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Marmer Penner Inc. Newsletter

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Computing Income For the Non-Resident Spouse

For the vast majority of payers of child support, the determination of income is fairly straightforward. For others, section 19 of the *Child Support Guideline*s ("the *Guidelines*") is required in order to permit the court to impute income to the payor-spouse. The tables in the *Guidelines* were prepared on the assumption that the payor-spouse pays income tax at Canadian rates. Where this is not the case, the payor-spouse may have more or less disposable income than anticipated. Section 19 permits the court to impute income where, among other reasons, as a result of lower income tax paid by the payor-spouse, the payor-spouse has greater disposable income. The factors that lead to such income tax anomalies include, among others:

(a) Statutory exemption from income tax for income earned by a member of Canada's First Nations covered by *The Indian Act*, income earned from personal injury award property and certain allowances received by members of parliament, members of provincial legislative assemblies and municipal officers;

(b) Spouses who earn a significant portion of income from dividends or capital gains or other sources that are taxed at favourable rates of taxation;

(c) Spouses who do not report all of their income or who claim income tax deductions for non-business expenditures; and

(d) Spouses who reside in foreign jurisdictions where the effective rates of taxation are significantly lower than those in Canada.

This article will concentrate on the latter situation where a payor-spouse lives in a foreign jurisdiction. Since Canada is a relatively high-tax jurisdiction, many non-resident payor spouses will be left with higher after-tax income than if they earn the same pre-tax amounts in Canada.

In 2004, a high-income earner in Ontario paid a marginal rate of taxation of 46.4%. A high-income earner in Texas paid a marginal rate of taxation of only 35% in the same year. Furthermore, while the highest Ontario rate commences for income in excess of $113,804, the highest rate for an American does not start until income exceeds US$319,100. This should not necessarily lead one to conclude that all American payor-spouses pay tax at rates that are significantly lower than those in Canada. A high-income taxpayer in California pays income tax at a marginal rate of 41% while a counterpart in Alberta pays at a rate of 39%.

Where a taxpayer resides in a foreign jurisdiction with no income tax such as the Cayman Islands or the Bahamas, the argument for imputing income becomes more persuasive. However, as a result of lower income taxes, the government may provide fewer services and accordingly the payor-spouse's cost of living may be significantly higher than that of a comparable person in Canada. As a result, it may be appropriate to consider the cost of living when adjusting income upwards for the lower rates of income taxation.

Let's consider the example of Mr. Tommy Bahamas who resides in Nassau. Tommy earns US$1,000,000 of business income and pays no income tax. However, Tommy must also pay for his basic medical services and his weekly garbage pickup. Furthermore, a can of Coca Cola at his local convenience store costs US$3. Accordingly, Tommy's net disposable after-tax income buys him a lot less than it would in Toronto.

In the schedule below, we calculate that after income tax, Tommy is left with his entire US$1,000,000 pre-tax income. Based on a foreign exchange rate of CDN$1.00 = US$0.82, we adjust this after-tax income to CDN$1,219,500. In this example, we have assumed that Toronto's cost of living as measured by the cost of a sample basket of goods and services is 75 while the same index for Nassau is 110. As a result, the cost of living in Toronto is 68.18%

(75/110) of that in Nassau. As a result of the higher living costs in Nassau, this index indicates that a sample basket of goods and services in Nassau costing $1,219,500 would cost only $831,455 in Toronto. This indicates that Tommy has the equivalent take-home pay of a Torontonian with after-tax income of $831,455. Working backwards we calculate that an Ontario taxpayer earning $1,525,772 of business income would also be left with $831,455 after tax. As a result, we gross-up Tommy's income for the lower income tax by $694,317 to arrive at *Guidelines* income of $1,525,772.

Calculation of Pre-Tax Equivalent Income for Mr. Tommy Bahamas

Total Income	$1,000,000	US
Income Tax Paid	(0)	
After-Tax Income	1,000,000	US
Foreign Exchange Adjustment (1.00/0.82)	x 1.2195	
Adjusted Income	1,219,500	CDN
Cost of Living Adjustment (75/110)	x 0.6818	
Cost of Living Adjusted Income	831,455	CDN
Gross-Up for Canadian Tax	694,317	
Guidelines Income	$1,525,772	CDN

Given that Tommy earned US$1,000,000, or CDN$1,219,500 once converted to Canadian currency, the net adjustment for the income tax gross-up less cost of living adjustment is $306,272 ($1,525,772 - $1,219,500).

Additional complicating factors not considered in this simplified example include:

(a) What if Tommy's income included capital gains and dividends which in Canada would have been taxed at more favourable rates than general business income?

(b) What if Tommy incurs higher than normal health costs than those considered in the sample basket of goods and services for the cost of living adjustment and all of those costs would have been paid by the province for a Canadian resident?

(c) What if Tommy incurs significant travel cost to visit his child(ren) in Canada?

The *Guidelines* try to determine a payor-spouse's ability to pay child support based on an expected level of after-tax income. Where non-resident issues arise, a business valuator's expertise may be required to calculate the payor-spouse's fairest determination of income.