Vol. 6 No. 5 July 2003

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Marmer Penner Newsletter

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HOW TO COMPUTE INCOME OF SELF-EMPLOYED INDIVIDUALS WHEN UNDER-REPORTING OF INCOME IS SUSPECTED

One of the many difficult challenges faced by family law practitioners is the determination of a spouse's alleged unreported income. Often this under-reporting is exacerbated by the spouse's incentive to keep his or her income low while matrimonial proceedings are ongoing, but chronic under-reporting of income may have been pervasive throughout the marriage. If this is the case, then the under-reporting of income not only decreases the spouse's support obligations but it may also impact negatively on the value of the spouse's business interests. The question therefore arises: How do you properly assess a spouse's unreported income so that the correct level of support and equalization can be determined?

A recent study[1] completed at the University of Victoria by Dr. Herb Schuetze, put forward an approach to estimate the average amount of under-reporting by the self-employed in Canada. Dr. Schuetze's study examined annual family expenditure on food, and related these expenditures to the income of the family. Dr. Schuetze's contention was that a family's expenditure on food will be the same, regardless of whether the income earner(s) are T4ed or are self-employed. For example, take two families, the Richards and the Jaggers. Both Mrs. Richard and Mrs. Jagger stay at home to raise their two children. Mr. Richard is a T4ed employee with an income of $80,000. The Richards report that, as a family, they have $16,000 of annual expenditures related to food. Mr. Jagger is a construction contractor who services mainly residential customers and reports an annual self-employment income of $60,000. The Jaggers also report $16,000 of annual expenditures related to food. Dr. Schuetze's study concludes that these two families should have the same "true income" because they spend the same amount on food. Accordingly, the study

[1] The study by Dr. Schuetze is entitled "*Profiles of Tax Non-Compliance among the Self-Employed in Canada*" from *Canadian Public Policy* June 2002.

suggests that Mr. Jagger under-reports $20,000 of income, i.e. this would bring him to the same level of income as Mr. Richards.

Another conclusion in Dr. Schuetze's study, not surprisingly, is that the construction and service industries had the most significant amount of non-reporting. For example, in order to obtain the "true income" of an average self-employed person in construction, the reported income of the individual had to be grossed-up by a factor of 1.46 in order to estimate the true income of the person. Therefore, an average construction worker who reports $100,000 of income really earned $146,000, with $46,000 going unreported, according to the Study's findings.

The conclusions made in studies such as Dr. Schuetze's, however, are based on averages, and would be of little use in a court of law when dealing with one individual, who may be above or below the average with respect to under-reporting. More focused analysis related to the individual's case must be undertaken in order to have income imputed under section 19 of the *Guidelines*.

When significant under-reporting is suspected, we undertake an analysis known as the "Back-End Approach", which can be used to impute income to a self-employed person when under-reporting is suspected. The analysis is the same process that Canada Customs and Revenue Agency ("CCRA") would undertake in an audit of a chronic under-reporter of self-employment income in order to reassess income taxes. The CCRA refers to this approach as a "Net Worth Analysis".

The "Back-End Approach" is accomplished by following these steps:

- Two fixed points in time are chosen and the individual's net worth at each point in time is calculated. In matrimonial litigation, this is often most easily accomplished by picking the significant dates from the individual's 69K. For example, you can choose the date of marriage and the date of separation, or, the date of separation and the date of statement.

- The growth in assets between the two fixed points in time, adjusted for "market growth", is calculated. (What this means is that you have to adjust for any growth in assets related to an increase in value of the asset itself, not as a result of earning unreported income and adding these proceeds to the asset pool). Once this is done properly, you know what the increase to the asset pool is as a result of total earnings.

- The growth in assets is compared to the individual's reported income and expenses over the period. If this has been done correctly, and if your original hunches about unreported income were correct, you will typically see a growth

in the asset pool that far exceeds the reported income of the individual (after cost-of-living is deducted).

Consider the following example:

The adjusted net worth analysis showing on Schedule 1 shows that the Jaggers amassed assets during the marriage of $436,000 ($445,000 - $9,000), or approximately $43,600 per year. Once this step is complete, an analysis of the Jaggers' personal tax returns will show the reported income, the income taxes that were paid and any RRSP contributions. Housing costs and other costs of living are often determined through an analysis of the budget section of the 69K, or through Examinations for Discovery. In this case, a review of the personal income tax returns show that the Jaggers had reported net income of $435,000 (based on reported income of $60,000 per year for ten years). This is shown on Schedule 2.

Schedule 1 "Net Worth" of Jagger Family in 1993 and 2003[2]

	Date of Marriage	Date of Separation
Matrimonial home (purchase price)	$ --	$200,000
Cottage (purchase price)	--	100,000
Furnishings for home and cottage (invoice costs during marriage)	Negligible	50,000
Cars (purchase price)	--	60,000
Boat (purchase price)	--	30,000
Savings account	5,000	5,000
Chequing account	5,000	5,000
RRSP contributions	--	50,000
Contributions to brokerage account	--	50,000
Line of credit	--	(100,000)
Credit cards	(1,000)	(5,000)
	$9,000	$445,000

The analysis in Schedule 2 also shows that the income reported by the Jaggers was insufficient to cover their cost-of-living during the marriage as shown by the deficit computed at the bottom. As long as the income taxes and cost-of-living are calculated properly for the entire ten year period, the deficit showing in Schedule 2 can only lead to one conclusion – that Mr. Jagger had unreported income that he was using to fund the family's cost-of-living. However, not only is the income unreported to the extent of the deficit, but the family also amassed significant assets during the marriage, which

[2] "Net Worth" in this case must be adjusted for market related growth of assets – you are only interested in the growth in assets as a result of total earnings being added to the asset pool.

also must have come from unreported income. In this case, as long as all the calculations are done correctly, one would conclude that the Mr. Jagger had annual unreported income of $53,700/per year, i.e. cost-of-living deficit of $101,000 + cost of net assets amassed during marriage of $436,000 ÷ 10 years = $53,700.

Schedule 2 Reported Income and Expenses Analysis

Reported income $60,000/year for 10 years	$600,000
Income taxes paid during period	(165,000)
Net income during period	435,000
RRSP contributions during period	(50,000)
Rent (for the first 3 years of marriage)	(36,000)
Support payments related to a previous marriage	(70,000)
Property taxes, maintenance, utilities, insurance on home and cottage in last 7 years of marriage	(30,000)
Cost-of-living	(200,000)
Private school tuition for 1 child during period	(150,000)
Expected deficit	($101,000)
Actual surplus based on "back-end approach"	$436,000
Unexplained difference over 10 years	$537,000
Additional annual imputed income	$53,700

The investigative and forensic accountant must question how the Jagger family maintained their standard of living and amassed almost $500,000 in assets with a single-income earner making only $60,000 a year – in this fashion, the "Back-End Approach" can be used to impute income to Mr. Jagger for Guidelines purposes.

It would be up to an experienced litigation accountant to calculate the unreported income using the "Back-End Approach" that we have illustrated here. The litigation accountant can also help to assess whether such demonstrated under-reporting might cause a depressed value for Mr. Jagger's business, which would lead to a lower equalization payment than would otherwise be calculated. It would be up to the family law practitioner to argue that a self-employed person in this situation should have to pay child support based on section 19 of the *Guidelines* given that he has imputed

income of some $113,700, comprised of $60,000 of reported income and $53,700 of unreported 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.