



Article

Family Law

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The pandemic has complicated child support payments by the self-employed

Courts are more carefully scrutinizing the pre-tax earnings remaining in a corporation controlled by a support payor

By Laurie H. Pawlitza

The pandemic's economic effect on Canadians has caused a significant decline in income in many industries with one result being that courts are more carefully scrutinizing the pre-tax earnings remaining in a corporation controlled by a support payor.

In Canada, child and spousal support is determined based on income, and the Child Support Guidelines prescribe the way in which a support payor's income is to be determined for the purposes of paying both child and spousal support. Determining income for a support payor who is a T-4 employee is straightforward, but it becomes more complicated for those who are self-employed and earn income through a corporation that they control.

The guidelines stipulate that child support should vary annually, depending on the change in the payor's income over the past year. Usually, parties exchange their tax returns to determine the amount of the change. Unsurprisingly, where a payor runs a business through a corporation they control, the annual change is honoured more in the breach than in the observance. In these cases, the guidelines require that if the total income disclosed on the payor's personal tax return is not the best indicator of income, the court may look at a number of other factors, including the expenses the shareholder/payor deducts within the corporation and the pre-tax earnings that may remain in the corporation year over year.

During the pandemic, despite applying the same provisions of the guidelines, the courts have come to

different conclusions, particularly when considering a situation where pre-tax earnings remain in the corporation.

In two Superior Court of Justice in Ontario decisions – one a trial decision of Justice Llana Nakonechny, heard in December 2020, and the other, an interim decision of Justice Jessica Kimmel, heard in February 2021 – both judges considered the effect of the pandemic and the reasons advanced by each shareholder about why corporate pre-tax earnings should stay in the company, rather than be withdrawn, either in part or entirely, as income from which child and spousal support would be paid.

In each case, the judge had to decide whether to assign none, some or all of the pre-tax earnings retained in the corporation to the shareholder's personal income for support purposes.

In *Nani v. Nani*, the husband had a successful business in property management and real estate ownership. Before separation, the family had a luxurious lifestyle and the wife asked the court to determine that the husband's income was \$653,000 annually, while he said his income for support purposes was \$440,000. The dispute centred on whether the pre-tax earnings in the corporation should be added to the husband's income.

In deciding the issue, Kimmel recognized she had to consider the historical pattern of how retained earnings had been treated, the industry in which the corporation operated, the husband's business plans, the corporate debt level, financing and any other debt restrictions, whether the salaries were at market or otherwise, and whether there were legitimate business reasons for keeping the pre-tax earnings in the company.

Nakonechny also applied the same kind of test regarding the pre-tax earnings in the case of *Nersisian v. Hyde*, where an employment lawyer, who started his own firm about a year prior to the pandemic, had pre-tax earnings in his professional corporation.

The effect of COVID-19 was considered by both judges. Kimmel looked at the cash-flow risks arising from the pandemic, which included the prospect of contract terminations or breaches by customers, possible collection issues, and payroll and other operating expenses that would need to be paid whether or not the customers defaulted on or terminated their arrangements.

Nakonechny considered the lawyer's nascent employment firm's level of cash in the business, the need for capital expenditures, the significant work that had arisen as a result of employment issues arising during the pandemic and whether the work would continue at the same pace, the increased expenses for more staff and office space, and that that the firm was only a year old.

In both cases, the court added about half of the pre-tax earnings to income for support purposes. There is little doubt when reading the reasons that each judge was exercising caution as a result of the pandemic.

Kimmel remarked the court must carefully consider where and how additional money could be found from a corporation's pre-tax income to fund the support, and cited a previous case by saying: "failure to properly understand this issue 'can lead to an incorrect result and ultimately, if the parent cannot find the expected additional money ... (it) may undermine the operation of the corporation and eventually kill the goose that lays the golden egg.'"

In *Leggett v. Leggett*, a September 2020 decision of Justice Alan Ross of the British Columbia Supreme Court, the court considered whether to include pre-tax earnings from a design business owned by the husband. The husband indicated that given the possible downturn arising from COVID-19, he was unsure whether he could continue to maintain his salary from his company and that he had reduced his income in June and July as a result of a decline in work. The issue was whether his salary as well as the pre-tax earnings in his corporation should be taken into account in determining support on an interim basis.

Without reference to any evidence about the state of the husband's business or the industry, Ross opined, "I am unable to make any prognostications for the economy in general. However, it is evident that the economic shutdown in this province was most severe during the months of April through to July. Economic activity has increased since the summer. Hence I put little stock in Mr. Leggett's concern that he will not be

able to sustain (his) income ... Subject to a further shutdown of the economy due to the pandemic, there is no reason to think that his overall income ... will be diminished."

Ross said he would not prognosticate, but it would seem he did just that. He calculated the husband's income as being his management income from the prior year plus the *entirety* of the pre-tax earnings in his corporation at year-end, and ordered support based on this income.

Any shareholder who wants to conservatively operate their business during these uncertain times and keep retained earnings in their corporation must make a clear business case for doing so. Failure to do so will likely result in more, rather than less, pre-tax earnings being included in income for support purposes.

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Author

Laurie H. Pawlitza
Partner

Tel: 416 777 5192
lpawlitza@torkinmanes.com

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