DETERMINATION OF INCOME UNDER S. 18 OF THE FEDERAL CHILD SUPPORT GUIDELINES

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I. Introduction

Determining income for child support purposes can be complicated when the payor is a shareholder, director or officer of a company. In these circumstances ss. 17 and 18 of the Federal Child Support Guidelines (the "Guidelines") may apply:

> s. 17 If the court is of the opinion that the determination of a spouse's annual income under section 16 would not be the fairest determination of that income, the court may have regard to the spouse's income over the last three years and determine an amount that is fair and reasonable in light of any pattern of income, fluctuation in income or receipt of a non-recurring amount during those years.
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> s. 18 (1) Where a spouse is a shareholder, director or officer of a corporation and the court is of the opinion that the amount of the spouse's annual income as determined under section 16 does not fairly reflect all the money available to the spouse for the payment of child support, the court may consider the situations described in section 17 and determine the spouse's annual income to include
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> (a) all or part of the pre-tax income of the corporation, and of any corporation that is related to that corporation, for the most recent taxation year; or
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> (b) an amount commensurate with the services that the spouse provides to the corporation, provided that the amount does not exceed the corporation's pre-tax income.

In *Baum v. Baum* (1999), 182 D.L.R. (4th) 715 the Court summarized the purpose of s. 18:

> Valid corporate objectives may differ from valid child support objectives. The purpose of s. 18 is to allow the court to 'lift the corporate veil' to ensure that the money received as income by the paying parent fairly reflects all of the money available for the payment of child support. This is particularly important in the case of a sole shareholder as that shareholder has the ability to control the income of the corporation.

To assess a claim pursuant to s. 18, the payor's personal tax returns, as well as his or her company's financial statements must be reviewed to determine what, if any, portion of the company's pre-tax corporate income may be available to the payor.

This paper will discuss the onus of proof and evidentiary considerations in applying s.18.

II. The Case Law

Prior to 2009, there was limited appellate authority in British Columbia on the application of s. 18. *Kowalewich v. Kowalewich*, [2001] B.C.J. No. 1406 (CA) provided an early analysis. In that case, the payor father operated an incorporated small business and the trial judge found that the corporate income method was the fairest way to determine Mr. Kowalewich's Guidelines income. Based on the evidence, the judge estimated the pre-tax corporate income at $350,000 and included a portion of it in fixing Mr. Kowalewich's income at $300,000 for support purposes. Mr. Kowalewich appealed that finding.

In considering whether the trial judge made an error in her determination of Mr. Kowalewich's pre-tax corporate income, the Court of Appeal said that although the Guidelines provide for <u>all</u> pre-tax corporate income for the most recent taxation year to be included in a payor spouse's income this was not a requirement, nor a default position. The only explicit guidance in the Guidelines on how much pre-tax corporate income should be included is found in s. 18, which allows the court to "…consider the situations described in section 17…" The Court then held that, not only should the historical pattern of income be considered, but so should the nature of the business and the evidence of legitimate calls on the corporate income.

In *Kowalewich*, neither party had provided the court with a detailed analysis of the evidence on the legitimate cash requirements of the company. This was acknowledged by the trial judge prior to her finding that Mr. Kowalewich's income should be fixed at $300,000. The Court of Appeal found that the portion of the pre-tax corporate income that the trial judge had included in Mr. Kowalewich's income was too high and allowed his appeal varying his income to $200,000. The Court used the same figures as the trial judge, but concluded that the trial judge's determination of Guidelines income did not allow sufficiently for legitimate corporate needs.

Although *Kowalewich* gave some guidance on the proper application of s. 18, it did not discuss the onus of proof under that section.

That issue was settled by the Court of Appeal's decisions of *Hausmann v. Klukas*, [2009] B.C.J. No. 121 and *Teja v. Dhanda*, 2009 BCCA 198. These cases, particularly *Teja,* make it clear that an incorporated professional or the controlling shareholder of a business bears a heavy onus to show why all of the pre-tax income of the corporation should not be included in the calculation of Guidelines income.

The principal issue on appeal in *Hausmann* was what amount, if any, of the pre-tax corporate income of the payor's company should be added to his line 150 income for the purposes of calculating child support pursuant to s. 18 of the Guidelines. The determination of Mr. Klukas's line 150 income was not in dispute.

The parties had separated after 10 years of marriage and had three children, all in the care of Ms. Hausmann. Mr. Klukas operated a business.

In 2001, the parties entered into a consent order that fixed Mr. Klukas's Guidelines income at $135,000 and child support at $2,037 per month. The parties were to exchange complete personal and corporate tax returns every year and vary the support as required by the Guidelines. Failing an agreement as to the new amount either party was at liberty to apply to the court.

Contrary to these provisions, Mr. Klukas failed to provide his income information as contemplated by the consent order, despite Ms. Hausmann's repeated requests for this information. Mr. Klukas had voluntarily increased the amount of child support, but Ms. Hausmann did not consider these amounts to be in accordance with the Guidelines. The chambers judge found that Mr. Klukas's failure to disclose his financial information pursuant to the order was blameworthy conduct and Mr. Klukas did not appeal that finding.

The delay in disclosure required Ms. Hausmann to obtain expert evidence on Mr. Klukas's personal income and the amount of pre-tax corporate income available to him for child support. In turn, Mr. Klukas obtained his own expert evidence, which was at odds with Ms. Hausmann's.

The judge preferred Ms. Hausmann's expert evidence, found that money retained in the corporation was required to meet legitimate corporate obligations and declined to include any pre-tax corporate income in the calculation of child support. The Court of Appeal found that the trial judge had made an error of fact as only a portion of the obligations were currently due.

The Court of Appeal found Mr. Klukas's evidence supporting his position that no pre-tax corporate income was available for child support unclear and the expert evidence conflicting. The Court addressed these evidentiary problems as follows:

> It is neither necessary nor desirable for litigants in family law disputes to have to adduce numerous expert reports to establish the legitimate calls on pre-tax corporate income of a company solely owned and controlled by the payor spouse. It should be a relatively straightforward exercise for the payor spouse with the benefit of financial advice.

Because of the lack of clear evidence, the Court then went on to discuss the onus of proof under s. 18. The Court approved *Jeffery v. Motherwell*, 2006 BCSC 140 which held that the payor has the onus to provide "clear" evidence that the corporation's pre-tax income is not available to the payor.

With the onus established, the court turned its mind to the approach in imputing corporate income under s. 18. The Court noted that some cases had looked to retained earnings on an application under s. 18, but agreed with the Alberta Court of Appeal's decision in *Miller v. Joynt*, 2007 ABCA 214 that found error in that approach.

In *Miller*, the court stated that the error in starting with the annual change in retained earnings rather than the pre-tax corporate income when doing the s. 18 analysis is that retained earnings are the result of taking pre-tax corporate income and subtracting income tax, shareholder dividends and other changes to capital accounts from the pre-tax earnings.

Given the onus set out above, Mr. Klukas's failure to lead evidence on legitimate calls on his company's pre-tax corporate income and the financial evidence which was available, the Court included all of the pre-tax corporate income in Mr. Klukas's income for the purpose of s. 18.

On the heels of *Hausmann* came the Court of Appeal's decision in *Teja*. In *Teja*, the wife, Ms. Teja, appealed the trial judge's determination of the husband's income under the Guidelines.

The parties were married for 10 years and had one child who was primarily in the care of Ms. Teja. The husband, Dr. Dhanda, was a retina surgeon who had incorporated his practice.

At trial, Ms. Teja argued that Dr. Dhanda had income available to him of $630,000. The trial judge acknowledged that Dr. Dhanda's line 150 income of $400,000 did not reflect all the income that was available to him. The trial judge also accepted the evidence that more income was kept in the company to take advantage of preferential tax treatment. Nonetheless, after considering the authorities, including *Kowalewich*, the trial judge fixed Dr. Dhanda's income at $425,000, adding only the $24,000 that had been paid to Ms. Teja by way of income splitting before separation. The trial judge found that when the parties were together Dr. Dhanda did not take all the money out of the corporation that was available to him and that it would now be unfair to him or the company to add in, "…all or most of the company's retained earnings".

On appeal, Dr. Dhanda conceded that all of the income available (personal and corporate) was $630,000, but maintained that it should not all be included in his income for child support purposes. Ms. Teja took the position that the trial judge erred in not including all the income available to Dr. Dhanda for child support purposes.

The Court of Appeal found that the trial judge had misapprehended the court's reasons in *Kowalewich* and that the *Kowalewich* factors did not apply to Dr. Dhanda's case due to the personal service nature of his corporation and the absence of evidence regarding legitimate calls on the corporation's pre-tax income. The analysis in *Kowalewich* dealt with a business that required capital to maintain or expand its operation or to allow for contingencies. An incorporated professional does not operate such a business. The Court also distinguished *Hausmann* from *Teja* on the basis that there was blameworthy conduct in that case where there was none on the part of Dr. Dhanda. In concluding that all of the corporate and personal income of $630,000 must be included in Dr. Dhanda's income for the purposes of calculating child support, the Court said:

> Dr. Dhanda has, through hard work and relative thrift, been able to accumulate significant savings represented by the retained earnings of the company. What he has not demonstrated is that there are legitimate calls on the pre-tax corporate income of his company, other than his desire to build up savings in the company. Through the *Guidelines*, Parliament has said that children are entitled to support based on the full income available to the payor spouse. The payor's desire to accumulate savings, to the detriment of the child, is not a legitimate factor to consider.

III. Conclusion

Teja and *Hausmann* decisions have established a very heavy onus on a payor to lead clear evidence why all pre-tax corporate income should not be included in the payor's income when s.18 applies. Blameworthy conduct is not a prerequisite for the application of s. 18. Finally, it is now apparent that incorporated professionals will have a particularly difficult time avoiding the application of s. 18.