expenses. It may help to speak with the non-titled spouse to find out which credit card was used most often for personal entertainment and then review how these expenses were recorded by the company – as either promotion expense or shareholder advance. If it is charged to the shareholder account, then no impropriety exists and no business expense was claimed. For automobile expenses, a review of the insurance policy will indicate if vehicles used by the non-titled spouse and children are treated as business expenses.

One oft forgotten add-back is depreciation expense on real property. If the titled spouse's business earns either rental or business income from an owned property, its depreciation expense on the building may be added back to income for *Guidelines* purposes only.

Business Losses From Limited Partnerships

What do you do if your client has income in excess of $150,000 per annum and purchases a film or a software tax shelter?

In plain English, a tax shelter is an investment which cost is exceeded by the tax savings it generates in its early years. The most common tax shelter you will see today are film or software limited partnerships. A typical film tax shelter costs about $25,000 over the first two years and generates tax savings of over $45,000. In order to generate this level of tax savings, tax losses of about $100,000 are flowed out to each limited partner. Most people buy tax shelters purely for the income tax savings, however, those who are non-custodial parents have the added incentive of reducing child support payments. For a parent paying child support for three children, the savings in support payments alone over the first two years in this example exceeds $16,000. It's important to remember the tax shelter losses are discretionary and generally non-recurring losses. The Guidelines may permit the court to consider all are part of these losses as inappropriate. Due to changes in income tax legislation, these tax shelters are slowly disappearing. However, oil and gas tax shelters still exist and the losses from these investments can be significant.

Other Income Issues

If someone is forced to withdraw $10,000 from an investment account at a brokerage firm, is that considered income? No, it generally considered a reduction of capital. However, if that withdrawal is from an RRSP account, it is income for income tax purposes. In a nutshell, RRSP contributions do not reduce Guidelines income but RRSP withdrawals increase Guidelines income. Notwithstanding this apparent inequity, this is clearly the law. Like many things in life (and in family law), it may not be fair, but those are the rules.

As indicated above, where rental income is earned, no allowance for depreciation expense is allowed where computing income for Guidelines purposes. It is important to remember that when indicating rental income on a financial statement such as a Form 69K or Form 13, net rental income should be shown on the front page. A mistake often seen is that rental revenue is indicated on the front page and related rental expenses are included in the payer's budget. Page 1 is intended to show income. Accordingly, by indicating the related expenses in the budget, income for support purposes may be overstated. The same issue arises where investment income is shown on page 1 and investment expenses such as related loan interest or professional fees are shown in the budget.

The Income Tax Act permits businesses to claim expenses with respect to an office in a home if the office is used all or substantially for business purposes. To calculate these expenses, in most cases a percentage of total housing expenses are allocated to this one office. Accordingly, in a ten-room house, if one room is used as a business office, one tenth of all expenses such as mortgage interest, utilities, property tax and insurance, etc. are claimed as business expenses. While this is permissible for income tax purposes, it may be inappropriate for calculating income for support purposes as these business expenses do not represent any incremental cost to the spouse in question. Had it not been for the existence of the business, these expenses would have been incurred anyway, however, they would have been considered as personal expenses.

Revenue/Income Recognition

They say timing is everything. And when it comes to capital gains and losses they may be right. The triggering of capital gains and losses is purely discretionary. If somebody wishes to intentionally lower his/her income for support purposes without risking any economic loss, here is a way to do it. An investor buys 100 shares of IBM at $50 per share for a cost of $5,000. In another brokerage account the investor short sells 100 shares of IBM at $50. That means the investor promises to deliver 100 shares of IBM in the future at this predetermined price. If the IBM stock price rises, the account holding 100 shares will rise in value, but the account with the short sale will diminish in value by an equivalent amount. Economically the investor cannot gain or lose as the two positions exactly offset each other. This is called hedging an investment. Let's assume the IBM stock price drops by December 31, of a particular year. The investor has an accrued gain in a short sale account and an accrued loss in the other account. If the investor sells his stocks on December 31, a loss is triggered in this year and reduces income for support purposes. If this is the last year of support obligations, the investor will trigger the gain in the other account in the next business day without concern since no support will be payable on the income earned in that year. Timing here made all the difference. The only way to prevent this strategy from being effective is to be aware of a payer's different brokerage accounts and tracing separate transactions to show that any such losses artificially and economically providing the court the opportunity to reject the validity of this type of loss. The timing issue also applies to stock options as discussed earlier and allowable business investment losses.

By the way, timing of income recognition issue is not an issue limited to investors. A lawyer, for example, could provide certain services and bill the client $10,000. That $10,000 is revenue and included in the calculation of income. If the lawyer wishes to defer recognition of this income, a $10,000 retainer invoice could be issued instead. A retainer is a deposit and is not recognized as income until the accounting adjustment is made to clear work in process against the retainer received. So if a professional's income is dropping but his/her unbilled work in process is increasing, it may be a sign of intentionally delaying revenue recognition.

To Catch a Thief

All of these investors, professionals, and business people who manipulate their income are small potatoes compared to the underground business operator. We have all seen these cases. A couple lives in an expensive home with little or no debt, one spouse claims a lavish life style but the combined income on both spouses' personal income tax returns could not possibly justify a fraction of the cost of their alleged life style.

Determining actual business revenues and expenses can be attempted in one of two general ways. The front-end approach is to concentrate on the actual business. In one case, we reviewed a hotel's operations. The reported revenue had seemed unreasonably low, however, the bank deposits tied in with the registration book listing rooms rented. This hotel (like most, we hope) laundered its sheets and made beds everyday. By checking the laundry records we were able to determine that the number of rooms cleaned exceeded the number of rooms rented on a consistent basis. Since there was no reason to clean an unused room, we showed that many of these apparent unused rooms were rented for unreported cash payments.

A similar approach can be used in manufacturing businesses by studying the inputs in, for example, an assembly process. If manufacturing a chair requires four legs and one seat, a review of the parts ordered compared to sales and the change in inventory levels can help indicate unreported sales or understated inventory.

These types of analyses are referred to as front-end approach because they concentrate on the actual business itself. The back end approach is used when there are scant business records or the unreported income comes from a service business where the cost of inputs is not correlated to the quantity of service provided.

The back end approach (which is also used by Canada Revenue Agency when assessing taxpayers with unreported income) is based on a knowledge that opening net worth plus income minus living expenses equals ending net worth. Determining current net worth is not difficult assuming there is no allegation regarding hidden bank accounts. Opening net worth can be estimated based on a net worth statement filled out a few years earlier for mortgage application. Even those with unreported income tend not to understate their net worth on mortgage applications knowing that higher net worth may shave half a point off their interest rates. Annual costs of living must be estimated but records exist for most major expenses such as mortgage payments, utilities, property taxes, children's tuition, childcare and anything purchased on credit. The rest, such as groceries, can be estimated by one spouse for the sake of accuracy. In a simple assumption, Rudolf the renovator's net worth was $200,000 four years ago. His living expenses were calculated at $70,000 per year but his reported income is $25,000 and his net worth has increased to $400,000. Based on these numbers, Rudolf had to earn enough in four years to finance $280,000 (four times $70,000) of living expenses plus another $200,000 in net worth increase for a total of $480,000. That's $120,000 per annum. He reports $25,000 per year, so his unreported income must be $95,000 per annum on average.

If these figures are supportable and Rudolf cannot show that any of this alleged unreported income was actually gifts or loans from family, then one might be content with basing support on $120,000 per annum. However, let's not forget that although Rudolf keeps $120,000 per year, he only pays tax on $25,000 so he really earns the after-tax equivalent of someone earning $200,000 per year. The Guidelines permit the court to adjust a payor's income where the tax rate paid by the payor is considered favourable. This is generally accepted as intended to apply that someone earning significant dividends or capital gains or someone living in another jurisdiction with lower tax rates. However, consideration should be given to someone who has the ability to get away with paying a significantly lower rate of tax than anticipated due to unreported income.

Income over which the Spouse has Access and Control

We normally apply the principles of access and control in determining income for spousal support purposes. It is unclear whether these same principles are to be applied under the *Guidelines* for child support purposes.

Access means that the corporate income is available for distribution to the spouse. To the extent that any portion of the corporate income must be retained in the company for capital reinvestment or due to restrictions imposed by the bank, the spouse may not have access to this income. In determining whether the spouse has access to the corporate income we consider capital reinvestment requirements, banking covenants, shareholder agreements, historic practices of the corporation and the financial status of the corporation.

Capital reinvestment requirements of the corporation are crucial. The *Guidelines* refer to a case where the spouse earns income through a partnership, and state that any amount included in his income that is properly required by the partnership for purposes of capitalization should be deducted. However, the *Guidelines* are silent with respect to the capitalization requirements of a corporation.

Take the case of a business which earned $1,000,000 of pre-tax income in the most recent year. The pre-tax income included a deduction for depreciation on the existing capital assets of $100,000. The business is capital intensive and $400,000 must be reinvested to maintain this level of pre-tax income. The required capital reinvestment of $400,000 exceeds book depreciation of $100,000, by $300,000. Therefore, the spouse has access to only $700,000 ($1,000,000 - $300,000) of the pre-tax income of the business. Where depreciation properly reflects the annual capital reinvestment, no adjustment should be made.

Banking covenants also play an important role. The current banking agreements should be carefully examined to determine what debt to equity ratios, current ratios or any other ratios must be met. As well, the banking agreement may specify the maximum amount of shareholder remuneration. Previous corporate practices in terms of meeting the banking requirements should be tested.

Consider the case where the banking agreement limits the shareholder remuneration to $100,000 per annum, unless specific approval is obtained from the bank. The corporation earns a pre-tax profit of $900,000 after payment of a salary of $100,000 to the spouse. The spouse claims that the income over which he has access and control is $100,000. He claims he does not have access to the $900,000 retained in the company due to bank restrictions.

Further investigation reveals that the banking agreement is five years old. The company's financial position has improved dramatically in the last year. The spouse has not requested specific approval from the bank to withdraw more than $100,000. If an additional $900,000 was distributed from the company it would still be in a healthy financial position. As well, you find that the company purchased a $500,000 home in which the spouse resides rent-free. All of the above factors indicate that the spouse may in fact have access to the corporate income despite the bank restrictions.

The financial health of the company is also important in determining the corporate income to which a shareholder has access. Consider the case of a company which has a substantial deficit. Much of its pre-tax income may need to be retained in the company to reduce the deficit and bring its debt to equity ratios and current ratios to an acceptable level. The debt to equity ratio measures how heavily the company is leveraged. The current ratio measures whether the assets which will be converted to cash in the current year are sufficient to meet the liabilities which will become due in the current year.

The accounting methods employed by the company should also be examined. A company with long-term contracts may recognize its revenue on a percentage of completion basis, before payment is received, if payment is reasonably assured. A start-up company in this scenario, may appear financially healthy on the books, however, it may be cash strapped. This would limit the distribution of profits in the near future.

Control means that the spouse can dictate how much of the income may be distributed and when it is distributed. In determining whether the spouse has control over the timing and the quantum of the income distributed from the corporation, we consider the percentage of ownership held by the spouse, and the distribution of the remaining shareholders. As well, the relationship of the shareholders in the company is important. At one end of the spectrum is the shareholder who owns 100% of the company and exercises complete control over the distribution of the corporate earnings. At the other end is the minority shareholder of a public company whose only income derived from the company is the dividends received.

A 30% shareholding, where the balance of the shares is held by family members may not mean lack of control. We usually assume a family acts in concert unless specific facts exist that prove otherwise. It is also possible that a minority shareholder's position in the company or special knowledge and expertise, or relationship with key clients, provide him/her with additional control beyond the stated shareholding.

A recent case, *Murray v. Murray*, highlighted the issue of determining access of control of corporate income where the spouse was a 50% shareholder.

On the date the parties separated, Mr. Murray had direct interests in four corporate entities. In three of these entities, Mr. Murray had 50% interests, with the balance of the shares being owned by his brother. Mr. Murray and his brother were partners in these three entities and their actions were governed by shareholder agreements between them. These shareholder agreements specified that all changes in direct or indirect remuneration and the payment of dividends required the unanimous approval of both Mr. Murray and his brother. Mr. Murray owned 100% of the fourth corporate entity.

The main difference in the approaches taken by the two business valuators was the extent to which Mr. Murray had access and control over the corporate income that was earned by the entities in which Mr. Murray only had a 50% interest. Mr. Murray's business valuator did not attribute any corporate income on the basis of his 50% shareholding and his inability to control the distribution of the corporate income. Mrs. Murray's expert attributed 100% of Mr. Murray's share of the corporate income, notwithstanding there was some question as to whether he had access and control of it.

Justice Croll set out the inquiries that should be made by lawyers and business valuators in making an assessment as to what corporate income, if any, should be attributed to a support payer. These inquiries were first set out by Justice Linhares de Sousa in *Brophy v. Brophy*. These inquiries are as follows:

1. Because of the separate legal entity of the corporation, should there be a general reluctance by the court to automatically attribute corporate income to the shareholder?

2. Is there a business reason for retaining earnings in the company?

3. Is there one principal shareholder or are there other bona fide arm's length shareholders involved?

4. What is the historical practice of the corporation for retaining earnings?

5. What degree of control is exercised by the spouse over the corporation?

In the end, Justice Croll attributed 50% of Mr. Murray's share of the corporate income to him for the purposes of determining his income. This represented 25% of the total pre-tax income for the companies in which he was a 50% shareholder and 50% of the pre-tax corporate income for the company in which he was a 100% shareholder. In her finding, she considered that although the shareholder's agreement required unanimity in decisions regarding the governance of the companies, the relationship between Mr. Murray and his brother was such that if Mr. Murray needed or wanted some share of the corporate profits, a distribution would have been made to Mr. Murray. Accordingly, Mr. Murray's line 150 income was not the fairest determination of his income. However, Justice Croll acknowledged that attribution of 100% of the pre-tax corporate income would be unreasonable and that at least some monies were needed to maintain the value of the business as a viable going concern.

This and another recent decision, *Fitzpatrick v. Fitzpatrick*, the issue dealt with employment income paid to a shareholder that had to be loaned back to the company.

Mr. Fitzpatrick was a minority shareholder. Every year, the corporation declared bonuses to all of the shareholders to reduce corporate income and income taxes thereon. However, the corporation needed this money, so each shareholder was required to lend back to the company the after-tax portion of their bonus. The court did not include these bonuses in Mr. Fitzpatrick's income for spousal support purposes even though the amounts were included on his personal income tax return because he did not have use of the amounts. It is important to note that this was not a child support case and may not indicate the same rationale applies for *Guidelines* income. It should also be noted that applying this rationale can increase a spouse's income in a year when shareholder loans are eventually repaid even though the repayment is itself not a taxable event.

In the Tauber and Tauber appeal, the court also faced the issue of a large year end bonus. However, the issue here was the timing of recognition of this income for the *Guidelines*. Mr. Tauber's company had a December 31 year end. In the year ended December 31, 1999, the company declared and accrued a bonus of about $2,500,000 to him. This amount was paid about six months after year end or in June 2000 and was included in Mr. Tauber's 2000 personal income. In the year ended December 31, 2000, the company's profits dropped and Mr. Tauber's accrued bonus was reduced to about $1,300,000. This amount was paid to him in June 2001 and included on his 2001 personal income tax return. The question arose as to Mr. Tauber's *Guidelines* income in 2000. His personal income tax return reflected the $2,500,000 bonus paid in 2000 but economically earned by his company in 1999. His company's earnings in 2000 were substantially reduced but this would not be reflected on his personal income tax return until 2001. The court's decision was to base 2000 income on the 2000 personal income tax return because "the fundamental basis of determining income under the *Child Support Guidelines* is set out in sections 16 through 20 of the *Guidelines*" and section 16 provides that Line 150 of that year's personal income tax return is the starting point.

Retained Earnings vs. Income

Retained earnings represent an accumulation of undistributed profits from the inception of the company to date. They do not represent undistributed profits for the most current year. This erroneous interpretation may lead to inequitable results.

In a recent Alberta case the judge included the retained earnings of the company in determining the husband's Guideline income. He relied on another Alberta case, where the court concluded that the retained earnings of the husband's business should be taken into account in establishing his Guideline income since it represents a real asset that the husband could have taken as income if he had chosen to do so.

We consider both decisions to be inequitable. In establishing "true income" one should not include retained earnings, which represent an accumulation of undistributed income of all prior years.

Consider a company which pays a $50,000 salary to its shareholder each year and retains $200,000 of pre-tax income or $156,000 after-tax income per annum. If the company has been in operation for five years, its retained earnings should be $780,000 ($156,000 @ five years). Based on the decisions above, the spouse's income would be $830,000 ($50,000 salary plus $780,000 retained earnings). However, the annual pre-tax income of the spouse is in fact his salary of $50,000 and the pre-tax corporate income of $200,000 or $250,000. Although the retained earnings of $780,000 can all be distributed in one year, the ongoing earnings capacity of the spouse is $250,000. The fact that the shareholder chose not to distribute all of the earnings of the company and accumulated substantial retained earnings should increase the fair market value of the company and should be equalized through property division.

Business Expenses with a Personal Component

Under the *Guidelines*, the court may impute income where the spouse unreasonably deducts expenses from income.

Often business expenses have a personal component to them. These include, but are not limited to:

a) home office expenses
b) auto expenses
c) travel expenses;
d) meals and entertainment;
e) promotion;

f) club dues;

g) legal and accounting fees; and

h) personal renovations.

The reasonableness of an expense deduction is not solely governed by whether the deduction is permitted under the *Income Tax Act*.

As well, under the *Guidelines*, salaries, wages, management fees, or other payments or benefits to non-arm's length individuals would be added to the pre-tax income of the corporation, unless the spouse establishes that the payments were reasonable in the circumstances. Therefore, salaries to spouses or children for income splitting purposes where no services were provided would be added to the pre-tax income of the corporation.

With respect to deductions of capital cost allowance on real estate, the *Guidelines* indicate that where a spouse makes such deductions this would be added back in calculating the spouse's income. The *Guidelines* are silent as to whether depreciation on real estate deducted by the corporation should be added back.

Hidden Benefits

In addition to the ability to deduct expenses which have a personal component to them, the shareholder may be deriving hidden benefits which are not reflected in the company financial statements. These may include:

a) interest free loans;

b) personal use of company automobile; and

c) personal use of real estate owned by the company without payment of rent.

Although the *Income Tax Act* requires that a benefit be calculated and included in the taxpayer's earnings from employment, in closely held owner operated businesses no such benefit is often reported.

Projected vs. Historic Income

Consider the case of a company with a July 31 year-end. The company had the following pre-tax profits in its three most recent years:

		July 31,	
	2004	**2003**	**2002**
Pre–tax income before shareholder remuneration	$600,000	$300,000	$300,000
Less:			
Salary to shareholder	(100,000)	(100,000)	(100,000)
Bonus to shareholder	(300,000)	--	--
Pre-tax corporate income	$200,000	$200,000	$200,000

The $300,000 bonus to shareholder in the year ended July 31, 2004 does not have to be paid for six months or until January 31, 2005. Therefore, the shareholder will not report the bonus on his personal income tax return until 2005. His personal income tax returns from 2002 to 2005 would show the following:

	Projected 2005	Actual 2004	Actual 2003	Actual 2002
Employment earnings	$400,000	$100,000	$100,000	$100,000

The *Guidelines* indicate that the court may determine the spouse's annual income to include all or part of the pre-tax income of the corporation. Therefore, the *Guidelines* permit inclusion of the $200,000 of pre-tax corporate income which would bring the spouse's income for *Guideline* purposes to $300,000 ($100,000 + $200,000) for the last three taxation years. The additional bonus of $300,000 earned in 2004, but not paid until 2005 would properly bring the taxpayer's income up to $600,000. Judicial interpretation of the *Guidelines* do not appear to provide for the inclusion of this bonus in 2004.

Work In Progress

Work in Progress, or "WIP" as it is referred to in accounting terminology, is the time docketed, which has not been billed. The accounting profession has looked at law firms in particular, and reached a consensus that a law firm should recognize its fee revenue as it provides services using the percentage of completion method, and not the completed contract method for financial statement presentation. This means that a law firm should not wait to include the unbilled time in income until the case is completed. If the collection of fees is reasonably assured, the WIP should be included in income.

The *Income Tax Act*, on the other hand, allows certain professionals to elect not to include WIP in income. These professionals are accountants, lawyers, medical doctors, veterinarians and chiropractors. Other professionals, such as, architects, engineers or management consultants, for example, must include WIP in income for tax purposes. Many professionals in the former category choose the income tax method, and do not account for WIP in their financial statements. The *Guidelines* rely on taxable income and are silent on the issue of whether any adjustment should be made for WIP.

This particular issue was decided in *Augaitis v. Augaitis*. The husband was a lawyer. He argued WIP should not be included in income for the following reasons:

1. Under the *Income Tax Act*, lawyers are allowed to exclude WIP in calculating their income; and

2. Inclusion of WIP produces an unrealistically high income, which does not reflect actual cash on hand, out of which support must be paid.

The wife argued that inclusion of WIP is the method favoured by the accounting profession, since this method provides for proper matching of revenues and expenses. In other words, it reflects most accurately the balance between the revenues and the expenses for that year.

The judge decided the appropriate method for calculating income for support purposes, is the income tax method, for the following reasons:

1. The exclusion of WIP causes an income deferral only. The unbilled WIP of one year will likely be included in billings of the following year. For the purposes of long-term support, the average level of income from year to year will not be altered no matter which method is chosen; and

2. The *Guidelines* have chosen the income tax method for calculating income. Courts should be wary of deviating from those *Guidelines*, unless there is strong reason to do so.

The judge's ruling was complicated by the particulars of the husband's situation. The husband had no WIP at the beginning of the year. This is because his former partnership was dissolved, and one of the terms of the dissolution was that each partner had to bill out all WIP at the end of the prior year. The husband's billings for the year were $76,330. His WIP at the end of the year was $38,670, or approximately 50% of his billings. Using normal accounting practices, the WIP would be included, increasing his income to $115,000 ($76,330 + $38,670). Using the income tax method, his income would be $76,330.

Since the judge ruled the income tax method was appropriate, and the husband did not have to include WIP in calculating income, the income of $76,330 would have been calculated. However, the judge noted that this rule by itself would produce an unrealistically low figure. This was because there was no WIP at the beginning of the year to bill out during the current year, as it had all been billed out at the end of the prior year. The husband received a payout of $27,000 from his former firm in winding-up. To rectify the situation, the judge included the figure of $27,000 in lieu of prior year's WIP that would normally have been billed out during the current year, increasing the husband's income to $103,330 ($76,330 + $27,000).

In effect, the judge included WIP. However, instead of including the WIP at the end of the current year, the judge included an amount in lieu of the WIP at the end of the prior year in calculating current year's income.

This decision indicates that where there are no extenuating circumstances, for professionals who are allowed to exclude WIP for income tax purposes, the same method should be used in arriving at income for child support purposes. However, where the billings are not representative of the normal income, due to unusual circumstances, the court may make adjustments. Given this was a lower court decision in the Barrie Family Court, it remains to be seen whether higher courts will uphold this decision.

In the case of professionals who must include WIP in income for income tax purposes, WIP should be included in calculating income for child support purposes.

Non-Resident Spouse

Where a non-resident parent resides in a lower tax jurisdiction, the court may impute such amount of additional income to account for the tax rate difference according to paragraph 19(1)(c) of the *Guidelines*. Living in a relatively high tax country like Canada means that many expatriates will have moved to lower tax jurisdictions, most commonly the United States. Seldom do we see someone moving to a higher tax jurisdiction.

The marginal tax rate for a high income earner in Ontario in 2004 is 46.4% and that kicks in a taxable income of $113,804. In the United States, the top federal rate is 37.6% and does not kick in until taxable income exceeds US$307,050 or about CDN$400,000. In certain states such as Texas and Florida, there is no state income tax, so the average tax rate there is much lower than here.

Notwithstanding the effect of different tax rates and tax brackets, the business valuator must also consider cost of living in different jurisdictions. If income taxes are lower in Hong Kong than in Toronto, one cannot ignore that a greater portion of after-tax earnings is required to pay for living expenses there.

In the recent case of *Nygard and Pakka*, the issue was Mr. Peter Nygard's income for the *Guidelines*, Mr. Nygard and some of his investment corporations reside in the Bahamas where there is no income tax. Both valuators in that case agreed that an income gross-up for the absence of income tax was appropriate. The approach used was to calculate what the equivalent pre-tax income was required to be earned in Ontario in order to result in the non-taxable income earned by Mr. Nygard. An adjustment was also made to reduce this income by a percentage based on the higher cost of living in Nassau as compared to Toronto. The rationale was that part of the downside of lower income taxes was higher user fees for services not provided by the local government.

Conclusion

This paper highlights a number of complicated issues in the determination of income for family law. It also attempts to show how investigative and forensic accountants and business valuators can navigate their way through complex and confusing financial documents and structures. Very seldom can business valuators and forensic accountants say that they have been in business long enough to have seen *all* of the tricks. Necessity is the mother of invention and spouses who do not wish to pay appropriate spousal and child support can always invent new ways to hide income.

Overcoming Common Obstacles in Income Calculations

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Treatment of Foreign Payor

- May not be as simple as converting foreign currency
- No Line 150 on foreign tax returns
- Consider oil executive who moved to Houston to earn a salary of US$300,000/year
- Converted to Canadian at CDN$1.00 = US$0.78, this amounts to CDN $385,000

Impact of Foreign Taxes

- Oil executive pays lower U.S. federal income tax (as compared to Canadian income tax rates)
- There is no state income tax in a number of U.S. states including Texas
- Oil executive pays about US$60,000 income tax on his earnings
- This leaves him US$240,000 after-tax earnings
- Should we convert this and gross it up for an equivalent Canadian salary?

Impact of Living Costs

- Lower income taxes in United States may go hand in hand with higher property taxes and private health costs
- Furthermore, the cost of other living expenses must be considered

(Big Mac is US$2.90 on average in the United States vs. US$2.33 in Canada)

Foreign Income Gross-up Calculation

Pre-Tax Income	$300,000	US
Income Taxes	(60,000)	US
After-Tax Income	240,000	US
Cost of Living Adjustment	÷ 1.2	
Adjusted After-Tax Income (US$)	200,000	US
Foreign Exchange Rate	X 1.28	
Adjusted After-Tax Income (CDN$)	256,000	CDN
Income Tax Gross-Up	194,000	CDN
Equivalent Canadian Pre-Tax Income	$450,000	CDN

Murray and Murray

- Mr. Murray held 50% interests in three businesses
- The other 50% shareholder was his brother
- Shareholder agreement stipulated that any changes in the shareholders' remuneration must be unanimous
- The businesses did not distribute all of the annual income to the shareholders
- Mr. Murray's position was that he had no access to this income
- Ms. Murray's position included all of Mr. Murray's 50% share of these corporate earnings in his income for support purposes
- The court considered:
  - Whether the court should automatically attribute corporate income to a shareholder?
  - Whether there are other arm's length shareholders and the 50% shareholder's degree of control?
  - Whether there was a business reason to leave corporate earnings in the company?
  - What was the historical practice for profit distribution?
- Court split the difference and attributed one-half of Mr. Murray's 50% share (or 25% of corporate income) on the grounds that a brother would permit Mr. Murray some access to corporate income

Fitzpatrick and Fitzpatrick

- Mr. Fitzpatrick was a minority shareholder
- The corporation paid a large bonus annually to the shareholders in proportion to their shareholdings but the after-tax portion was required to be loaned back to the corporation so no shareholder "kept" any portion of the bonus
- The bonus was "paid" only to minimize corporate income tax
- The bonus was included in Mr. Fitzpatrick's T4
- The court did <u>not</u> include the bonus in his income for spousal support purposes
- Question #1: What would the court have done if this had been child support?
  - Line 150 income
  - Schedule III, Section 12
- Question #2: What happens in a year when Mr. Fitzpatrick draws down on all or part of his loan to the company?

Tauber and Tauber

- Mr. Tauber owned 100% of his company
- Company has a December 31 year end
- Bonus declared every December 31 and paid in the following year
- Bonus calculated to reduce the year end income
- Should bonus based on corporation's 2000 income but paid in 2001 be considered for the *Guidelines* in 2000 or 2001?
- Court's view: 2001 because that is when it appears on the personal income tax return

Family Trusts:
Neither Gone Nor Forgotten

- February 1999 federal budget taxes dividends at the highest marginal rate when paid to minors by a family corporation

- Previously, businesses could income split with minors by paying fees to a corporation held by a family trust

- The corporation would pay the low small business tax rate and pay the remainder as a tax-free or very low taxed dividend to the minor children

- The budget took away the last step for children under age 18

- It did not remove the ability to income split with the corporation held by the children indirectly through a family trust

- A self employed person can still pay administration fees to a corporation and shift personal income that would have been taxed at 46% to the lower small business corporate tax rate of 19%

Overcoming Common Obstacles in Valuation and Income Calculations

Scenario #1 – Hidden Income

Jack and Susie were married for 10 years. Jack is a dentist and Susie is a doctor. Jacks' dentist practice includes 4 other partners, and three separate offices throughout the suburbs of Toronto. One day the parties separated, and Jack filed a personal financial statement that included the value of his dentist practice. Jack also included a bank account that he had in the Isle of Man, which he had opened 3 years earlier.

Susie was concerned that Jack had additional assets offshore. During the marriage, Jack often complained about the high level of income taxes that he paid. Susie was aware that Jack and his partners had sought professional assistance years ago to help them arrange their practice in order to minimize taxes.

In addition to property issues, the potential offshore assets also affected Jack's income.

Questions:

1. What are the potential legal issues in this matter?
2. How can we find out about any potential offshore assets?
3. In this case, how was the Husband diverting assets?
4. How did we find the assets?
5. How were the income and property issues affected by the offshore "business"?

Scenario #2 – Problems with self-employed payors

Barb is a management consultant who specializes in the high tech field; during her 15-year marriage to Frank, she worked mainly for a company in downtown Toronto. In the year prior to separation, Barb decided to "go out on her own" and become a self-employed management consultant. She rented space downtown, in a professional office. Many of her clients from the company continued to hire her.

As a self-employed consultant, she took advantage of the many tax advantages offered to her. Frank, a stay at home husband, was on the payroll, as were their two minor children.

When the parties separated, Frank got custody of the children, and Barb had to pay child and spousal support. Problem was, during the year before separation and the year after separation, Barb's line 150 income decreased from on average, $200,000 as a T4 employee, to $75,000 as a self-employed consultant.

Questions:

1. What are the potential legal issues in this matter?
2. What are the common problems faced by Counsel and accountants when assessing a self-employed persons income for support purposes?
3. What were the specific issues related to this matter?
4. How can you overcome these problems?
5. How would you calculate Barb's income for support purposes?

Scenario #3 – Dealing with foreign payors

Sally and JR lived in Calgary during their 20-year marriage. JR was an oil executive who had worked in the industry all of his career, and by separation date he was CEO of United Oil Producers, with headquarters in Calgary. His annual salary was approximately $150,000 per year.

After separation date, when the children moved out on their own, JR decided to take a new position in Houston, Texas. Sally stayed in Calgary. JR's new salary was US$300,000 per year. In order to determine JR's salary for support purposes, JR's lawyer took JR's current salary in US$, and simply multiplied it by the average foreign exchange rate, in order to determine the equivalent Canadian salary.

Sally's lawyer disagreed. What is the appropriate way to do it?

Questions:

1. What are the potential legal issues in this matter?
2. What are some of the problems from simply converting a salary in foreign currency to Canadian currency?
3. What is the impact of foreign taxes?
4. What is a more appropriate way to determine JR's "income" for support purposes?

Scenario #4 – Lifestyle issues

Bob and Carol lived in Oakville, Ontario, in a modest home that backed onto a ravine. Their three children were enrolled in private school, and during the summers, the kids went to overnight camp.

Bob worked in the family owned business, which manufactures boxes and other packaging materials. Bob's grandfather started the business 40 years earlier, and Bob and the other grandchildren all worked in the business. The extended family was very close, with most of the third generation living nearby, and sharing a series of family cottages at Turkey Point.

There were 5 grandchildren in the business, with each owning 20% of the outstanding shares of the family company. Although each person had separate duties, the owners all were paid approximately the same salary. For tax purposes, the spouses of the owners were also on the payroll, although they didn't provide any services to the company.

Although Bob and Carol enjoyed a nice lifestyle, with travel, private school, cottage and camp, it wasn't until separation that Carol realized that Bob's income was only $75,000, clearly insufficient to pay the lifestyle that the family had enjoyed during the marriage.

Questions:

1. What are the potential legal issues in this matter?
2. What are the common problems when dealing with lifestyle issues?
3. What documents should you review to assess the family's lifestyle?
4. Who else should you speak to?
5. What are the common addbacks to a payor's income, when dealing with lifestyle issues?