

Marmer Penner Inc. Newsletter

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Tax Savings from Paying Child Support

In general, most of us believe the following:

- a) Child support arising from a new agreement is non-deductible to the payer; and
- b) After the introduction of the “Kiddie Tax” in 2000, income splitting using dividends paid to a family trust is not worthwhile.

For self-employed business persons, these generalizations may not be true. Consider an example of Dan, a dentist, whose practice incurs at least \$600,000 of expenses including salaries, rent, and supplies. Dan settled a family trust for the benefit of his two children. The family trust subscribed for the shares of Newco. Newco writes all the cheques to pay the practice's expenses and for this service charges the dental practice a 15% fee as permitted by Canada Revenue Agency. Thus, Newco can charge the dental practice at least \$90,000 (15% of \$600,000) each year. While the children are minors, if they actually work for Newco (for example, if they write all the cheques for the practice's expenses), they can be paid limited tax-free salaries due to the available personal exemption for each child. Thus, this allows some fees paid to the children to be deductible by the practice. These fees can be used towards the children's Section 7 expenses, possibly. CRA only requires that the salaries are reasonable. But the big savings occur when one or both of the children are 18 and over.

If Dan has combined annual child support and Section 7 expenses of about \$73,000, he would normally have to pay it from his after-tax income. However, in this case, he can arrange his affairs as follows:

- a) The dental practice pays Newco the \$90,000 as the management fee to pay of the practice's annual expenses;
- b) Newco pays corporate income tax of about \$16,000 on this income leaving it with about \$74,000 of after-tax income;
- c) Newco declares a \$74,000 dividend to the family trust, which allocates it to the two children; and
- d) Each child reports \$37,000 of dividend income on their personal income tax returns.

If the children have no other income, there is only about \$500 of income tax on the dividends for each child. Accordingly, each child is left with \$36,500 of after-tax income, or \$73,000 in total. This can be used by the custodial parent towards child support and Section 7 expenses. Accordingly, Dan pays \$90,000 to Newco and deducts it from his personal income. Thus it only costs about \$48,000 after-tax. The children receive \$73,000 in total. As can be seen, the income tax system subsidizes about \$25,000 of Dan's child support.

If the children are also enrolled in post-secondary school, the amount of tax free dividends that they can receive increases above the \$37,000 used in this example, because they will have tuition and education credits to further offset the tax on additional dividends.

These types of income splitting techniques might help bridge the gap when two sides are apart on support issues. However, organizing affairs appropriately to take advantage of these strategies will require the involvement of professional accountants familiar with both income tax and matrimonial litigation.

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.