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2 Bloor Street West, Suite 2603, Toronto, Ontario M4W 3E2
Telephone: (416) 961-5612 Fax: (416) 961-6158
E-mail: valuators@marmerpenner.com

Marmer Penner Inc. Newsletter

Written by Pier Sperti, CPA, CA•CBV
Edited by James A. DeBresser, CPA, CA•IFA, CBV

Availability Trumps Industry Benchmarks

Section 18(1) of the *Federal Child Support Guidelines* ("*Guidelines*") relates to spouses who are shareholders of a corporation. In addressing the shareholder spouse, the section states that when Line 150 Income as presented in the shareholder's income tax return does not "fairly reflect all the money *available* to the spouse," the Court may consider including all or part of the pre-tax income of the shareholder's corporation in *Guidelines* income. The key word in section 18 is "available".

The issue of availability typically is more complex than an analysis of a corporation's financial ratios for the purposes of assessing whether the distribution of profits in a particular year adversely affects the operations of the business and its future ability to generate cash flows. In actuality, the argument of availability may override any financial ratio analysis.

Take the shareholder spouse whose reported income is not in line with his/her reported lifestyle. The shareholder may claim that his/her lifestyle is being financed by way of encroaching on capital, specifically by borrowing from the corporation or having the corporation accelerate repayments of funds that were previously lent to it by the shareholder. The shareholder loan account, especially in closely held corporations, often includes a large number of transactions in a particular year. A review of the shareholder loan account is critical in determining access to pre-tax income.

On many occasions, we have encountered situations where a corporation's financial ratios, compared to industry benchmarks, clearly illustrate the company's inability to distribute any funds in the form of salary, dividends, or any type of cash outlay. In fact, the analysis may even show that the business is

assuming increased risk as it operates below industry norms. Yet, despite these conclusions, availability to income is present and is often demonstrated by changes in the shareholder's loan account.

Accountants refer to the shareholder loan account as being in either a "credit" or "debit" balance. A credit balance represents amounts previously lent by the shareholder to the company by way of an actual loan to the company or by the payment of business expenses from the shareholder's personal funds. A credit position means that the company owes the shareholder the balance in the account. A "debit" balance represents amounts the shareholder owes the company, usually arising from the company loaning funds to the shareholder or paying personal expenses on his/her behalf.

Table 1

Availability Corporation
Balance Sheet

	Year 1	Year 2	Year 3	Year 4
ASSETS				
Current				
Bank	$ 10,000	$ 8,000	$ 11,000	$ 12,000
Accounts receivable	10,000	11,000	12,000	13,000
	20,000	19,000	23,000	25,000
Shareholder loan	-	-	-	5,000
	$ 20,000	$ 19,000	$ 23,000	$ 30,000
LIABILITIES				
Current				
Accounts payable	$ 10,000	$ 8,000	$ 10,000	$ 13,000
Taxes payable	5,000	4,000	5,000	4,000
	15,000	12,000	15,000	17,000
Shareholder loan	4,000	3,000	1,000	-
	19,000	15,000	16,000	17,000
SHAREHOLDER'S EQUITY				
Stated capital	10	10	10	10
Retained earnings	990	3,990	6,990	12,990
	1,000	4,000	7,000	13,000
	$ 20,000	$ 19,000	$ 23,000	$ 30,000
Current Ratio	1.3	1.6	1.5	1.5
Excerpt from Income Statements				
Reported pre-tax net income	$ 990	$ 3,000	$ 3,000	$ 6,000

Consider the above example (Table 1). Availability Corporation ("AC") is in the widget manufacturing business. A study of the widget industry tells us that an acceptable current ratio[1] for the company is 2:1. That is, for every $1 of obligations due within one year, the company should ensure it maintains $2 in liquid assets. Based on the analysis of AC's current ratio, it appears that the company is well below the industry benchmark of 2:1 (current ratios range from 1.3 to 1.6 in each of the 4 years shown). If asked to determine the pre-tax income available to the shareholder in Years 2 to 4, the shareholder spouse would be quick to argue that the profits earned in each of those years, totalling $12,000, have to be retained in the business in order to ensure the company's current obligations can be met.

Enter the availability argument. At the end of Year 1, the shareholder loan was in a credit position i.e. the shareholder spouse had loaned the company a total of $4,000. In each of Years 2 and 3, the company repaid $1,000 and $2,000, respectively, of its debt outstanding to the shareholder spouse. In Year 4, the company not only repaid the remaining $1,000 of the shareholder loan, it also lent $5,000 to the shareholder, leaving the final shareholder loan account in a debit balance. The availability argument tells us that over Years 2 to 4, the company made a total of $9,000 available to the shareholder by way of shareholder loan repayments and lending activity while the company earned pre-tax profits of $12,000. The shareholder spouse will be hard-pressed to convince anyone that the company has no available funds to distribute and that it would be imprudent to distribute funds, notwithstanding the company's worse-than-average ratios. Based on this, a total of $9,000 would be added to the shareholder's *Guidelines* income over Years 2 to 4.

The argument as to whether a shareholder loan repayment by a company to its shareholder is representative of available income can be looked at in a number of ways. Those who are of the opinion that it is unfair to classify shareholder loan repayments as available income may argue that when a shareholder lends money to the corporation, or funds operations personally, the expectation of an eventual repayment of those amounts is reasonable. A shareholder loan

[1] The current ratio is a measure of liquidity which compares a company's current assets to its current liabilities. "Current" represents those assets and liabilities that are expected to be available/come due within the next 12 months. The ratio is used to measure the ability of a business to meet all of its current obligations if they were to all mature at once.

repayment is not in fact income earned by the shareholder, but merely a capital transaction between the two parties. The repayment would not be viewed as being "available" if it were made to third party debtors who placed covenants on the business. The shareholder in this case, is just another debtor of the company.

On the other hand, the argument is one of availability. The corporation chose to make funds available to the shareholder by way of a loan repayment, rather than a distribution of salary or dividends which would have been included in his/her Line 150 income. Often, we see a note in the financial statements of corporations which describes the shareholder loan as "non-interest bearing, no fixed terms of repayment". This is further proof that the corporation's debt to the shareholder is its last worry and that it could have chosen to distribute income before the repayment of the loan.

Overall, when analysing the corporate income available to a support payer, a detailed review should be done which not only focuses on measuring whether additional income could have been distributed based on maintaining reasonable financial ratios and industry benchmarks, but also, an analysis of amounts actually distributed and not classified as income should be clearly understood.

In a later edition, we will examine what the *Income Tax Act* has to say about shareholder loans and we will contrast the *Income Tax Act* with the practices under the *Guidelines*.

From all of us at Marmer Penner, we wish you and your family and friends a happy holiday season!