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Marmar Penner Inc. Newsletter

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Some Gross-Up Musings

It's been about 11 years since the income tax gross-up came into common application. In a couple of notable cases in that spring and summer of 2000, the courts decided that the *Child Support Guidelines* ("the *Guidelines*") permit the imputation of additional income where a party gains an advantage from earning a portion of his/her income that is taxed at a lower rate when this arises from deducting non-business expenses from his/her taxable income or that of a controlled corporation.

Although we believe that the applicability of a gross-up is a legal issue, it has become commonly applied. If the person is in the highest tax bracket, the gross-up factor is 86.6% of the improperly deducted personal expenses. The 86.6% gross-up factor is calculated as $[1 \text{ divided by } (1 \text{ minus the } 46.41\% \text{ highest personal tax rate})] \text{ minus } 1$. For example, where a high bracket taxpayer expenses \$1,000 of personal travel as business travel, the court realizes that that individual needed to earn \$1,866 pre-tax to be left with the same \$1,000 benefit after-tax.

However, the gross-up should not automatically be applied at 86.6% because an Ontario taxpayer needs to earn in excess of about \$130,000 before income is taxed at the 46.41% rate. For taxpayers who earn less than \$130,000, lower gross-up factors will apply.

This newsletter pointed out at the time that HST came into effect in Ontario that the gross-up, when applied to certain business expenses, might need to be augmented to consider both sales tax and income tax savings. If a spouse causes her business to deduct a \$10,000 fee to a related party (for alleged services that were never performed) that is actually retained by that spouse, then both the \$10,000 and an \$8,660 gross-up might appropriately be added to income as the spouse gained a \$10,000 non-taxable advantage. However, what if instead the spouse caused her business to deduct \$10,000 of personal use automobile leasing, gasoline and repairs expenses? Each of these expenses had the 13% HST initially paid and then likely refunded to the business as an input tax credit. In this case, the \$10,000 of automobile expenses would have cost the spouse \$11,300 including HST if not charged as a business expense. Accordingly, when one factors in the HST savings, the actual gross-up should be applied to both the \$10,000 of personal expenses and the \$1,300 of related HST. This amounts to a 111% gross up on the \$10,000 of expenses. So far, we've not seen the courts apply this higher gross-up.

The gross-up is not limited to improperly deducted expenses. It may also apply to the following situations:

- 1) The spouse lives in a jurisdiction with income tax rates that are significantly lower than those in Canada; and
- 2) The spouse derives a significant portion of income from dividends, capital gains and other sources that are taxed at a lower rate than employment income.

The second example above begs the question: how do we define "significant"? Most of us are aware that income tax rates are lower in the United States than in Canada, however they vary significantly within the United States. A resident of New York City pays federal, state and city income taxes at a marginal rate that amounts to about 43%, but only once income exceeds is US\$500,000. For a very high income earner,

the overall income tax expense compared to an Ontario resident may not be that different and fail to meet the definition of “significantly lower”. Conversely, the highest tax rate in a jurisdiction with no state income tax such as Texas or Florida has a highest marginal rate of just the federal rate of 35%. That is far more likely to meet the “significantly lower” test.

What about the spouse who earns \$100,000 of employment income, \$10,000 of dividend income and \$5,000 of capital gains. Is the \$15,000 of combined dividends and capital gains a significant portion of the total \$115,000? It’s about 13%. In income tax lingo, “all or substantially all” was defined as 90% or more while “primarily” implied more than 50%. We are unaware of percentage thresholds that may apply to “significantly”.

Lastly, what if the spouse has \$100,000 of employment income and another \$100,000 of dividend income? That may meet the definition of “significant”. However, what if the spouse also incurred \$50,000 of capital losses that year? Capital losses are not deductible against other income so not only is there no tax advantage, there is a tax disadvantage compared to other types of losses. Does this mitigate the tax advantage of the dividends? Will those who argue that capital losses should not be considered in determining *Guidelines* income also argue they should not be considered in calculating the “significance” if multiple sources of income are considered together?

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.