
CANADA / JUDGMENT

S.M.E. v. J.A.E.

2020 BCSC 332

COURT

Supreme Court of British Columbia

DECIDED

9 March 2020

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2020 BCSC 332 S.M.E. v. J.A.E.

IN THE SUPREME COURT OF BRITISH COLUMBIA

Citation:

S.M.E. v. J.A.E.,

2020 BCSC 332

Date: 20200309

Docket: E68718

Registry: Kelowna

Between:

S.M.E.

Claimant

And

J.A.E.

Respondent

Before: The Honourable Mr. Justice G.P. Weatherill

Reasons for Judgment

Counsel for the Claimant:

G.K. Thomas

Counsel for the Respondent:

B. Hardwick

Place and Date of Hearing:

Kelowna, B.C.

May 9, 2019 and

February 21, 2020

Place and Date of Judgment:

Kelowna, B.C.

March 9, 2020

Introduction

- [1] This dispute centers on the correct manner in which to calculate the respondent's income for the purpose of child support.
- [2] The respondent is a practising lawyer. His law corporation is a partner in a moderately sized, well established, Kelowna law firm. At issue is whether the respondent's increase in his law corporation's capital account in the partnership should be included in his income for child support calculation purposes.

Background

- [3] The parties began to cohabit in 1986. They were married on May 12, 1996, separated in July 2005, and were divorced on January 23, 2012. They have two children, E., age 22, and I., age 20 ("Children").
- [4] The respondent has been practicing law his entire career with the firm now known as Doak Shirreff LLP ("DS"). He has been in practise since 1991. DS is a limited liability partnership. The respondent has been running his practise through his personal law corporation called J.A.E., Law Corporation ("Law Corp") since it became a partner of DS in 1997. The Law Corp provides him with T4 income and dividends which are his only source of income.
- [5] All partners of DS are parties to a partnership agreement which is updated from time to time as required. The current partnership agreement is dated January 1, 2016, and is in evidence ("DS Partnership Agreement"). For the purpose of the matter before me, its material terms have not changed.
- [6] A consent order was pronounced April 11, 2012, granting both parties joint custody and guardianship of the Children, shared parenting on alternating weeks, and ordering the respondent to pay the claimant child support based on the Guidelines, to be reviewed on June 1 of each year thereafter. For the purposes of child support, the claimant's income was set at the greater of \$25,000 or her actual income. Since then, the claimant's income has at all times been \$25,000 for the purpose of calculating child support.

- [7] Over the years, child support payable by the respondent has been the subject of multiple applications. On July 23, 2012, the matter of the calculation of the respondent's income was before Madam Justice Fitzpatrick. The issue was whether the respondent could deduct from his income bank loan principal payments he had been making on money borrowed to join DS. The bank loan was taken out by the Law Corp to pay the amount it was required to pay to acquire an interest in the DS partnership by way of a capital contribution. Relying on s. 12 of Schedule III to the Federal Child Support Guidelines, the respondent's position was that these payments (which varied from year to year) were properly deductible from the Law Corp's income because the loan was taken out "for the purposes of capitalization".
- [8] Justice Fitzpatrick disagreed. In oral reasons given the following day, July 24, 2012, and citing both Justice Melnick's decision in *Boniface v. Boniface*, 2007 BCSC 407 and his supplementary reasons at 2007 BCSC 1543, as well as *C.R.E. v. K.L.E.*, 2011 BCSC 291, both of which she found persuasive, she held that the loan payments were not a proper deduction from the respondent's income for the purpose of determining child support.
- [9] But that didn't end the discussion. Following the pronouncement of her decision, the claimant's then counsel, Ms. Oien, and the respondent's then counsel, Mr. Smith, had the following discussion with the court:

MS. OIEN: Thank you, My Lady. I just wanted to say, as well, that the other aspects of the order that we did agree to would be that [J.A.E.]'s income would be averaged over the preceding three years to determine his income. Secondly, funds held back for the capital account would be deducted in years that he does not receive those funds, but would be included in income for years that he did. For example, this year I think a little more than \$50,000 was paid out to [J.A.E.]'s law corporation from the capital account of the law corporation, so that is included in his income "

[10] And later

"MR. SMITH: Yes, so basically my thoughts were it's the income of the law corporation before tax, less expenses exclusive of management salaries and benefits, add or subtract to increase or decrease in investment in partnership from the previous year, period."

THE COURT: Yes.

MR. SMITH: Is that right, Ms. Oien?

MS. OIEN: I don't know if we need to be that complicated in the wording.

MR. SMITH: Except that what we will have, if you and I aren't around a year from now or two years from now, is the formula.

- [11] In short, both parties' counsel requested that Justice Fitzpatrick's order include a provision respecting the Law Corp's capital account so that the calculations of the respondent's income in future years could be resolved without dispute. Accordingly, Fitzpatrick J.'s formal order, entered September 12, 2012 ("Fitzpatrick Order"), set out the formula that the parties would use going forward to calculate the respondent's income for child support purposes. Paragraph 4 of the Fitzpatrick Order states:
4. The Respondent's income for the subsequent review years shall be determined as follows:
 - a. An average of the previous 3 years income before tax of [J.A.E.] Law Corporation;
 - b. Less expenses, exclusive of management salaries and benefits;
 - c. Adjusted by any increase or decrease in investment in partnership from the previous year."
- [12] No appeal of the Fitzpatrick Order was taken.
- [13] From the date of the Fitzpatrick Order until June 2017, the parties approached the issue on the basis that an increase in the Law Corp's capital account would be deducted from his income used to calculate spousal support.
- [14] Commencing in September 2016, E. began living with the respondent full time, thus requiring a review of child support payable. Once again, the parties agreed to the formulae, and an order setting out the new child support amount was entered on February 6, 2017, for the period June 1, 2016 through May 31, 2017. Once again that recalculation was in accordance with how the parties had previously treated the Law Corps' capital account, namely, any annual increase in it would be deducted from income.
- [15] E. completed her second year at UBCO in April 2017 and decided to take a break from school to work. She turned 20 on August 12, 2017.

The Applications

- [16] The respondent filed an application on February 8, 2018, seeking orders that E. ceased to be a child of the marriage as at April 30, 2017, and that his child support obligations be adjusted accordingly ("Respondent's Application").
- [17] The claimant countered with an application of her own filed March 1, 2018, seeking a recalculation of child support for the years 2014, 2015, and 2016, and arrears of child support for those years totalling \$41,000 on the basis that, since the Fitzpatrick Order, the respondent had been improperly deducting increases in his capital account against his income when that income was available to him for child support purposes. She also sought prospective child support based on the recalculated amount ("Claimant's Application").
- [18] Both applications came on before Justice Cole on April 23, 2018, who declared that E. ceased to be a child of the marriage effective April 30, 2017. She was therefore not a child of the marriage on March 1, 2018, the date the claimant filed her notice of application.

- [19] At the April 23, 2018 hearing, Cole J. ordered, apparently on his own motion, that the respondent provide documents and explanations respecting the internal operations of DS relating to the respondent's capital account and whether or not the other DS partners were treated similar to the Law Corp. The obvious purpose of Cole J.'s inquiry was to determine if, as the claimant suggests, the Law Corp's annual increase in its capital account was money that the respondent had available to him as income, or, as the respondent suggests, that money was not available to him because of how the DS partnership worked.
- [20] The respondent says that he has provided the claimant with full and complete disclosure of and explanations for the internal financial workings of DS which confirm his position that he has been paying proper Guideline child support since the Fitzpatrick Order. The claimant remains skeptical and asserts that the respondent has simply made conclusory statements and has failed back them up with admissible evidence.
- [21] Meanwhile, the respondent continues to pay the claimant child support of \$2,376 per month, as he has since June 1, 2017. He has not increased child support pending the outcome of these applications.
- [22] Save for the issue currently before the Court, there is no suggestion that the respondent has not fulfilled his child support obligations throughout. He has paid all amounts due to the claimant in accordance with various child support orders that have been made over the years, increasing child support each year based on the running three-year average of his earnings. Indeed, the respondent's current application seeks to increase his child support because his income has increased. It was not until it was time to discuss the annual adjustment in child support proposed by the respondent's counsel in the spring of 2017 that the claimant raised for the first time that an increase in the respondent's capital account should result in a corresponding increase in his available income for the purposes of child support calculations.
- [23] Both parties prepared extensive submissions and calculations on what the respondent's child support should be, based on their respective positions on how the Law Corp's capital account should be treated.

Court Proceedings

- [24] The following is a summary of other relevant court orders that were made in this proceeding, mostly by consent:
- a) On April 20, 2015, the parties consented to an order setting a new amount of child support for the period June 1, 2014 to May 31, 2015, and confirming that child support would be reviewed in accordance with the previous court orders;
 - b) On September 28, 2015, Justice Steeves made a final order setting a new amount of child support for the period June 1, 2015 to May 31, 2016, and ordering that child support would be recalculated in accordance with the previous court orders;

- c) On February 6, 2017, Justice Rogers ordered child support for the period June 1, 2016 to May 1, 2017, be recalculated in accordance with previous court orders;
 - d) On April 23, 2018, Cole J. ordered as follows ("Cole Order"):
 - 1. The Respondent, [J.A.E.], is to obtain and provide any and all documents from Doak Sherriff for 2014, 2015, 2016 and when available, 2017 that establish the following:
 - a. That the partnership known as Doak Sherriff required the partners to contribute to the day to day costs of running the partnership for each of the noted years, and the same is to include memoranda or written direction or such other written communication by the partnership requiring the partners to contribute their proportionate share of day to day costs to partnership;
 - b. That pursuant to the partnership requests as set out in (a) that the respondent contributed to the day to day costs of running or operating the partnership, and the said documents will set out the additional information, to wit, the amount or amounts paid per year and with reference to the other partners, his proportionate share, per year, and that by reason of the same, that amount or amounts paid by him were not available to him for support purposes for any or each of the noted years;
 - c. That the other partners of Doak Sherriff were required to and made similar contributions of capital to the Doak Sherriff partnership to assist with the day to day expenses of the partnership and the said documents will set out particular amount or amounts that were requested of each partner, per year, and each partners proportionate share of such obligation, per year, of the total contributions made to the partnership. For the purposes of this Order the other partners of Doak Sherriff names are to be redacted (but not the amounts contributed by them or their respective proportionate shares).
- [25] Justice Cole also ordered that for the period May 1, 2017 to April 30, 2018, the respondent was to pay \$3,514 as arrears of child support to the claimant without prejudice to the claimant's ability to argue that the arrears were greater than that amount.

Issues

- [26] The main dispute between the parties is whether an annual increase in the respondent's capital account ought to result in a decrease of his income or conversely, whether a decrease in his capital account would result in an increase in his income.
- [27] Depending on the determination of that issue, a further issue is whether the claimant is entitled to retroactive child support from 2014 to the present.

Claimant's Position

[28] The claimant asserts that since the Fitzpatrick Order, the respondent has artificially reduced his available income each year for the purposes of calculating child support by increasing the Law Corp's capital account. The claimant says that this approach improperly reduces his legitimate available income, and thus the amount he owes for child support. She argues that the respondent has failed in his duty to provide admissible evidence explaining that the increase to the Law Corp's capital account does not reflect money that is available for child support purposes and his failure to do so is fatal to his position.

[29] The claimant relies on an expert report prepared by Ms. Patti Daum, a certified business valuator, dated February 28, 2018, who, after reviewing DS's full un-redacted financial statements for the years 2014-2016 concluded:

"20. It is unclear why the changes in the capital account have been included in [the] calculations of available income. The increase in the capital account reflects the portion of earnings attributable to the Law Corp that were not withdrawn from the Partnership; however, that does not mean this additional income (not withdrawn) was not available to [J.A.E.] through his Law Corp."

[30] In essence, the claimant says that during those years the respondent had the right to withdraw monies from the partnership by reducing his capital account and did not take the full amount of allocated money that he could have. The money was still available to him and there is no evidence that the partnership required the money. The claimant argues that the respondent has the onus, especially since the Cole Order, to show exactly what happened. She says the Cole Order established an obligation on the respondent to clearly, precisely, and compellingly show why he did not take available money out. Because the respondent has failed to produce the evidence, there is nothing upon which he can base his argument. She argues that because there is no affidavit material that indicates that the money was not available to him, it should be included.

[31] Through Ms. Daum, the claimant has added back the Law Corp's increased capital account to the respondent's income for each since year 2014 and has recalculated the child support the respondent should have paid, thus taking the position he is currently in arrears by some \$41,000.

[32] Respecting arrears of child support, the claimant argues that despite the timing of the filing of her application (some 11 months after E. was no longer a child of the marriage), the recent decision of the Supreme Court of Canada in *Michel v. Graydon*, pronounced November 14, 2019 with reasons to follow, overturned its earlier ruling in *D.B.S. v. S.R.G.*, 2006 SCC 37, at paras. 88-89 that a retroactive child support award will only be available if the child was a child of the marriage when the application was filed. Regardless, she argues, D.B.S. made specific exceptions to that rule, one of which is where a court had previously made a child support order on how future annual adjustments were to be made and the payor did not comply with that order: *MacCarthy v. MacCarthy*, 2015 BCCA 496 at paras.

52-53, 56; Dring v. Gheyle, 2018 BCCA 435 at para. 61. That, she argues, is what has occurred here.

Respondent's Position

- [33] The respondent argues that the claimant is seeking to launch a collateral attack on the Fitzpatrick Order which has been the manner in which the parties have calculated the respondent's income since 2012.
- [34] He asserts that the claimant's position is not supported by the law and is contrary to the realities of how the DS partnership has always functioned. The respondent says that s. 12 of Schedule III of the Guidelines ("s. 12") is a complete answer to the issue before the Court.
- [35] He asserts that s. 12 makes it clear that an increase in a capital account, where that increase is properly required for capitalization, results in a decrease in available Guideline income. Thus, the manner by which child support was calculated each year since the Fitzpatrick Order is correct.
- [36] He points out that E. was no longer a child of the marriage eleven months prior to the claimant filing her application. He asserts that despite Michel, a bar continues to exist preventing this Court from making a retroactive award where the child was no longer a "child of the marriage" at the time the application for arrears. Michel, he says, could be restricted to its facts and may not apply to this case. Until the full reasons are received, this Court should be reluctant to make a decision on the point.
- [37] In any event, if I determine that the respondent's position is correct respecting the treatment of the Law Corp's capital account, I need not engage in an analysis respecting arrears.

Discussion

- [38] It is well settled that where an increase in a capital account is properly required to operate a business or partnership, that increase will result in a decrease in available Guideline income for support purposes.
- [39] In Richardson v. Richardson, 2013 BCCA 378, the court laid out three key points regarding retained earnings in a corporation:
 - a) the Federal Child Support Guidelines are driven by "available income". The court is attempting to determine what resources a payor has available with which to pay child support;
 - b) monies retained for the legitimate operating of a business will not be included in the payor's income as they are not a resource available to pay child support; and

- c) the payor will need to provide the court with evidence as to the corporation's working capital requirements. A payor will need to show that it is reasonable for the company to maintain the retained earnings at the level it is.
- [40] Ultimately, the question boils down to whether the respondent is holding back income deliberately that could be reasonably available to him.
- [41] Section 12 of Schedule III to the Guidelines provides that the respondent can deduct any amount included in income that is properly required for the partnership for the purposes of capitalization:

Partnership or sole proprietor income

12 Where the spouse earns income through a partnership or sole proprietorship, deduct any amount included in income that is properly required by the partnership or sole proprietorship for the purposes of capitalization.

- [42] Capitalization is, in effect, the cash needed for the partnership to operate. It is needed in order to generate income. In Melnick J.'s supplementary reasons in Boniface, he stated:
- [9] There is little law in this area. However, in Ghosn v. Ghosn, 2006 NSSC 2, 242 N.S.R. (2d) 84, Mr. Justice Coady stated at para. 24 that "[c]apitalization refers to the cash needed to operate on a day to day basis".
- [10] Two other cases were referred to in argument by counsel for Mr. Boniface, namely de Goede v. de Goede, [1999] B.C.J. No. 330 [Master] (QL) and Gossen v. Gossen, 2003 NSSF 7, 213 N.S.R. (2d) 217. The facts of these cases are sufficiently different so as not to be of assistance to me.
- [11] Despite the lack of case law in this area, there has been some, albeit limited, academic material devoted to the discussion of s. 12, Schedule III of the Guidelines. Steve R. Pittman of Ernst & Young has stated with respect to the function of s. 12, Schedule III of the Guidelines that, although a partner's income for tax purposes is determined without regard for the amount actually drawn from partnership, there may be occasions where a partner cannot draw all of the income attributable to him or her if the partnership cash flow is insufficient to cover operating costs or if money is needed to finance capital expenditures. In such cases, that money will have been left in the partnership for reasons of capitalization (Steve R. Pittman, "The Definition of Income for the Purposes of Applying Child Support Guidelines" in Federal Child Support Guidelines: Reference Manual, 2nd ed. (Ottawa: Department of Justice, 1998) G-25 at G-39).

- [12] In James C. MacDonald & Ann C. Wilton, *Child Support Guidelines Law and Practice*, 2nd ed., looseleaf (Toronto: Thomson Carswell, 2004) vol. 1 at 16-12, capitalization is referred to as "cash capital to operate on a day-to-day basis ". Capital may be borrowed, contributed by the owner, or retained from profits. A look at the business's use of the cash, such as whether it was used to finance accounts receivable, inventory, or the purchase of capital assets can help to determine whether the funds were for the purposes of capitalization.
- [13] Also, Diane M. Bell et al., *Financial Issues in Family Law*, 2nd ed., looseleaf (Vancouver: The Continuing Legal Education Society of British Columbia, 2006) at §7.30, states that the Guidelines do not help to determine what a proper amount of capitalization is, but that it may be helpful to look at whether, over a period of time, certain funds were necessary in order to finance the business. It states that there may be circumstances where the partner is prevented from withdrawing all of the income from the business, but that capitalization of a partnership, "does not generally require regular annual retention of cash flow from income, but, typically, is a one-time or periodic requirement".
- [14] Finally, Terry Hainsworth states that s. 12, Schedule III of the Guidelines addresses the situation where a portion of a partner's income must be left in the business to properly fund the business (Terry W. Hainsworth, *Child Support Guidelines Service*, looseleaf (Aurora: Canada Law Book, 1998) at 5-20.4). Hainsworth does not elaborate on what it means to "properly fund" a business. He does, however, state at p. 5-20.4 that, "[t]he amount of income required for capitalization purposes may be deducted against the partner's [] income."
- [43] The purpose of the Guidelines is to permit an impartial assessment of "money" available to a spouse to pay child support: *Kowalewich v. Kowalewich*, 2001 BCCA 450 at paras. 42-45. Valid corporate, or in this case, partnership objectives may differ from valid child support objectives: *Baum v. Baum* (1999), 182 D.L.R. (4th) 715 at para. 28.
- [44] A court's effort to ensure fairness does not require a court to second-guess business decisions nor to "place the largest available shovel in the company store." What it does require is that a spouse's allocation of pre-tax corporate income between business and family purposes be assessed for fairness: *Kowalewich* at para. 44. Regard must be had to the nature of the business involved and legitimate calls on the business' income so that the business can continue to run. Monies needed to maintain the business' operations as a going concern are not generally available for support purposes and should not be included in determining annual income: *Kowalewich* at para. 58. At the same time, the Guidelines do not intend that deductions from income ought to be made for the acquisition of assets, such as an interest in a partnership that is then used to earn income. This is why Justice Fitzpatrick did not allow the respondent to deduct from the Law Corp's income the principal payments made on the loan taken out to purchase a partnership interest in DS.

- [45] Here, there is no suggestion that the respondent's capital account is used for the purpose of increasing his interest in the partnership. It clearly is not. To the contrary, the respondent is mandated by the DS Partnership Agreement to maintain or increase his capital account in accordance with the other partners in order that the partnership can fund ongoing partnership activities.
- [46] In effect, the increase in the respondent's capital account is a 'reinvestment' in the law firm's ability to continue to operate. That money is not available to individual partners to take out of the partnership and is not available to fund such things as child support obligations. Even though an individual partner may be allocated income at the end of the year, that allocation does not necessarily translate into cash available to the partners but is made up of such things as an increase in accounts receivable, partnership disbursements and work in progress.
- [47] I am satisfied on the evidence that the respondent's Law Corp was treated no differently than DS's other partners each year since the Fitzpatrick Order and was in accordance with the DS Partnership Agreement. I am also satisfied that the methodology set out in the Fitzpatrick Order for calculating the respondent's income for support purposes makes perfect sense. That, presumably, is why the parties, with the benefit of counsel, consented to it and have been using it consistently ever since during the annual reviews, including the various subsequent orders.
- [48] The reality of the operation of a law firm like DS is that some years, cash is simply not available in the firm to payout all of the "income" allocated to each partner. This could be for many reasons, including, that the cash is tied up in accounts receivable, or there has been an increase in the firm's need to fund disbursements, capital improvements or expenditures for such things as computers, office equipment or furniture. That lack of cash is reflected in an increase in the partner's capital account and may or may not be available to the partner in the future.
- [49] The DS Partnership Agreement mandates the respondent to maintain and contribute to his capital account, the same as the other partners, and in accordance with its terms. The respondent does not control the changes in his capital account and he has no ability to access it in order to generate cash.
- [50] DS's partners' capital accounts are all treated in the same manner and are used by the partnership to fund ongoing partnership needs as required. Each partner is required to maintain his or her percentage of the firm's capital account based on their respective ownership. It is the core funding of the firm's day-to-day operations.
- [51] I am not persuaded by the claimant's assertion that the respondent has not met the duty on him to explain why the income reflected by the increase in his capital account over the years was not available to him. I am more than satisfied that he has.

Retroactive child support

[52] Given my conclusion and given that the Supreme Court of Canada's reasons in Michel have not yet been delivered, it is unnecessary for me to rule on the issue of arrears and I decline to do so.

Decision

[53] The respondent's treatment of the Law Corp's capital account in relation to the determination of income for child support purposes is correct. The past annual increases in the Law Corp's capital account did not result in a corresponding increase in the respondent's available income for the purposes of calculating child support.

[54] Going forward, assuming the Law Corp's capital account is treated by the DS partnership as it has in the past, an increase will not result in a corresponding increase in the respondent's income for the purpose of calculating child support and a decrease will result in a corresponding increase in the respondent's income for the purposes of calculating child support.

[55] Accordingly, the claimant's application is dismissed and the respondent's application is allowed, with costs.

"G.P. Weatherill J."

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