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Marmer Penner Newsletter

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The Guidelines – of Little Guidance on Corporate Income

The starting point in calculating the payor spouse's income under the *Federal Child Support Guidelines* is Line 150 - Total Income reported in the personal income tax return. As one might guess, spouses with corporate holdings might be tempted to minimize the funds paid out to them as salaries, bonuses or dividends from the corporation, to minimize total income reported on their personal income tax returns.

Section 18 of the *Guidelines*, gives the court discretion to attribute all or part of the pre-tax income of the corporation in determining the shareholder's annual income. However, in some cases the courts have been reluctant to attribute the corporate income to the shareholder, finding that it is not their place to interfere in the operation of the business, unless it could be demonstrated that a spouse arranged his/her affairs in an attempt to minimize support.

Perhaps wanting to leave these matters to the courts' discretion, the *Guidelines* have done little to assist the courts in determining whether to include the corporate income. Before the *Guidelines*, the courts had applied a two-part test, being access and control.

Control relates to the ability to 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 relative ownership percentages held by 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 who receives dividends, and has no say over the size or the timing of the dividend distribution. Along the spectrum lie a multitude of possibilities. Consider for example a 50%/50% ownership structure, with neither party having control. A 50% ownership may not be enough to provide control, however, the shareholders' pattern of conduct or shareholder agreements may prove otherwise.

Access relates to the availability of the corporate income for distribution. To the extent that any portion of the corporate income must be retained in the company for operations, 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 health 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 or a proprietorship, and state that any amount included in his income that is properly required by the partnership or proprietorship for purposes of capitalization should be deducted. Although, the *Guidelines* are silent with respect to the capitalization requirement of a corporation, it may be an issue here as well. One can see how inequities can arise in this area. Imagine a spouse who is faced with the choice of operating the business at status quo, and having the income of the corporation

attributed to the spouse for support purposes, versus undertaking an expansion, thus having the funds properly required by the business and not available for payment of child support. The *Guidelines* are silent as to what is meant by "properly required for purposes of capitalization". Does this include expansion at the expense of the recipient spouse or simply capital replacement to maintain the status quo?

Banking covenants also play an important role. The bank may require that certain key financial ratios be met, which may restrict the withdrawal of additional funds from the corporation. As well, the banking agreement may specify the maximum amount of shareholder remuneration, or capital purchases. Previous corporate practices should be tested to ensure the company has been meeting the banking requirements, and where there have been violations, what actions were taken by the bank. Consider a shareholder who is limited to total remuneration of $100,000 per annum, but draws another $200,000 by way of shareholder loan. Although, shareholder drawings are normally not considered income, they are an indication of the accessibility to funds. The bank's reaction to the additional drawings is important. If the bank lends the shareholder who has no personal assets, $200,000 to repay the shareholder loan to the company, the bank is in effect approving the excess withdrawals.

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. Beware of assets, which are recorded at cost on the books of the company, but have appreciated in value, and would wipe out the deficit if properly valued. The banks will often be apprized of this added value and will allow additional borrowing, beyond the apparent deficit on the books.

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.

With respect to adjustments to corporate income, very little is addressed by the *Guidelines*. Under the heading "Adjustment To Corporation's Pre-tax Income", the *Guidelines* allow for adjustment for salaries, wages, management fees, or other payments or benefits to non-arm's length parties unless the spouse establishes the payments to be reasonable. This would include salaries paid for income-splitting purposes where no services were provided and personal expenses deducted by the corporation, among others. Beware of the recent controversial trend by the courts to gross-up personal expenses for income tax.

The *Guidelines* give the court discretion to impute income to a spouse where it appears that income has been diverted. Presumably this would encompass unreported income. There does not appear to be a similar provision for imputing income to a corporation.

With respect to non-recurring items, the *Guidelines* give discretion to the court to adjust personal income for non-recurring income and non-recurring capital or business investment losses; however, the *Guidelines* are silent on adjustment for non-recurring items at the corporate level.

Similarly, the *Guidelines* provide for an adjustment to T1 income for capital cost allowance with respect to real property; however, no mention of this adjustments is made at the corporate level.

Another issue that often appears where spouses have corporate holdings is the timing of earnings. Take for example a start-up company with a November 30, 2001 year-end that earns income of $200,000 after declaring a $100,000 bonus to its shareholder. The bonus is declared November 30, 2001 and paid 180 days later on May 29, 2002. Therefore, the bonus will be reported in the 2002 personal income tax return. Assuming the spouse has full access and control over the corporate income, is his total income for 2001 $200,000 or $300,000? An accounting principle known as “Matching” would say $300,000 since the bonus was earned in 2001. However, there does not appear to be a mechanism in the *Guidelines* to back-up the bonus to 2001, since the starting point is the line 150 T1 income.

In the end, we are left with the difficult issues of determining whether corporate income should be attributed to the shareholder and if so, the appropriate amount, with very little guidance from the *Guidelines*. The courts’ interpretation of the Guidelines and new case law begin to play leading roles in deciding these issues.

This newsletter is intended to highlight areas where professional assistance may be required. It is not intended to substitute for proper professional planning. The professionals at Marmer Penner Inc. will be pleased to assist you with any matters that arise. Please feel free to visit our website at www.marmerpenner.com.