

Income Determination For Federal Child Support Guidelines

INTRODUCTION

The Federal Child Support Guidelines were intended to simplify the calculation of child support by combining all relevant information into schedules based on the number of children being supported. Since all types of income are not taxed equally and certain income is discretionary and subject to manipulation for income tax and other purposes, the Guidelines permit the court the discretion to adjust the payor's income using Total Income on page 2 of the tax return as a starting point.

The following comments outline some of the common adjustments required. Most have been addressed in the Guidelines specifically. However, some have not, such as losses from limited partnership expenses which are discussed in greater detail below. The following points are numbered to tie into the numbering on schedule 1.

COMMENTS ON THE ATTACHED INCOME DETERMINATION SCHEDULE

Additions

The following are in addition to the income per line 150 of the Personal Income Tax Return.

1. Actual capital gains and losses are not indicated on page 2 of the 1997 personal income tax return. Where capital gains exceed capital losses for the year, 75% of the excess appears on page 2 of the tax return and is included on line 150. Schedule 3 of the income tax return should contain a breakdown of actual capital gains and losses. Accordingly, where capital gains exceed capital losses for the year, 25% of the actual capital gains must be added to line 150, or, the same result can be achieved by adding 33.3% of the taxable capital gains that appear on page 2 of the tax return.
2. Depreciation claimed on a rental property represents a non-cash expense for that year, and according to the guidelines is added back in determining income. No

depreciation can be claimed on a rental property if a loss has been incurred on the property before calculating any depreciation. Accordingly, if a rental loss appears on page 2 of a personal income tax return, no depreciation was properly included in the amount. However, if a rental property generates a profit, it is likely that depreciation was deducted and this amount can be determined by reviewing Form T776 of the personal income tax return.

3. In most cases, a stock option benefit is included on an employee's T4 slip, and as a result is already included in total income per line 150 of the personal income tax return. Where the stock option benefit has not been included, it is determined to be the difference between the fair market value of the shares purchased less the exercise price paid by the employee.
4. Not all income is required to be reported. Social assistance payments are generally excluded from total income. Where an individual received social assistance for all or part of the year, it may be appropriate to add these amounts to other income earned in the year.
5. For self-employed individuals, the incentive may exist to income split. As a result, a taxpayer may pay an excessive amount to an otherwise low income family member in order to avoid paying tax at a higher marginal rate of taxation. Where this occurs, the excessive portion of the salary or fees paid to the non-arm's length party will be added to the individual's income.
6. Dividends received from a Canadian corporation are taxed at more favourable tax rates because the income represents distribution of corporate tax paid income to a shareholder. Not all dividends, however, are subject to income tax. Dividends representing an allocation of certain gains accrued prior to 1972 and the non-taxable portion of capital gains earned after 1971 may be distributed on a tax-free basis to shareholders. None of these tax-free dividends are required to be reported by the individual taxpayer on his or her personal income tax return, and accordingly will not be included on line 150 of the personal income tax return. A review of the corporate financial statements and corporate income tax returns will uncover the extent of any tax-free dividends. It is uncertain whether tax-free dividends must be added to a payor's income. In addition to considering adding these non-taxable dividends to the payor's income, consideration may be given to adding the pre-tax equivalent of these amounts.

7. Another type of non-taxable benefit which may represent income to the recipient is disability insurance. Where disability insurance premiums were paid personally by a taxpayer with no corresponding deduction for these payments, the proceeds received as a result of a claim are themselves non-taxable. As a result, none of these amounts would be included in total income per line 150 of a personal income tax return. Accordingly, not only should an adjustment for the non-taxable amount be considered, but calculating a pre-tax equivalent (which may be as much as twice as high) may be appropriate.
8. The child support guidelines are based on the payor's expected disposable income. As tax rates differ by province, separate guideline amounts were created for each province. Where a payor resides in a different province than the custodial parent, the guideline amounts of the payor's province apply. In a similar vein, if the payor resides in a lower tax jurisdiction (e.g. Texas or Florida where no state income taxes exist), paragraph 19(1)(c) of the Guidelines permit the court to impute an additional amount of income. Paragraph 19(1)(h) allows the court to make a similar adjustment to income if the payor earns a significant portion of income from dividends or capital gains which are subject to lower marginal rates of taxation. Consider the example of Leo the oil executive who has moved to Texas where he earns \$200,000 US and pays income tax of \$50,000 US. His after-tax disposable income of \$150,000 US based on a foreign exchange rate of \$1.40 CDN = \$1.00 US amounts to approximately \$210,000 CDN. For Guideline purposes, one might assume that Leo's income should be \$280,000 based on \$200,000 US adjusted for the foreign exchange rate. However, if we examine his after-tax income of \$210,000 CDN, we realize that a similar taxpayer in Ontario would need to earn about \$400,000 CDN to be left with \$210,000 CDN of after-tax income. It appears as if the intent of paragraph 19 (1)(b) is to allow for the latter adjustment.
9. Many investments structured as limited partnerships permit the investor to deduct a share of a partnership loss greater than the actual cash cost of the investment. This is achieved by financing a significant portion of the investment with debt. The Guidelines do not refer to any adjustments in this area. Where an investor paid \$30,000 to obtain a \$100,000 deduction in a particular taxation year, it is uncertain whether the income for Guidelines purposes should be adjusted for the \$100,000 loss, the \$30,000 cash cost or nothing at all. Conversely, upon the disposition or wind-up of a partnership interest, a capital gain or loss is usually realized. Since all or most of the proceeds of disposition are usually used to repay debt, very little, if any, of the proceeds is actually received by the investor. Accordingly, depending on how the investor's losses were treated in the initial years of the partnership, a consistent approach should be used at sale or wind-up.

10. Where it is viewed that a spouse is intentionally underemployed or is not utilizing property available to earn investment income in a reasonable fashion, the extent of the underemployment or underutilization may be imputed in income. It is not uncommon for individuals who wish to minimize their income for support purposes to shift income to business partners or to invest purely for long-term capital growth.
11. Where an individual has the discretion to determine the income payable to him or her by a corporation he or she controls, it is possible that for income tax purposes it is to his or her advantage to retain significant income in the corporation. Where this is the case, the income retained in the corporation still represents income available to the individual and may be considered in determining income for support purposes in certain circumstances. In order to appropriately be included in the shareholder's income, the corporate income should be both available to the shareholder and within his/her control. For example, where a corporation has undistributed income of \$100,000 and the corporation's loan agreement with a bank requires it to repay \$70,000 of principal in that year, the income over which the shareholder has access may be only \$30,000. It is also important that there be a commercial reason for retaining the income in the corporation. Where it is evident the income is being retained for non-commercial reasons (e.g. unnecessary build-up of inventory), the payer's failure to satisfy the "commercial reasonableness" test will likely result in the court attributing all or a portion of this income to him for Guideline purposes. Accordingly, a review of corporate financial statements, tax returns, and other relevant documents is required.

Deductions

The following are to be deducted from total income per line 150 of the Personal Income Tax Return.

12. As indicated above, dividends from Canadian corporations are subject to more favourable rates of taxation. However, the dividend tax credit process requires that the taxable dividend amount indicated on page 2 of the personal income tax return be grossed up by a factor of 25%. As a result, the taxable dividends included in line 150 of the personal income tax return actually represent 125% of actual dividends received, and accordingly this amount must be reduced to determine the actual dividend received by the individual.
13. Where capital losses exceed capital gains in a year, none of this amount will be considered in calculating total income per line 150 of the personal income tax return.

Accordingly, 3 of Schedule the tax return must be reviewed to determine the amount of the actual capital losses in excess of actual capital gains. According to paragraph 6 of Schedule III - Adjustments to Income contained in the Guidelines, taxable capital gains are to be replaced by actual capital gains in excess of actual capital losses in a year. The Guidelines do not specifically address the issue of capital losses in excess of capital gain. If capital losses in excess of capital gain are not considered as a reduction of income of the payor, an inequitable situation is created. Capital gain would be considered, but years with greater losses would not be considered. Based on the wording of paragraph 6, it is uncertain whether capital losses in excess of capital gain will, in fact, serve to reduce income, or do they merely reduce capital gains to a nil amount.

14. Business investment losses differ from capital losses in that they may be deducted against any type of income as opposed to capital losses which may only be deducted against capital gains. Similar to capital gains, only 75% of the amount is considered for income tax purposes. This deduction is claimed on page 2 of the personal income tax return below line 150 and accordingly, where a business loss is incurred, an adjustment is required to total income for 100% of the business loss which represents 133.3% of the amount deducted on page 2 of the personal income tax return.
15. An individual is entitled to deduct carrying charges such as interest expense and investment counsel fees which are incurred in order to earn investment income. As investment income is included in total income per line 150 of the personal income tax return, a deduction is permitted for the related expenses incurred to earn this income.
16. For the purpose of determining income for the Child Support Guidelines, spousal and child support received from the other spouse is not considered. Where there is split custody, this adjustment will most commonly be required. It should be noted however that for the purposes of extraordinary expenses which are generally shared under a $\hat{=}$ Paras $\hat{=}$ formula, this support is considered in determining the income of both the payor and the recipient.
17. Certain benefits such as old age security and employment income benefits are subject to clawback once an individual's income exceeds a certain threshold amount. The clawback is deducted below line 150 of the personal income tax return and accordingly, where these amounts are included in Total Income and a repayment of these benefits is indicated underneath on page 2 of the personal income tax return, a deduction for the repayment should be made.

18. Where an individual earned professional or business income from an unincorporated business which had a non-calendar year end prior to December 31, 1995, there may be a requirement for this individual to continue reporting a portion of the income earned between his or her first fiscal year end in 1995 and December 31, 1995. Although this amount must be reported for income tax purposes, it does not represent actual income earned subsequent to 1995, and accordingly should not be considered in the individual's income for child support purposes. A review of Form T1139 in the personal income tax return should indicate the amount of the 1995 reserve added into each year's taxable income.
19. Certain employees are required by the terms of their employment agreement to pay for their own expenses, such as automobile, promotion and entertainment expenses. Where these amounts have been incurred to earn employment income, a deduction is permitted for income tax purposes. The Child Support Guidelines also permit this amount to be considered as a deduction from income. These expenses appear on page 2 of the personal income tax return and are provided in full detail in Form T777 of the personal income tax return. Certain expenses, such as meals and entertainment, are limited to a 50% deduction and as a result, another adjustment for the non-deductible portion of these expenses for income tax purposes may be required for the determination of income for child support purposes.
20. Included in employment expenses eligible for deduction in determining income for the purposes of the Guidelines are CPP and EI premiums paid. These are the CPP and EI amounts paid on behalf of employees of the payor-spouse, not the payor's own CPP and EI contributions.
21. The Guidelines recognize that where business requires a portion of the income generated for reinvestment, this amount does not reflect income actually available to each investor. For this purpose, the Guidelines indicate that where a spouse earns income through a partnership and a portion of that income is required to be retained by the partnership, that amount should not be included in his or her income for the purposes of the Guidelines. We had commented in the past that this provision did not recognize that similar capital requirements may exist in a sole proprietorship or a corporation. Technical amendments released on November 26, 1997 amended the original provision by adding "or a sole proprietorship" after "partnership". Capitalization requirements of an incorporated business remain noticeably absent. If the Guidelines are not to be further amended, owner-managers of an incorporated business will be forced to choose between optimal tax strategies and optimal income reduction for Guidelines purposes.

Consider the example of an incorporated business with income of \$300,000. In order to minimize income tax, a bonus is paid to the shareholder-manager to reduce taxable income to the \$200,000 threshold for small businesses. After personal income tax is paid on the bonus, the remainder is loaned back to the corporation to be used to finance operations. Although the \$100,000 was included in the shareholder's income, it does not represent income available to him. If this business was a proprietorship or a partnership, the \$100,000 would presumably not be included in his income for the purposes of the Guidelines.

22. Schedule 2 indicates a number of other deductions which are not as common as those which appear on Schedule 1. It should be noted that in many cases professional dues are paid by an employer and may be included on a personal income tax return in error.

CONCLUSION

As a result of recent court decisions, most notably in *Baker v. Francis*, it appears that income determination will be the most critical factor in determining child support, even in instances where the child support amounts exceed prior amounts spent on the needs of the children. With all the detail contained in the Guidelines, significant professional judgement and experience will be required to determine the payor's income.