

Marmer Penner Inc. Newsletter

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To “Double-Dip” or Not to “Double-Dip”, That is the Question

We are often retained by legal counsel to calculate a spouse's income pursuant to the *Federal Child Support Guidelines* (“*Guidelines*”). In doing so, a situation that we frequently encounter relates to an issue that has been coined “double-dipping”. “Double-dipping” can arise when a spouse equalizes an asset and subsequently, there is an income inclusion arising from the same asset. For example, consider the case where Ms. Jones owns nothing but marketable securities worth \$100,000 with a cost base of \$20,000 at the date of separation. The \$100,000 value is included in her net family property (“NFP”). If she sold these shares days later, she would have to report an \$80,000 capital gain in her income. However, including the \$80,000 in her *Guidelines* income would be double-dipping since the \$100,000 value already equalized included the accrued \$80,000 gain at the valuation date. If, simplistically, Ms. Jones paid Mr. Jones an equalization of \$50,000 on her \$100,000 of NFP, it would be inequitable to pay her husband 50% support on her \$80,000 gain since he would then receive \$90,000 of her total value (\$50,000 equalization plus \$40,000 support).

As there is no specific reference in the *Guidelines* for such an adjustment, we look to legal counsel for instructions when preparing calculations. More often than not, we are instructed to deduct any amounts related to the asset subject to equalization that is subsequently included in employment income. In the past, such “double-dipping”

adjustments have arisen when a spouse equalizes on assets such as employee stock options, restricted stock units or a pension. Should the same adjustment be made if the spouse equalizes on a business interest? Should a “double-dipping” adjustment be considered when determining income for support? Is such an adjustment appropriate? There is no clear answer yet, however, the example given further below may show the inequity of ignoring the double-dipping issue.

In the more familiar cases that involve employee stock options and restricted stock units, the value of these assets held by a spouse is determined at the date of separation and subject to equalization. The subsequent exercise of the options or the vesting of restricted stock is a taxable event that results in “income” reported on a spouse’s income tax return. This is where the “double-dipping” issue arises. Suppose the husband owns options on the valuation date and equalizes their value with his wife. In each of the three successive years, the husband exercises the stock options and receives an additional \$500,000 in income. The wife seeks spousal support based on the husband’s income in those years. Should the additional \$500,000 each year be included in the husband’s income for the purposes of support? There is no clear answer yet, however we are often instructed to make the adjustments to eliminate the “double-dipping” that arises in this situation, that is, if \$100,000 of each tranche of options was included in NFP, only \$400,000 of each year’s option benefits should be included in *Guidelines* income.

Is a business interest any different from an employee stock option or a restricted stock unit from a “double-dipping” perspective? The value of a business is based on its future cash flows. The value of these cash flows are quantified, included in NFP and equalized. After separation, there are income inclusions that arise from the business interest. Sound familiar? In order to examine this issue further, consider the following example:

On December 31, 2008, Mr. Woods is offered a one-year contract to operate a lemonade stand. In order to limit his liability, he decides to

incorporate Refresh Inc. in order to operate his business for the duration of the contract. On January 1, 2009, Mr. Woods decides to separate from Mrs. Woods. In order to determine his net family property, Mr. Woods retains an expert to value Refresh as at January 1, 2009. The expert relies on Refresh's 2009 budget to value Mr. Woods' business interest, which is as follows:

Revenue	\$5,000,000
Cost of Sales	(2,000,000)
Overhead Expenses	(2,000,000)
Salary to Mr. Woods	<u>(1,000,000)</u>
Net income	<u>\$ 0</u>

The husband's' expert considers a salary of \$400,000 to be fair market value for the work that will be done by Mr. Woods. Accordingly, for valuation purposes, he makes an adjustment to the net income of \$0 by replacing Mr. Woods' projected salary with the fair market value salary to arrive at the expected cash flow from Refresh of \$600,000 ($\$0 + \$1,000,000 - \$400,000 = \$600,000$). Since the business will only be operated for one year, Mr. Woods' expert arrives at the fair market value of the business interest of \$600,000 (the expert has ignored income taxes and present value for simplicity). Mrs. Woods accepts the expert's analysis and on that basis, is entitled to equalization of \$300,000 (50% of the value of the business).

Support is then considered for 2009 and a rate of 50% is deemed to be appropriate. Mr. Woods' has no other income other than his salary from Refresh. Also, according to the financial information available, the pre-tax corporate income from Refresh for 2009 is \$0. Accordingly, Mr. Woods' 2009 income pursuant to the *Guidelines* is determined to be \$1,000,000, which is his salary from Refresh. At a rate of 50%, Mrs. Woods is entitled to support of \$500,000.

At the end of 2009 after paying support of \$500,000 and equalization of \$300,000, Mr. Woods is left with \$200,000 (\$1,000,000 salary - \$300,000 equalization - \$500,000 support). On the other hand, Mrs. Woods receives \$800,000 (\$300,000 equalization + \$500,000 support).

If we were instructed to make the “double-dipping” adjustment in this case, Mr. Woods’ 2009 income would be calculated at \$400,000 (\$1,000,000 salary - \$600,000 value of business included in net family property). At a rate of 50%, Mrs. Woods would be entitled to \$200,000 of support. Accordingly, Mr. Woods would be left with \$500,000 (\$1,000,000 salary - \$300,000 equalization - \$200,000 support) and Mrs. Woods would receive \$500,000 (\$300,000 equalization + \$200,000 support).

The decision whether “double-dipping” is appropriate and whether such an adjustment should be made when a spouse has a business interest is a legal one and beyond our scope upon which to opine. However, we suggest that the “double-dipping” issue be considered for all assets included in net family property that have an “income” component in subsequent years.