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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 Anna M. Barrett, BSc, CPA, CA, CBV, CFF
Edited by Steve Z. Ranot, CPA, CA•IFA, CBV

Has the Veil Gotten Heavier or is the Pin Duller?

The *Federal Child Support Guidelines* ("the *Guidelines*") allow a court to impute additional income to a spouse who benefits from deriving a significant portion of income from dividends, capital gains or other sources that are taxed at a lower rate than employment or business income (Section 19(1)(h)). The additional amount added to the spouse's income as a result of this income tax advantage is known as an "income tax gross-up".

The term "significant" is not defined in the *Guidelines* and is often a source of controversy. It has been our experience that parties tend to agree that amounts less than 10% are considered less than "significant" while amounts in excess of 25% meet the "significant" threshold. *The Income Tax Act* appears to suggest the term "significant" should be interpreted as closer to 10% than 25%.

The actual calculation of the income tax gross-up for significant income from dividends or capital gains received by a taxpayer is not subject to much controversy, however. If a high rate Ontario taxpayer reports a $2,000,000 capital gain, he or she will pay tax of $535,300 ($2,000,000 x 50% capital gains adjustment x 53.53%) as only 50% of the capital gain is taxable. This will leave the taxpayer with $1,464,700 of after-tax dollars for their enjoyment. If this same taxpayer received $2,000,000 as employment income, rather than a capital gain, he or she would pay tax of $1,070,600 ($2,000,000 x 53.53%) and would be left with a

measly $929,400 of after-tax dollars. Assuming this $2,000,000 capital gain was a significant source of income for the taxpayer, in determining *Guidelines* income, we would include a $1,151,926 gross-up using the logic that one would need $1,151,926 of additional pre-tax income to be left with the same $1,464,700 after-tax amount enjoyed by the capital gain recipient.

What happens when those same capital gains or dividends are earned within a corporation, rather than by a taxpayer? From a strict reading of the *Guidelines*, it is not entirely clear and we are not aware of any court decisions on this issue. We are often asked to review situations where a spouse has incorporated a holding company or has investments within their operating company that earn both dividends and capital gains. Within the corporation, these sources of income continue to be subject to lower taxation than employment or business income. If a spouse is a shareholder, director or officer of a corporation, the *Guidelines* allow a court to include all or part of the pre-tax corporate income of the corporation (Section 18(1)(a)). The purpose of this section of the *Guidelines* is to ensure that in determining income for support purposes, all sources of income, available and accessible to the support payer, are taken into consideration. This is often referred to as “piercing the corporate veil” as it allows the court to look through the corporate structure and determine what income earned in the company is accessible and available for support purposes. Without this section of the *Guidelines*, a shareholder could simply chose not to declare any salary to themselves, leave all of the income within their corporation and successfully have no income on their personal income tax returns. But what about the income tax gross-up to reflect the income tax advantage with respect to these capital gains and dividends earned within a corporation? Has this become hidden by the corporate structure? Very often we are asked to review and critique *Guidelines* calculations wherein no income tax gross-up has been considered when sources of income subject to preferential taxation are within a corporation. This is clearly inconsistent and provides an advantage to those support payers who received advice to maintain their investments within a corporation, rather than holding them personally. If the gross-up was not required on capital gains and dividends earned in a corporation, then every single

support payer should immediately roll his or her investments into a holding company and watch with glee as their *Guidelines* income drops. From our example, this is a $1,151,926 advantage. In our opinion, this is too "significant" of an issue not to consider next time you are determining income for support.

This newsletter is not intended to substitute for proper professional planning. It is intended to highlight areas where professional assistance may be required or enough to discuss at the next hoedown. 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***.