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PREC Implications During a Separation: Income for Support

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If you are a self-employed real estate agent in Ontario, you are likely already aware of the province's recent decision to allow you to incorporate and earn commissions through a Personal Real Estate Corporation ("PREC").

You may be considering incorporating your real estate business and taking advantage of the various benefits including, but not limited to, the ability to defer taxes and income splitting with family members.

Those who plan on incorporating their real estate business should be aware of the potential family law implications should they subsequently be involved in a separation.

Income for the purposes of determining support, whether child or spousal, has always had the potential to be very contentious during a separation, in which (typically) the higher earning spouse's sources of income are subject to review and possible recalculation by the family law courts, usually through an expert like a Chartered Business Valuator ("CBV"). This is particularly so in cases where the higher earning spouse has one or more business interests, whether self-employed or through a separate business entity. Businesses usually require much closer financial analysis, review, and scrutiny.

This raises some concerns over the financial ramifications when a real estate agent who owns a PREC finds themselves in the unfortunate process of a separation.

How is income for support calculated for a real estate agent in Ontario who is not incorporated?

Up until the October 2020 announcement allowing PRECs, the process was simple: Every real estate agent in Ontario would earn commissions through their self-employed business and report the entirety of the commissions earned in each tax year in their personal tax return.

More specifically, agents would report their gross income (i.e. per the T4A slip issued from the real estate brokerage) and deduct applicable business expenses in Schedule T2125 or the "Statement of Business or Professional Activities". The resulting net income figure would then be reported as part of Total Income earned (Line 15000 - formerly referred to as Line 150) of their personal tax return.

As the entirety of the net income earned from commissions was reported in each tax year, and if there were no other income sources, the only significant family law issue requiring financial analysis and review by CBVs were the expenses deducted against gross commissions.

If upon review any expenses were found not to be allowable for family law purposes (i.e. personal and/or discretionary expenses, expenses that are allowed for tax purposes but are not for family law purposes, or other non-business-related expenses) they were added back to the spouse's Total Income - Line 15000, along with a possible income tax gross-up. The income tax gross-up reflects the incremental amount of pre-tax employment or business income required to achieve the same after-tax benefit, which effectively accounts for the tax savings realized.

To illustrate, if Mary reports \$250,000 of net income from her real estate business (and no other income) and it was determined she is deducting \$10,000 of personal expenses in arriving at the

\$250,000 figure, her income would be calculated as \$271,500, being \$250,000 plus the \$10,000 of personal expenses plus \$11,519 ($(\$10,000 \div [1-53.53\%]) - \$10,000$) for the gross-up.

How will income for support be calculated for real estate agents that operate their business through a PREC in Ontario?

For real estate agents who incorporate, the favorable tax saving features of PRECs (i.e. retaining income in the corporation) may not help them in a family law matter.

The analysis and review of expenses discussed above will remain an area that financial professionals and the family law courts will be interested in, and expenses reported in the PREC that are considered personal/discretionary will be added back to the spouse's personal income and grossed-up as before.

There will be several additional considerations.

What happens when a real estate agent splits income with family members through a PREC?

If a real estate agent takes advantage of the income splitting feature of a PREC, he/she may be able to pay wages to family members or dividends to family members who hold non-voting/

non-equity shares of the PREC. In this case the agent is required to ensure that the amounts paid to family members or nonvoting/non-equity shareholders are reasonable for the actual services rendered. In an income for support calculation, a CBV will assess the services that were rendered and what the fair market value of those services would have been had they been rendered by an unrelated third-party. If amounts paid are found to be higher than the fair market value, the incremental amount is added to the spouse's income and potentially grossed-up for support purposes. In this case the potential tax benefit, if any, will be accounted for in the determination of the spouse's income.

What happens if a real estate agent doesn't draw out all the income generated in a PREC during a given year to minimize taxes?

One of the most beneficial features of a PREC is undoubtedly the ability to defer a portion of your personal tax if you don't require all of your income to finance your living expenses in any given year, and therefore, reduce your overall taxes payable. This provides real estate agents with tremendous flexibility as they were previously subject to a tax bill every year commensurate with their level of income. If they had taxable income of over \$220,000, they would be subject to a personal

marginal tax rate of 53.53% on all income earned above \$220,000 in Ontario. Now they can use tax planning to help reduce overall taxes payable and potentially smooth earnings over a period of time.

In terms of income, the major area of interest to the courts and CBVs is the pre-tax corporate income generated in the PREC in any given fiscal year under review. Per section 18(1) of the Federal Child Support Guidelines, where a spouse is a shareholder, director or officer of a corporation, "The court may consider all or part of the pre-tax income of the corporation, and of any corporation that is related to that corporation, of the most recent tax year."

Consider the following example: Jane is a real estate agent in Ontario and is the higher earning spouse in a family law matter with her husband John. Her income is subject to review for support purposes.

Scenario 1:

Jane is an unincorporated real estate agent earning commissions through her self-employed business and reporting them in her personal tax return. In 2021, Jane has gross commissions of \$350,000 with a net income of \$200,000, after deducting business expenses of \$150,000. Pending any other sources of income and inclusion of personal and/or discretionary or

otherwise non-allowable expenses in her income with an applicable gross-up, her income for support purposes in 2021 will be \$200,000.

Scenario 2:

Jane incorporated her business on January 1, 2021 and earns her commissions through her PREC, Jane Realty Inc. ("JRI"). In 2021, JRI reports \$350,000 in gross income, with a net income of \$200,000, after deducting business expenses of \$150,000. Jane decides that she doesn't need to take out all the income and can retain some of the earnings in her PREC to reduce taxes. She declares a dividend of \$50,000 (which is not tax deductible to the company), retains \$150,000 of net income in the company, and the company pays tax on the \$200,000. A CBV will review the financial statements of JRI and after speaking to Jane may determine that since JRI is a service business and not capital intensive, it requires approximately \$15,000 of the \$200,000 pre-tax corporate income to be retained in the corporation for working capital

purposes (i.e. required for additional advertising/marketing, etc.). The CBV then determines that per section 18(1) the remaining \$185,000 can be allocated to Jane's total income for 2021 as it is not required to operate the business and could have therefore been paid out as income during the year.

As Jane has already drawn out \$50,000 of dividends from the corporation in 2021 (which were drawn from the after-tax income of the company) if applicable corporate tax rates were 25%, the CBV may conclude that Jane has already drawn out the equivalent of approximately \$67,000 of pre-tax corporate income in 2021 ($\$50,000 \div (1-25\%)$). This would leave \$133,000 ($\$200,000 - \$67,000$) of pre-tax income to be examined to determine what portion of such income could be attributed to Jane for support purposes in 2021. If it is determined that all but \$15,000 of the \$133,000 was available to Jane, then a further \$118,000 ($\$133,000 - \$15,000$) would be added

to Jane's notionally calculated \$67,000 of income, resulting in a 2021 income for Jane of \$185,000. As a result, Jane may have only received \$50,000 of dividends in 2021, however her income for support purposes may be \$185,000.

In this scenario the benefit and flexibility to declare income at the agent's discretion as the owner of a PREC will not necessarily allow him/her to defer income in a family law matter.

If you are a real estate agent in Ontario, either as a self-employed individual or through a PREC, and are concerned about how income for support may be determined in a separation situation, we encourage you to contact Crowe Soberman's Valuations, Forensics, and Litigation Group to discuss the various family law concepts, issues, parameters, and implications.

This article has been prepared for the general information of our clients. Please note that this publication should not be considered a substitute for personalized advice related to your particular situation.

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