Vol. 24 No. 1 July/August 2021

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

Lower-Taxed Investment Income Earned in a Corporation

What are the objectives of the *Child Support Guidelines* that apply to those of us who calculate such income? The words “fair” and “consistent” in Section 1 of the *Guidelines* should resonate in our minds. Where income is earned in a controlled corporation, once again, the *Guidelines* reference fairness in paragraph 18(1)(a). That is the critical clause in the *Guidelines* that permits a court to consider undistributed income to be included. Otherwise, there would be vastly different income determinations between two identical spouses, one who earns, say, $500,000/year in his unincorporated medical practice and another who earns the same $500,000/year in her incorporated medical practice. Piercing the corporate veil is critical to fairness in income determination so that the form of business ownership does not cloud the substance of actual available earnings.

While chartered business valuators might differ on the extent of available income in each particular case, most of us agree that form should not weigh more heavily than substance. But, there is one area where form appears to continue to hold court in the minds of other business valuators. Many affluent spouses have sizeable portfolios of marketable securities earning a combination of interest, dividends and capital gains. We know that each of these three types of income is taxed at different rates with both capital gains and Canadian-source dividends subject to preferential rates. That is why paragraph 19(1)(h) of the *Guidelines* permits a court to impute an income tax gross-up to increase a spouse’s income in situations where a significant portion of a spouse’s income arises from such capital gains and dividends.

Let's consider the *Guidelines* income inclusion for a high-income spouse who earns additional investment income from a personally-held portfolio of marketable securities. If that portfolio earned her $100,000 of capital gains and $60,000 of dividends, these would lead to the following adjustments using 2020 tax rates in Ontario:

Actual capital gains	$100,000
Income tax gross-up thereon	57,500
Actual eligible dividends	60,000
Income tax gross-up thereon	18,300
	$235,800

Let's consider a second high-income spouse who earns the exact same additional investment income from the exact same portfolio of marketable securities however, this time, it is earned by a wholly-owned investment holding corporation. In our minds, the words "fair" and "consistent" combined with the intent of 18(1)(a) and 19(1)(h) require the exact same income tax gross-ups on these lower-taxed components of income regardless whether the investment income was earned personally or in a corporation.

On multiple occasions, we have been opposite chartered business valuators who do not apply the income tax gross-up on the capital gains and dividends on the basis that 19(1)(h), the provision allowing a court to gross-up lower-taxed investment income applies where "the spouse derives a significant portion of income from dividends, capital gains or other sources that are taxed at a lower rate…". We acknowledge that, technically, it is the corporation that is temporarily earning the lower-taxed income until the spouse decides when it should be distributed. However, it is the spouse that makes that determination and, in our opinion, allowing the spouse's timing decision to impact when the gross-up applies is akin to allowing the spouse to decide when corporate income should be included in *Guidelines* income. Look at some of the other provisions of subsection 19(1) such as 19(1)(e) and 19(1)(g). Paragraph 19(1)(e) allows a court to impute additional income where "the spouse's property is not reasonably utilized to generate income". Consider the situation where a spouse causes his corporation to rent one of its Toronto rental properties at a very below-market $500/month to a friend. Would any of us expect a court to leave this unadjusted on the basis that the provision applies only if the spouse rented the property at intentionally below market rates? After all, in this case, it is a corporation owned by the spouse not the spouse himself who is not reasonably utilizing the property to generate income. Similarly, the income tax gross-up for paragraph 19(1)(g) is so commonly applied that no one even pauses to question it. This paragraph applies where "the spouse unreasonably deducts expenses from income." In most cases where this is applied, the spouse operates an incorporated business but no one seems to point out that it is not the spouse who is technically deducting the expenses but rather it is the spouse's corporation. It seems clear that "spouse" includes the "spouse's controlled corporation". Otherwise, there would be a huge incentive for support-payers who wish to minimize their income to do so through a corporation. We believe that the courts have made it clear that a spouse cannot reduce *Guidelines* income by introducing a corporation into the mix as that would neither be fair nor consistent with other spouses earning the exact same income personally. Ask yourself this question – would a court that accepted the spouse's income as $235,800 above in 2020 permit it to be reduced to $160,000 ($100,000 of capital gains plus $60,000 of actual dividends but without the gross-up amounts) if the exact same income recurred in 2021 but the spouse had since rolled the portfolio into a corporation and elected not to cause any to be distributed?

Everyone at Marmer Penner welcomes Mr. Kier Mckenzie to our firm. Kier is a chartered business valuator with years of experience in matrimonial and other litigation accounting. At the same time, we wish to extend our heartfelt thanks to Mr. Patrick Chhen, a very hard-working member of our team, who is leaving to pursue other opportunities. Patrick's enthusiasm and perpetual smile will be missed.