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Marmer Penner Newsletter

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ATTRIBUTION OF CORPORATE INCOME UNDER SECTION 18 OF THE *GUIDELINES* – WHAT IS LEARNED FROM *MURRAY V. MURRAY?*

Arguably, the most difficult accounting issue in determining a spouse's obligation for child or spousal support is the amount of corporate pre-tax income that should be attributed from a corporate entity owned by that spouse. As the number of cases that go to trial increase, lawyers and business valuators obtain more guidance on the issues that the courts consider when making an income determination. Further guidance has been provided in the recent Ontario Superior Court of Justice case heard by the Honourable Justice Croll, in *Murray v. Murray*.

Mr. and Mrs. Murray were married in October 1978, separated in October 1994 and entered into a separation agreement ("agreement") in October 1995. There were three children of the marriage. The salient facts of the agreement that pertain to child and spousal support were as follows:

1. The agreement recognized that Mr. Murray would owe an obligation for child support of approximately $87,000 based on his income when the agreement was signed. The parties agreed that, in lieu of ongoing payments for child support, the husband would transfer his interest in the matrimonial home, which amounted to $84,000. It was agreed that, as long as Mr. Murray's income did not increase, that this transfer would substantially cover his obligation to Mrs. Murray for child support.

2. However, in the event that Mr. Murray's income were to increase by a material amount above his then current income, his obligation to pay support for the children could then be recalculated with reference to his increased income and the needs of the children at that time. If such a recalculation were to occur, the court would take into consideration the transfer of Mr. Murray's interest in the matrimonial home.

3. In lieu of spousal support, Mrs. Murray continued to receive dividends on shares that she owned in Mr. Murray's company. Prior to the separation, these dividends were paid to achieve income splitting within the family. Instead of formal spousal support, the parties agreed to simply maintain these dividends for approximately three years after separation, at which point, the shares would be transferred to Mr. Murray at a nominal amount and the dividend payments would cease.

4. Following the transfer of Mrs. Murray's shares, the agreement contained a release of spousal support. The agreement provided that "The parties acknowledge that upon the property transfers and payments being made [in accordance with] this agreement, each shall be deemed to be self-supporting and not in need of support from the other."

Business valuators for Mr. Murray and Mrs. Murray were asked to calculate Mr. Murray's income for child support purposes spanning the period 1995-2002, and then calculate the child support that was payable based on this income. Mrs. Murray's pleadings claimed both child support and spousal support. However, in the end, her claim for child support was abandoned and the income calculations were used in order to assess the *spousal* support (both retroactive and ongoing) that should be payable. In the Reasons for Judgment, Justice Croll stated that the income calculations that are found in sections 15 through 19 of the *Guidelines* should apply to the calculation of Mr. Murray's income for spousal support purposes as well. This decision is also supported in the recent case *Brophy v. Brophy* where the Honourable Justice Linhares de Sousa found that, "In essence, both [the paying of child support and the paying of spousal support] relate to a paying spouse's ability to provide support to a dependant."

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.

Although the *Guidelines* themselves offer very little guidance on the amount of corporate income that should be attributed to a shareholder, the emerging case law, including the findings from *Murray v. Murray* and *Brophy v. Brophy,* will assist lawyers and business valuators with the key factors that the courts consider important in attributing income.

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 will be pleased to assist you with any matters that arise. Please feel free to visit our website at ***www.marmerpenner.com***.