

## **A DIVORCE PRACTITIONER'S INTRODUCTION TO DETERMINING SCHEDULE C AND SUBCHAPTER S INCOME**

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### **INTRODUCTION**

This Chapter will discuss the ways in which the practitioner can ascertain how various business entities have an impact on spousal income and cash flow in the context of payment of maintenance and child support. Traditionally, individual income tax returns and the tax returns of partnerships or corporate entities, where relevant, were the primary source of information that lawyers and judges used in ascertaining a party's "net income" for purposes of setting an award of maintenance and child support. In reality, both personal and business tax returns, and other financial documents prepared for business entities can be deceiving, and a party's net taxable income may bear little relation to his or her actual net cash flow.

For example, it is common for a payor of spousal maintenance and/or child support to execute mandatory financial affidavits that list reported taxable income in an effort to minimize support obligations, as opposed to listing money actually received. Payors of maintenance and child support may also attempt to reduce their income by failing to acknowledge the receipt of gifts which, in certain jurisdictions, are relevant to a determination of support. It is also the case that a party's individual income tax return may, in some cases, create the impression that the

taxpayer is reporting substantially more income than the taxpayer actually receives. The important thing for the practitioner to remember is that the contents of individual and business tax returns can be used to distort reality either to the financial benefit, or detriment, of the taxpayer. As such, while tax returns provide a useful departure point, they must be reviewed in conjunction with other documentation obtained in the course of discovery.

In general, many courts throughout the country have already come to appreciate just how deceptive tax returns can be. Under Illinois law, for example, an obligor's net income for the purposes of child support is not determined solely by the obligor's tax returns. *See In re Marriage of McBride*, 166 Ill.App.3d 504, 510, 519 N.E.2d 1095, 1099 (1988); *see also In re Marriage of McGowan*, 265 Ill.App.3d 976, 979, 638 N.E.2d 695, 697-98 (1994) (stating that "income' for tax purposes is not synonymous with 'income' for determining child support."). It is with this caveat in mind that the present discussion of certain tax return issues can proceed.

### **"Five Easy Pieces": Schedule C and the Sole Proprietor**

The sole proprietor of a business reports income using a form Schedule C. While helpful to the practitioner attempting to ascertain a spouse's income, ultimately, the Schedule C is merely a simple statement of a company's gross receipts and the company's alleged business expenses. There are, essentially, five basic component parts to every Schedule C: (1) Income; (2) Expenses; (3) Costs of Goods Sold; (4) Vehicle Expenses and (5) Other Expenses.

In general, if the owner-spouse pays personal expenses through the company (such as his automobile loan or lease payments, automobile insurance and/or repairs, insurance premiums for non-business expenses, personal meals, or family vacations) and deducts them on Schedule C, the taxable income generated by the company would be reduced by the cost of these personal expenses, and the reportable income would appear much lower on the tax return than it is in

actuality. Furthermore, any enumerated depreciation expense found on the Schedule C does not represent an actual cash outlay. Indeed, under certain circumstances, depreciation expenses can be added back to the individual to determine cash flow for purposes of setting an order for support. It is incumbent upon the practitioner to get a depreciation schedule to ascertain what is actually being depreciated and whether the depreciation is straight line or accelerated.

This Article will take each component part of the Schedule C, discuss the relevant information to be gleaned from it, explore how the practitioner should use documents obtained in discovery to further analyze the basic information reflected on the tax return, and discuss relevant case law that highlights the danger of exclusive reliance on Schedule C.

#### METHOD OF ACCOUNTING

Before turning to the components of the Schedule C, it is important to note first that the two forms of accounting most commonly found are the Accrual and Cash bases. Generally, when a business conducts itself on a cash basis, revenues are recognized in the year when the revenue is received and deductions for expenses are recognized when actually paid. In the Accrual basis, revenues are recognized when earned whether or not received and expenses are recognized when they are incurred, even if they are not paid in the tax year.

Cash basis accounting is most common to professional practices and service industry businesses while accrual basis accounting is typically found in retailers of goods with income generating inventory.

#### Part 1: Income

Line 1 reports the Gross Receipts or Sales which are, roughly, the revenue earned by a business operating on a cash basis. This may not be the case for a business operating on the accrual basis. Importantly, when comparing the figure recorded on Line 1 over multiple years, if

one discerns a drop-off in gross receipts in the year(s) preceding a dissolution action, the practitioner should dig deeper to ascertain whether unreported income is being earned and not reported.

Line 2 reports Returns and Allowances and this figure will reflect goods that were sold and then returned, or in the case of a business providing personal services, it will reflect the refund of any overpayments that were made. If the refund is significant, look at the general ledger of the business and either utilize the existing chart of accounts, or create a chart of accounts to ascertain who was paid and the reason for the payment. Line 4 reports the Cost of Goods Sold; businesses holding an inventory report the cost of the goods they sell on Line 4. As such, a business involved in personal services usually does not report any figure on Line 4. Greater detail regarding the cost of goods sold by the business is reported more specifically in Part III of Schedule C. Line 5 represents “Gross Profit,” which, for purposes of Schedule C, is the difference between (A) “Gross Receipts or Sales” less any “Returns and allowances” and (B) “Cost of Goods Sold.” Line 5 is an important item in Schedule C because it provides insight into overall, “big picture” trends for the reporting business. Line 6 usually represents taxable, non-ordinary, non-repeating “Other Income” that is not includable as Line 1 “Gross Receipts or Sales.” Line 7 – Gross Income -- is typically a figure that is equal to or greater than Line 5 – Gross Profit by the amount found in Line 6 – Other Income.

#### Part 2: Expenses

Advertising expenses reported on Line 8 must be analyzed for the possibility of hidden perks to the owner-spouse. It is not uncommon for items of personal expense to be inappropriately included as a Line 8 expense. Moreover, whatever figure is listed should be analyzed in conjunction with the practitioner’s review of the company’s general ledger. Line 9,

Car and Truck Expenses are often over inflated and generally require additional analysis. As such, one should check the depreciation schedules to ascertain the type of vehicle being depreciated, and that it is in fact being used by or for the business. In Line 10, Commissions and Fees and Line 11, Contract Labor, the practitioner will want to be watchful for so-called “double dipping” wherein the owner-spouse double deducts as Commissions, Fees or Contract Labor paid that which is already deducted as Wages elsewhere in the Schedule C. Line 13 - Depreciation and Section 179 Expense Deduction – is important to the practitioner’s analysis of Schedule C because it reduces income while allowing actual cash flow to increase. Many items such as computers or furniture could be purchased by a business for personal use and depreciated, which should not be a proper business deduction. This is a double-edged argument, if the deduction was disallowed, the taxable income would increase, but the amount of the expense could be imputed as additional income. Form 4562 and other schedules are useful in conducting the analysis of depreciation. These additional forms and schedules should be scrutinized in conjunction with internal business documents such as depreciation schedules. Where one encounters depreciation write-offs the effect is the overstatement of operation costs for the business and a concomitant understatement of the business’s value.

The figure recorded on Line 14 - Employee Benefit Programs – will be in addition to that which is recorded on Line 19 below. These Line 14 items typically include: health insurance, optical and dental insurance and any dependent care programs. One must scrutinize any figure recorded in Line 14 to ascertain whether personal expenditures are being inappropriately deducted as business expenditures. Line 15 is an important figure because, where insurance expenses (other than health) are paid by the business have the result of benefiting the spouse personally, this amount may constitute a perquisite that is relevant in the context of

determining income for purposes of child support and maintenance. Line 16 – Interest – indicates that an outstanding loan exists. Where a Line 16 figure is recorded, the practitioner must develop full documentation regarding the liability. As noted below, the thorough practitioner will subpoena the lending institution for loan application documentation which often provides a wealth of useful information, along with a copy of the note and repayment schedule.

Line 17 reflects expenditures for the payment of legal and professional fees. This figure should be scrutinized closely to determine the degree to which personal legal or professional fees associated with a dissolution action may be deducted as a business expense. The figure recorded for Office Expenses in Line 18 should be compared against the general ledger of the company to determine accuracy and consistency. Many times personal expenses of a spouse or paramour can be recorded here. The figure reported on Line 19 reflects payments made on behalf of employee retirement plans. Where a figure is reported on Line 20 – Rent or Lease – the practitioner will want to ascertain whether the company has entered into a lease with a family-member, paramour or friend such that the Line 20 rent figure may be inappropriately deducted. In Repairs and Maintenance, listed on Line 21, the practitioner must conduct a searching examination to determine whether any personal repairs or maintenance are being deducted as a business expense.

Travel, Meals and Entertainment expenses frequently include payment of personal expenses. As with Lines 17, 18 and 21, the practitioner should examine Line 24 expenses to determine whether personal expenditures are being deducted as business expenditures. Only one-half travel and entertainment is deductible; sometimes an aggressive individual may list the other half of the deduction on IRS Form 2106 as unreimbursed business expenses. One general consideration is whether the business actually requires substantial travel, meals and

entertainment. The practitioner will also want to compare the relevant figure deducted here again his or her examination of corporate credit card statements, expense reports or reimbursements, and other corporate documentation that should be requested in discovery. Similarly, in respect of Line 25 – Utilities – be aware that the owner-spouse may deduct utility expenses for marital residences as a business expense. Again, this figure should be analyzed for consistency and accuracy. Wages, reported on Line 26, may reveal relatives, paramours or friends of the owner spouse who are compensated for services they do not render. As such, the practitioner will also want to review all available payroll records. If a figure is reported as an Expense for Business Use of the Home on Line 30, one should also analyze Form 8829 and other relevant documentation to ascertain whether and to what degree any home-office expenses are legitimately reported as business expenses. The practitioner should note that if a home office is deducted, there will be a recapture of depreciation when the house is sold. The figure reported on Line 31, Net Profit or Loss, is ultimately only an informative number and is subject to certain adjustment variables discussed above.

### Part 3: Costs of Goods Sold

Line 35 will indicate the inventory at the beginning of the year. Ideally, this figure will correlate with the inventory at the end of last year as reported on previous year tax return for the company. Discrepancy between the numbers warrants further investigation. On Line 36, one will find the cost of items purchased for sale. As noted above, where businesses hold inventories they typically utilize the Accrual Basis on Schedule C. As such, the date of purchase becomes central. Anomalies in purchase activity require investigation. As noted below, it is important to obtain documentation regarding both the company's cash disbursements and accounts payable. Line 37 will report the cost of labor for those companies that manufacture goods. Once again, as with

Line 26, it is vital to obtain a roster of all employees to determine whether relatives, paramours or friends are compensated for unperformed or overpaid services. In respect of Line 38 -- Materials and Supplies - be watchful for personal expenses that are inappropriately reported as business expenses. Line 41 reports the inventory held at the end of the year by the company, and as noted above, should be reviewed by reference to the subsequent year's return Line 35. Moreover, Line 41 should be analyzed against other discovery documentation obtained from the company in order to ascertain the degree to which there is an unreported sale of inventory.

#### Part 4: Vehicle Expenses

As noted above, the vehicle expense is one of the most frequently misreported items in Schedule C because self-employed owner-spouses commonly write off their personal vehicle for tax purposes and frequently report a business use of the vehicle that is far beyond the actual use of the vehicle for that purpose. As such, an owner-spouse may attempt to deduct both mileage and actual expenses in respect of the vehicle. The practitioner should be mindful that deducting actual costs such as gasoline, automobile insurance, oil changes, and repairs in addition to deducting the standard mileage rate is not permissible. The standard mileage rate is permitted in lieu of other expenses, not in addition to it. On the other hand, if these personal expenses are characterized as business expenses and are disallowed by the IRS, the deductions decrease and gross profit increases.

#### Part 5: Other Expenses

The fifth component of the Schedule C reports Other Expenses of the company and deducts those expense items that were not listed in the second part of Schedule C. Numerous and varied expenses can potentially be listed here and will vary by business and industry. However,

whatever expenses are deducted here must be reviewed in conjunction with other discovery documentation obtained.

### **The Importance of Discovery Documents to Supplement Schedule C**

While personal and business tax returns and schedules, such as Schedule C, are indispensable, the practitioner must supplement the information gleaned from those sources with exhaustive discovery. As such, the importance of a close analysis of a spouse's personal and business documents cannot be underestimated. The following non-exhaustive list provides a useful starting place for the practitioner conducting discovery.

#### **Basic Personal Documents to be Obtained:**

- Personal credit reports
- Bank Statements
- Cancelled Checks (both front and back)
- Deposit Slips
- Withdrawal Slips
- Debit and Credit Memos
- Check Registers
- Signature Cards
- Monthly Credit Card Statements
- Applications for Credit cards
- Applications for bank or investment accounts
- Applications for life insurance policies
- Loan Applications and Financial Statements

Often overlooked, a loan application completed prior to a spouse obtaining lender financing will often demonstrate in summary form all of the assets a spouse owns along with that spouse's estimate of his or her worth. Frequently, when a spouse and his or her business have a long-term financial relationship with a bank, the bank will require some form of an annual financial statements to continue the existing financing. The loan application and financial

statement become crucially important especially when in light of the fact that the spouse-applicant, because of the very natural desire to depict his or her financial status in the most advantageous fashion and the fact that it is a criminal offense to knowingly provide false information to an FDIC insured institution.

- Spousal credit reports to reveal accounts and loans of which the practitioner was not aware
- Tax returns (personal and gift tax) for 5 years
- Phone records with monthly detail for land line and cell
- K-1s for all Partnerships and Subchapter S Corporations
- All paid bills and receipts
- Security buy/sell advice and monthly broker transaction statements
- Any tax authority's revenue agent reports
- Auto boat plane registrations and documents
- Detailed documents for all purchase and sales of real estate
- Stock options documents
- Frequent flyer / frequent guest (both hotel and restaurant) programs
- Appraisals
- Insurance documentation re home, art, jewelry and other insured valuables

Basic Business Documents to be Obtained:

- Business credit reports
- Detailed general ledgers
- Cash disbursement journals
- Cash receipts journal
- Sales journal
- Petty cash journal
- Purchase journal
- Accounts receivable ledger and aging of accounts receivable

Assets that do not appear typically on the balance sheet of a professional practice are unbilled "work in progress." Though the figure will vary from firm to firm, this figure may

represent up to several month's of billing and its ability to be collected, like any other asset of the practice, of the must be analyzed.

- Account payable ledger with aging
- Perpetual inventory records
- Fixed asset work papers and depreciation lapse schedule.
- Payroll records
- Contracts for services

Including as yet unperformed contracts that may have substantial value

- Lease agreements
- Bank statements
- Deposit slips
- Credit card statements
- Loan files
- Brokerage account statements
- Telephone records
- Financial Statements
- Subpoenas to all financial institutions providing credit to the business for complete file
- Tax returns and all schedules or attachments and accountant work papers
- All paid bills and receipts
- Notes, Mortgages or other documents evidencing indebtedness
- All 1099 and W-2s issued
- Employment contracts
- Buy-Sell agreement
- List of directors and titles
- Corporate minute book
- Schedule of States where Authorized to Do business
- List of competitors, largest customers and sales volume
- Marketing literature

- List of shareholder's or partners with the percentage owned by the shareholder or partner
- Main suppliers list
- Copies of appraisals of business, real estate or other property

### **Analyzing Discovery Documentation for Economic Benefits**

Once the practitioner has obtained discovery documentation, he or she should pay particular attention to seven particular areas where income issues frequently arise.

(1) **Documents Regarding Automobiles and Vehicle Expense**

In looking at motor vehicle expenses, it is important to go beyond merely looking at the cost associated with the purchase or lease of the vehicle itself. As such, it is vital to analyze the entire suite of automobile-related expenses that may be incurred such as gasoline, parking expenses, routine and extraordinary maintenance, and insurance. If a spouse only uses the so-called "company car" for transportation, driving to work is not a business need. As such, one must look at actual nature of the spouse's employment and job description to determine what is an actual business need in respect of the use of a "company car." Just because a company writes off the expense on its corporate tax return does not make it legitimate. Do not just accept a blanket statement that the Internal Revenue Service conducted an audit and no changes were made to the company's return. One must dig deeper and determine the type of audit conducted. Merely auditing a corporation with no changes to the corporate return does not mean that no personal items were run through the company. One must review the corporate balance sheet, any M-1 adjustments and a depreciation lapse schedule to truly determine whether the company owns any personal automobiles, whether it leases them or whether the company merely pays the cost of the automobile directly for the benefit of the owner-spouse and his family.

(2) Documents Regarding Corporate Credit Cards / Cancelled Checks / Cash Disbursement Journals

The practitioner, by reviewing the company's cash disbursement journal, should be able to ascertain those credit cards for which the company is actually paying. Additionally, the practitioner will need to identify all of the people employed by the company who have credit cards paid by the company and determine their relation to the owner-spouse. It is quite possible that the owner-spouse could be having other employees charge items on behalf of him or her that would not appear on the owner-spouse's credit card even though the company is still paying the expense.

In light of this possibility, one must look at all credit card statements and also look at employee expense reimbursement forms to see what the company actually pays for – the reimbursement could be the way in which a spouse gets to pay back a “straw man” or himself. The next level of analysis is to determine if the reimbursement check was actually deposited somewhere or was cashed. And most importantly, just because an item appears on a business expense form does not render it a legitimate business expense. When going through the cash disbursement journal and any cancelled checks it is good practice for the practitioner to identify all of those payments made to a spouse directly as there could be certain non-payroll checks cashed by the spouse. Also, though seemingly self-evident, it is important to review the back of all checks to see the actual deposit amounts and the account the funds were deposited into because this information could reveal an account the non-owner spouse did not know about; and, this information can also can reveal who cashed the check and this fact could reflect that it was cashed by a different person than that person who appears on the books of the general ledger. A thorough review of corporate payroll records can show payments to relatives, friends, and

paramours who do not actually work at the company or who are “underemployed” by the company (i.e., receiving compensation disproportionate to the work performed).

Analysis of these records should also include comparison of payroll records to corporate health insurance policies to further identify any “phantom” employees. Another important task for the thorough practitioner reviewing payroll and employment records is to look for the recent loss of any former employees who could be a further source of information regarding the owner-spouse. Finally, the practitioner will need to consider where the owner-spouse actually does business. A rigorous analysis of frequent flyer, frequent hotel guest and restaurant points could lead to the practitioner to a pattern of frequent destinations or locations where the owner-spouse conducts “non-business” activities paid for by the company. Relatedly, it is important to review company (and personal) telephone records to reveal possible paramours or business clients or partners that do not show up on books of the company. The extent of all analysis must bear a risk-reward relationship in weighing the cost to the value of the entity and the amount of the adjusted income that could be generated to the owner spouse.

(3) Documents Regarding Depreciation Lapse Schedules

The depreciation lapse schedules are the company’s detailed records of depreciation. These schedules are normally an excellent source of more specific information than what one finds in a corporate tax return. Furthermore, the analysis of these schedules can lead to discovery of unplanned remodeling, upgrading, and replacement of corporate facilities for which the practitioner may otherwise be unaware. It can also indicate the use of funds that ordinarily would have been paid to the owner-spouse and as such, it can represent a reinvestment into the business by the owner-spouse. The thorough practitioner must also be aware of the possibility that certain assets have been expensed by an owner-spouse that do not show up on the corporate

tax return's depreciation lapse schedules. The practitioner can attempt to determine this possibility by a comparison of the depreciation lapse schedules to other items on the corporate balance sheet.

(4) Documents Regarding Insurance Policies

A detailed review of the company's insurance policies can reveal payments for the owner-spouse's home, car, life or disability, long term care insurance policies that are not business related. Furthermore, a review of these documents could reveal assets of which the practitioner is not aware. For example, a property and casualty policy can indicate an automobile driven by the owner-spouse's paramour or a second condominium or home being maintained by the company as a "love nest" for the owner-spouse and his or her paramour.

Finally, life insurance premiums paid for by the company should be reviewed as to who are the selected beneficiaries. Also, sometimes overlooked by practitioners as a hidden asset is a policy's significant cash surrender value or a policy tied to an annuity, which can potentially produce a significant earning stream later. Moreover, the current premiums on insurance policies paid by the company may be an additional tax free economic benefit to the owner-spouse.

(5) Documents Regarding Deferred Compensation and Direct Payments

Review all forms of documentation regarding deferred compensation for evidence of phantom stock and stock appreciation rights that do not otherwise appear as current income. Additionally, review any pension plans for unusual or extraordinary payments credited to the owner-spouse account. This analysis is essential in the event the owner-spouse is attempting to shift income into another year.

Pay attention to any direct payments and/or “house accounts” of the company, i.e., house florist, caterer, liquor retailer, limousine service, travel agency, etc. The practitioner should subpoena records pertaining to these goods and services providers and follow up where appropriate with depositions in order to demonstrate personal spending by the company on behalf of the owner-spouse and perhaps others. For example, scrutinizing third-party vendor documentation, in comparison to corporate documentation, can show deliveries recorded by the company in its records as a delivery to a client, but recorded in the vendor records as a delivery by the vendor to an owner-spouse’s paramour for jewelry, furs or other luxury items.

Finally, it is important to also look at the receipts and/or purchase orders from a company’s office supply vendor or warehouse supply store (i.e., Sam’s Club, Costco) to show any items delivered to an owner-spouse’s personal residence and not to the company.

(6) Documents Regarding Related Party Transactions

It is absolutely vital that, in addition to scrutinizing loans to and from the company, the practitioner also investigate any and all other financial arrangements between the company and any related party to the owner-spouse and whether interest is being paid or received for the loan. For example, the financial investigations should attempt to determine, if a company’s building is leased from a family member, whether the rent is set at above or below market rates; and furthermore if the family member, after collecting the rent, turns over the net profit as a gift to the owner-spouse. In looking at rents, it is always best to have a retained real estate appraiser address this issue as part of the determination of the fair market value of the property.

Also, the practitioner will want to determine if the owner-spouse is “parking profits” – for example, the company may have a venture relationship that is not formalized in

writing whereby a share of profits from vendors are given back to the owner-spouse as a rebate or some other form. The important facts to look for in this regard are changes in a company's customers and vendors and sudden shifts in the costs of goods purchased and sold. Be watchful for the costs of goods being sold without any increases being passed on to the customer. The same analysis should be considered in a business that keeps goods in inventory. Look for significant purchases of inventory at year-end where the owner-spouse can build up the inventory, thereby increasing costs and reducing income which would affect support payments.

An additional consideration to be mindful of is where an owner-spouse may also pay significantly inflated commissions and/or bonuses to an employee at the present time which increases costs and reduces income. If the payment is substantial, the practitioner may need to subpoena the employee to see the reasons for the increase and account for whether the money was really used for the benefit of the employee or an asset purchased for the owner. In such situations, it is advisable that the practitioner retain a compensation expert to show proper compensation to the owner-spouse.

Finally, the practitioner will want to review expenses deducted to ascertain if payments of common household expenses are being paid by the business. In reviewing a spouse's personal records, the practitioner would expect to see payments to utilities, telephone, automobile and home insurance, real estate taxes, health club and/or country club dues, etc. The absence of such expenses by the individual may lead one to ask who is actually paying these expenses. In the absence of payment of such expenses by the individual, the practitioner will want to review the company's utility bills (or other personal expenses) to see if personal utility expenses are "bundled" in with corporate expenses. The practitioner should also determine how many telephones the company is paying for and to whom those phone are assigned by the

company. Furthermore, if the divorcing family is constantly entertaining and traveling but, no such expenses show up in the spouses respective personal bank or credit card statements, the practitioner can be fairly certain that the company is likely paying for these travel and vacation expenses. Importantly, if these type of expenses were paid during the marriage with full knowledge of the non-owner spouse, that party may have liability by reason of signing joint income tax returns. This type of evidence must be presented carefully; the innocent spouse defense generally applies to extreme fact situations involving income tax fraud.

(7) Documents Regarding Cash Transactions

Where applicable, cash is always an important consideration as to whether or not reported as taxable income. Where a company is involved in manufacturing, the practitioner will want to review any company participation in any so-called “back-door” sales that are not recorded by the company. In any event, it is important to compare the company’s bank deposit slips to other company reports that record daily sales and collection activity. For medical, dental and other similar professional practices, the practitioner should review the professional’s appointment book in comparison to the bank deposit slips and other records of daily cash intake.

When the practitioner is dealing with any type of cash business it is important for him or her to review the accounts receivable ledgers closely in search of credit or adjustments. This analysis should make sure that any entry to reduce the company’s accounts receivable was set off with a corresponding deposit to cash. Furthermore, one should review the deposits made to the company’s bank account to determine to what degree the deposit slips only show checks being deposited and not cashed. The deposit slip itself breaks down what is deposited as cash and what is deposited as checks. If it appears from this review that the company is paid only in checks, the practitioner should look at the check detail to ascertain whether all client/customer

checks are being deposited. If not all checks are being deposited, but there are credits to the company's accounts receivable, the practitioner should confirm payments made on outstanding receivable with the clients/customers and, to the extent possible, obtain cancelled checks from the client/customer to review whether the check was cashed or deposited into a separate bank account under the name of the company that does not appear on the books of the company. Finally, another useful endeavor is to select a sample of the cash sales recorded on the company's books and trace them to see if they appear on deposit slips for the same period.

This is another area where lifestyle analysis is critical, Where significant purchase are paid by cash such as jewelry, furs, automobiles, time shares, vacations, etc., if the non-owner spouse knowingly participated, the method of presentation can implicate the non-owner spouse in income tax fraud or tax evasion issues and joint and several liability.

#### Final Review: Checklist of Items to Scrutinize

As the foregoing brief review of the importance of a close analysis of the income tax return and discovery documents made clear, the savvy practitioner must be attuned to certain "red flags." The following list reviews those most frequently "abused" items of personal expense that the owner-spouse may attempt to include or "bury" as an expense of the company:

- Personal insurance expenses such as homeowner, boat, automobile, art, jewelry, liability, disability, life and hospitalization
- Personal clothing, food, liquor, furniture, drugs, gifts, jewelry and flowers
- Personal telephone, water, sewer, electric, gas, utility and cell phone bills
- Gardener, snow removal, repairs and maintenance expenses in personal residence or other vacation or secondary homes
- Personal entertainment expenses, theatre tickets, symphony, sport events, and club dues
- Personal legal or professional fees

- Personal or family members' automobiles – including gasoline, insurance, maintenance, repairs and parking
- Personal and vacation travel and meal expenses including travel and meals for a paramour
- Personal country club, athletic or social club memberships
- Personal maid and cleaning services, alarm, gatehouse, pool and sprinkler systems for personal residence
- Payment of salaries for phantom employees (i.e., relatives, paramours and friends)
- Payment of rent for a paramour's apartment or a second "in-town" or "out of town" abode for the owner-spouse
- Payment of excess rent to an owner-spouse if the spouse is the landlord of the company
- Tuition for children's schooling and tuition for the schooling of a paramour's<sup>t</sup> or relative's children
- Medical expenses not covered by insurance being reimbursed to owner by company paid insurance for expenses paid by company (including surgery for a spouse, paramour, friend or relative)

#### Schedule C: Case Law Review

In an important recognition of the potential distorting effect of Schedule C deductions on income and cash flow, the Court of Appeals of Indiana, in *Beardsley v. Heazlitt*, 654 N.E.2d 1178 (Court of Appeals of Indiana, 1995), considered modifying a child support order based upon a spouse's allegation that there was a "substantial and continuing change in the circumstances affecting the expenses of the children and the income of the parties." *Id.* at 1180. At the time of the modification hearing, the payor spouse was a self-employed attorney who testified that he did not receive a salary, but was paid strictly in the form of dividends from his corporation. The Court of Appeals stated explicitly that Indiana Child Support Guidelines require a careful review of income and expenses from self-employment or operation of a business, and

only deductions for “reasonable out-of-pocket expenditures necessary for the production of income” are considered legitimate reducers of income for calculating child support: included in the term reasonable expenditures was “a reasonable yearly deduction for necessary capital expenditures.” *Id.* at 1181, 1181.

In an unpublished opinion, the Court of Appeals of Kentucky, in *Leonhardt v. Leonhardt*, 2008 WL 275139 (Ky. App. 2008), conducted a review of a Schedule C in an attempt to determine a former wife’s income for purposes of child support. In *Leonhardt*, the former wife operated two cosmetics businesses and prepared Schedule C’s for both of them. Mrs. Leonhardt claimed that approximately \$10,000 in business “losses,” including alleged “inventory losses” should have been deducted from her gross income, but the Court of Appeals, in affirming the trial court’s determination of the wife’s net income, denied her request in part because of the “questionable business practice of selling her inventory below cost . . . .” *Id.* at \*6. Moreover, the Court held that her losses were merely “‘paper losses,’ primarily incurred because she has carried her inventory forward.” *Id.* at \*6. As such, the Court found that Mrs. Leonhardt did not present any evidence to show that the gross receipts of her business were unavailable to meet her support obligation.

In an unpublished decision of the Court of Appeals of Iowa in *In re Marriage of Lance*, 730 N.W.2d 210, 2007 WL 461312 (Iowa App. 2007), the Court of Appeals held that the trial court improperly deducted several Schedule C business expenses from a support payor’s self-employment income. The *Lance* Court noted that certain personal expenses were inappropriately included as business expenses, including utilities and phone and licensing and insurance fees for the payor’s vehicles. *Id.* 2007 WL at \*3. Furthermore, the Court found that the permitted deductions for depreciation “were not reasonably necessary to maintain the business and

artificially reduced [payor's] net income for purposes of calculating child support.” *Id.* 2007 WL at \*3. The Court reversed the trial court’s permitting the deduction of accelerated depreciation and held that straight-line depreciation, rather than accelerated or same-year section 179 depreciation was the only permissible depreciation method accepted by the Iowa Supreme Court. *Id.* 2007 WL at \*3. In *Lance*, the trial court had permitted the accelerated depreciation deduction for a truck that was used only once or twice per week for business purposes and an accelerated depreciation for certain dumpsters purchased in previous years and a single Section 179 deduction for a dumpster purchased in the year of the decision. *Id.* 2007 WL at \*2. The Court noted that these impermissible deductions “significantly reduced [payor’s] net annual income.” *Id.* 2007 WL at \*2.

Not all jurisdictions have the foresight displayed in the foregoing cases. In most states, the practitioner must take responsibility for asking the right questions and garnering information necessary to uncover hidden income. Such questions could include:

- Historically, what has been the parties’ standard of living?
- How much does it cost to maintain that standard of living?
- Are there large amounts of personal debt?
- How is monthly debt serviced?
- Were capital assets acquired that are being depreciated?
- Is the asset being depreciated a business asset?
- Is the depreciation schedule being accelerated?
- Should the depreciation be added back in determining support?
- How are retirement plans funded?
- Is the support payor’s business expanding or contracting?
- For a home office expense, should an imputed deduction be added back for determining support?

These questions only touch the surface of what areas that should be examined carefully. Each expense must be analyzed individually, and general ledgers and charts of accounts must be scrutinized.

But Schedule C deductions are only one of the tactics utilized to deflate income. Often, a support payor may have a substantial non-marital estate, or may receive gifts annually from a parent or family member, yet, he or she will not account for these sources of income in calculating payment of spousal or child support. Courts throughout the country have addressed the issue of gifts with varying results. For example, in the recent Illinois Supreme Court decision of *In re Marriage of Rogers*, 213 Ill.2d 129, 820 N.E.2d 386 (Ill. 2004), the Court considered whether cash gifts and loans received by the Appellant, Mark Rogers, should be considered as income for the purpose of calculating child support. In *Rogers*, the trial court found that Mr. Rogers received \$15,000.00 as his annual salary for a teaching job, but received an additional \$46,000.00 annually in gifts and “loans” from his parents. *Id.* at 133, 820 N.E.2d at 388. Mrs. Rogers argued that the gifts and loans represented a steady source of dependable annual income; that Mr. Rogers never repaid the supposed loans; and he had never paid taxes on the loans or gifts. *Id.* at 134, 820 N.E.2d at 389. The appellate court upheld the trial court’s decision to include the gifts and loans as part of Mr. Rogers’ income for support purposes, and the Illinois Supreme Court affirmed. The Supreme Court found that even if the gifts were not subject to taxation by the federal government, “[t]hey represented a valuable benefit to the father that enhanced his wealth and facilitated his ability to support” his child. *Id.* at 137, 820 N.E.2d at 390.

Although the Illinois court considered the pattern of gifts from parent to child as income for support purposes, other states have held that payors with support obligations do not have to

access the corpus of trusts established for their benefit to pay support. In the Pennsylvania Supreme Court case of *Humphreys v. DeRoss*, 567 Pa. 614, 790 A.2d 281 (2002), the Court held that trust principal cannot be utilized as income for support. A similar opinion was issued in the Pennsylvania Supreme Court case of *Maher v. Maher*, 575 Pa. 181, 835 A.2d 1281 (2003).

#### Subchapter S Shareholder and Retained Earnings Issues

While, as noted above, a tax return can often severely understate a spouse's income, it is equally important to note, however, that tax returns can sometimes present an inflated picture of a taxpayer's income. There is no bright line rule as to Subchapter S income. Subchapter S corporate shareholders often file tax returns reporting earned income far in excess of the money the taxpayer actually receives. A Subchapter S Corporation is a corporation which has elected a special tax status with the IRS, allowing the corporation's income to be treated like the income of a partnership or sole proprietorship, with the income "passed-through" to the stockholders. Subchapter S shareholders avoid paying income taxes on two levels, corporate and individual, and are only required to pay taxes individually. The stockholders report the income or loss generated by the S-Corporation on their individual tax returns regardless of whether the stockholders actually receive distributions of S-Corporation income. 26 U.S.C. 1366 (West 2009). The same analysis should apply to Limited Liability Corporations and Limited Liability Partnerships.

Many times, income from S-corporations are not a form of cash flow, but instead represent a disbursement used simply to offset pass-through shareholder tax liability; often the shareholder reports their share of corporate income and receives funds from the corporation to pay their taxes on this income. The taxpayer is reporting income from the Subchapter S entity but not actually receiving the money. *Tebbe v. Tebbe*, 815 N.E.2d 180, 184 (Court of Appeals of

Indiana, 2004). In *Tebbe*, David Tebbe was a minority shareholder of a company called Tebbe-Butler, Inc (“TBI”). In 1999, 2000, 2001, and 2002, Mr. Tebbe reported pass-through income that he did not actually receive. In fact, TBI paid Mr. Tebbe an amount sufficient to offset his tax obligations incurred from claiming TBI’s earnings as part of his annual income. Nonetheless, the trial court found that this pass-through income Mr. Tebbe reported from TBI should be included when calculating his child support obligation. The Indiana Court of Appeals reversed, stating that “[h]ad TBI not disbursed money to offset [Mr. Tebbe]’s corporate tax liability, [his] actual income would have been less than that represented by his yearly salary.” *Id.* The Court found that undisbursed pass-through income of a minority shareholder in an S-corporation should not be included in child support calculations unless the trial court finds the corporation is being used to shield income. *Id.* Other state court decisions have been consistent with *Tebbe*.<sup>1</sup>

*Tebbe* was narrow in scope in that it dealt specifically with minority shareholders, but other courts have made the same observation as the *Tebbe* court regarding income shielding using an S-corporation, and have issued opinions consistent with *Tebbe*. In the Arkansas case of *Anderson v. Anderson*, 60 Ark.App. 221, 963 S.W.2d 604 (1998), Tom Anderson was a shareholder in a closely held family business (“AMCO”). He appealed a lower court’s ruling that he should pay \$1,267 of alimony and child support each month, which was calculated exclusive of retained earnings in the business, but inclusive of the taxes on the earnings that he paid. His argument was that the lower court failed to consider the income taxes he paid on a portion of his 24% share of earnings that was retained by the business. The appellate court upheld the lower court’s decision in *Anderson*, and stated that they were to follow Mr. Anderson’s logic, “[a] subchapter S-corporation shareholder . . . would have an incentive to keep most or all of his

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<sup>1</sup> See *Taylor v. Taylor*, 118 N.C.App. 356, 455 S.E.2d 442 (1995); *Roberts v. Wright*, 117 N.M. 294, 871 P.2d 390 (Ct.App.1994); *Lendman v. Lendman*, 157 Wis.2d 606, 460 N.W.2d 781 (1990).

shareholder income as retained earnings by the corporation. The greater the percentage of his income that the shareholder has retained by the corporation, rather than distributed to him, the lesser will be his income available to pay child support.” *Id.* at 230, 963 S.W.2d at 609.

Another Arkansas opinion, *Pannell v. Pannell*, 64 Ark.App.262, 981 S.W.2d 531 (1998), addressed the issue of including retained earnings in income for calculating support. In *Pannell*, Vick Pannell argued that the lower court erred in considering undistributed income retained by his wholly owned S-corporation when calculating his support obligation. *Id.* at 267, 981 S.W.2d at 534. The Court of Appeals rejected Mr. Pannell’s argument, distinguishing this case from *Anderson* by reasoning that Mr. Pannell was “the sole owner of his S-corporation, and, as such, ha[d] complete control over [distribution of] the retained corporate earnings”, while Mr. Anderson held only a minority interest. *Id.* at 269, 981 S.W.2d at 535.

More recently, the Tennessee Supreme Court ruled in *Taylor v. Fezell*, 158 S.W.3d 352, 354-55 (2005), that absent a showing that retained earnings are excessive, or that the shareholder is manipulating his income, the retained earnings should not be imputed as income in calculating support obligations. In that case, the lower court calculated support based upon an average of income for three years prior to the divorce. Included in that average, was an imputation of all retained earnings in the S-Corp to the husband as income. The appellate court affirmed the ruling of the lower court, but the Supreme Court reversed, finding that inclusion of the retained earnings as income was improper. *Id.* at 359. In its opinion, the Supreme Court recognized that although the potential for manipulation of income existed in the S-Corp context, absent specific evidence of malfeasance, retained earnings should be treated as indicated by their corporate function; in this case, the retained earnings made possible a proper level of corporate credit and ensured the corporation’s ability to meet routine operating expenses. *Id.* at 358. The Court also

emphasized that no presumption of manipulation should arise, if the level of retained earnings remained constant both before and after the divorce filing. *Id.* at 358. Finally, the Court acknowledged the need for expert testimony to ascertain the appropriate level of retained earnings from industry to industry. *Id.* at 358.

In the case of *In re Marriage of Brand*, the Kansas Supreme Court warned against relying on tax returns as the sole evidence of income for the purposes of determining child support obligation. The Court stated that taxable S-Corporation income attributable to a shareholder did not reflect actual income if not distributed. *In re Marriage of Brand*, 273 Kan. 346, 357, 44 P.3d 321, 328 (2002). The Court further stated that there was “no presumption that an individual’s share of S-Corporation income should be included as income for purposes of calculating child support.” *Id.* at 356, 44 P.3d at 328. However, the *Brand* Court provided three factors to determine whether S Corporation income should be included as income: (1) the corporation’s past earnings history, (2) ownership share and (3) the shareholder’s ability to control distribution or retention of the net profits of the company. *Id.* at 359-60, 44 P.3d at 330.

Likewise, in *Taylor v. Taylor*, the North Carolina Court of Appeals reversed the trial court’s calculation of the shareholder’s income for a child support determination because the amount actually distributed to him was significantly lower than the amount reported on his income tax returns. *Taylor v. Taylor*, 118 N.C.App. 356, 455 S.E.2d 442, (1995) *rev’d on other grounds*, 343 N.C. 50, 468 S.E.2d 33 (1996). The *Taylor* court emphasized that the allocated income amount for the purposes of state and federal income tax returns which was used by the trial court did not represent the actual income received by the obligor as cash distributions. Because the trial court ignored the obligor’s actual cash flow and ability to pay child support, the trial court committed a reversible error. *Id.* at 364, 455 S.E.2d at 447-48.

In *Walker v. Grow*, 170 Md. App.255, 907 A.2d 255 (Md. App. 2006), the Court of Special Appeals of Maryland, citing extensively both *Brand* and *Tebbe*, held that,

in determining a parent's actual income for child support purposes, a trial court can consider whether subchapter S income shown on a parent's tax return was actually received by the parent as actual income, or constituted pass-through income not available for child support. Distributions from an S corporation that are used to fund ordinary and necessary business related investments are not required to be included in the computation of the parent's actual income.

*Id.* at 281, 907 A.2d at 270.

In *Brand*, *Walker*, *Taylor*, and *Tebbe*, the shareholder-obligor reported some pass-through S-Corporation income on his tax returns, but it was not actually distributed. The Kansas, North Carolina, and Indiana courts all agreed that income not actually received by the shareholder obligor should not be included in child support calculations.

Other states have found that where earnings are retained in a manner consistent with pre-divorce practices, and they are retained for a legitimate business purpose, they ought not to be imputed as income for the purposes of calculating maintenance or child support. In the case of *Lendman v. Lendman*, 157 Wis.2d 606, 460 N.W.2d 781 (1990), the Wisconsin Court of Appeals affirmed the trial court's refusal to include retained earnings of the close corporation as "part of the equation" for determining income. *Id.* at 609, 460 N.W.2d at 782. The Wisconsin appellate court first referred to authoritative literature to support the general proposition that it is necessary for businesses to retain earnings. The Court then provided an explanation as to the applicability of that general principle to the case before it. In referring to circumstances when retained profits remain within the corporation instead of being distributed, the appellate court stated:

This surplus might be divided among the stockholders of the corporations as fast as it accumulated. In practice, however, this is not ordinarily done. . . . The general purpose of this accumulated surplus is to increase resources, the reputation, the credit standing and the stability of the corporation. . . . From the standpoint of general stability, a substantial surplus acts as a "shock absorber" to

take up the financial “jolts” encountered in its course by the corporate mechanism. If some extraordinary loss is incurred, or if a bad year turns anticipated profits into losses, an adequate surplus interposes to prevent any impairment of capital or curtailment of operations. . . . A substantial surplus also permits the easy increase of stated capital . . . .

*Id.* at 615, 460 N.W.2d at 785 (quoting WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS 543-44 (rev. ed. 1988)). The court ultimately declined to write a “bright-line rule” regarding retained earnings and instead proposed a case-by-case analysis to determine whether “retained earnings might be a necessary adjunct of a well-managed corporation or a pretext for a one-man band shareholder to keep profits from being considered by the family court for maintenance.” *Id.* at 615, 460 N.W.2d at 785. The court held that acting as a “shock absorber” in the face of “continually declining earnings . . . to permit the capitalization of surplus” was a legitimate business purpose. *Id.* at 615, 460 N.W.2d at 785. *See also* Roberts v. Wright, 117 N.M. 294, 871 P.2d 390 (Ct.App.1994) (holding shareholder’s retained earnings would not be income where they were used for normal operating costs).

In the Pennsylvania Supreme Court case of *Labar v. Labar*, 557 Pa. 54, 731 A.2d 1252 (1999), the payee spouse argued that funds used for capital expenditures should have been disbursed to shareholders as income. The Supreme Court found that the argument of the payee spouse implied that the corporation “could have elected to disburse to its shareholders” and that (capital expenditures) “were unnecessary disbursements made to shelter cash flows from the support obligation . . . .” *Id.* at 62, 731 A.2d at 1256. The court said in such event, as in the case of retained earnings, the payor spouse has the burden of showing this decision regarding possible distributions to shareholders was “necessary for the continued operation and smooth running of the business.” *Id.* at 62, 731 A.2d at 1256.

At the moment, imputing the retained earnings of a taxpayer as income for support purposes would be contrary to the weight of existing case law from a majority of jurisdictions around the country.

### Shareholder Loans

Shareholder loans can affect reported income. Loans to shareholders can be a way to both provide funds to the owner-spouse without paying taxes and generate cash flow to shareholders. These loans need to have a proper purpose, should be documented and bear interest to the entity. If a business is non-marital and the owner takes out a loan and makes an investment with the loan proceeds, the owner will claim the asset purchased is non-marital. This issue gives rise to whether or not the owner was reasonably compensated for personal effects expended during the marriage. If in the hypothetical, the same funds could have or should have been deemed as compensation, the subsequent investment with earned income would have changed the characterization of the asset purchased.

Also, a shareholder paying off previous loans made to the company by an owner-spouse can be a way to change the characteristics of funds obtained by the spouse. The important thing for the practitioner to remember is that, no matter what it is officially termed, the loan may be an economic benefit to the owner-spouse that warrants further scrutiny.

Loans from an entity to the shareholder or partner are tax-free and exempt from any taxes. These loans should be considered either in determining the recipient's cash flow or in determining whether the loan is disguised as compensation. The loan is not a deductible expense to the entity and, although the entity pays more in taxes, there should be a rate of interest charged to the recipient.

The repayment of any loans made to or from a shareholder should appear on Schedule L of the corporate balance sheet included in the corporate return. To be completely thorough, a review of the general ledger or entity balance sheet should also be conducted, as the K-1s do not have to be prepared until the entity files an income tax return. As a consequence, while the divorce is pending, the cash-flow analysis is incomplete.

In examining the legitimacy of such loans, one must consider the past history of the company. For example, one should ascertain whether the company has ever before loaned money to the shareholders or borrowed money from the shareholders. If the company has loaned money to the shareholder in the past, has interest been charged or imputed, and how long did it take to repay the loan? If the company has borrowed money from the shareholders in the past, one must determine whether it was the practice of the company to pay down these shareholder loans or paid interest on the loans. One should also compare loan payments to other factors related to the company, such as whether shareholder salaries have decreased while shareholder loans have simultaneously increased.

It is crucial that the practitioner look for trends. A close analysis of the company's balance sheet along with a comparison of loan activity for other owners of the company will be most helpful in this regard. If the company is a Subchapter S Corporation, the loan will show up on the Schedule K-1 if the loan is repaid to the shareholder by the company. If the loan does not appear on the Schedule K-1, the practitioner should review the company's general ledger to see the official classification the company used. Misclassification could indicate an attempt to disguise distributions to the owner/shareholder-spouse.

A recent Tennessee decision highlights this fact. In *Pruett v. Pruett*, 2008 WL 182236 (Tenn. Ct. App. 2008), the Court of Appeals of Tennessee affirmed the trial court's

determination of a support obligor's income and in a passage that warrants quotation at length, stated:

[W]e are not unmindful that Father can treat money taken in by these companies and paid out to him as a loan repayment of money loaned by him and thereby avoiding any income tax liability. This is perfectly legal. However, this does not mean that none of the money coming in to the businesses and to Father should be considered as income for purposes of calculating child support. For example, assume that Father loans his business \$1,000,000. Also assume that: (1) this business is Father's only source of income; and (2) the business is profitable and after paying all necessary expenses, there is remaining profit of \$100,000 each year for the next ten years. According to Father, he would have no income whatsoever for purposes of paying child support so long as he repays himself the \$100,000 each year in order to pay back the amount of the original loan. Our adoption of Father's position would mean that a parent in the financial situation and control of a business such as Father's could successfully avoid paying any child support by loaning money to his business and then receiving from that business during his children's minority only "loan repayments." Such a result would be untenable.

*Id.* at \*8.

#### LLC's, LLP's, and Other Partnerships

The LLC and LLP, and other partnerships, can pose additional challenges to the gatherer of income information, even beyond those posed by the Subchapter S Corporation. For example, in the partnership context, where partners have capital accounts, the balances in those accounts often bear no relation to the partner-spouse's ownership interest in the entity or the amount of money due him or owed by him upon his departure from the partnership; a partner with a negative capital account does not necessarily owe the partnership money beyond his earnings once he leaves the firm. Contrarily, a partner with a surplus in his capital account is not necessarily cash-rich. Often, such additional money is earmarked for investments or other special needs of the partnership. The practitioner must remember that all money held in a capital account already had been taxed, but the money need not be drawn down in the same tax year. This delay between the "earning" of income and the use of it can result in its slipping through the

proverbial crack for purposes of calculating support. Alternating the member of the entity can also withdraw money from their capital account on a tax-free basis. The withdrawal of funds, although not taxable, is cash flow and a source available for payment of support. At all times, the partner-spouse bears the burden of showing that earnings retained in this fashion are held for a legitimate business purpose. No understanding of the capital account system is possible without a thorough review of all partnership documents with special attention paid to the initial capitalization of the partnership.

To assess the level of partnership distribution to a partner-spouse, attention must be directed to the K-1 statements issued by the partnership, because no tax-free distributions from the partnership will appear on the individual tax return. K-1's will also reveal the presence of any loans owed by or to the partner, as discussed below.

#### Reasonableness of Spousal Compensation

Shareholders of S Corporations or other types of pass-through entities or partnerships will often seek to minimize their income from employment even outside the context of divorce for purposes of keeping their employment taxes low. Once a divorce is filed, however, this tax lowering strategy can take on new dimensions as shareholders may also try to minimize their reported income for purposes of calculating support. The most obvious means of lowering income is simply to take an inappropriately low salary in respect of the value of services rendered by the shareholder to the entity. In a closely held S Corporation, for example, a single shareholder can often have unilateral control over how much salary is apportioned to him by the corporation. In such cases, it is important to benchmark the shareholder's salary as against the salaries of others in the industry who perform similar services, and as against the other employees or shareholders of the entity in question, if any. If the shareholder-spouse's salary is

not comparable, a higher salary can be imputed to him by the court. It is important to note that a salary is subject to FICA, FUTA and SUTA (Federal and State Unemployment Taxes) and Medicare deductions whereas Sub-S distributions are only subject to Federal and State taxes at the taxpayer's rate, which is predicated upon the amount of taxable income that will be reported. Since there are no restrictions on when the distributions can be made, this is another strategy where the recipient's cash flow should be closely scrutinized. This is compensation disguised in the form of profit distribution.

In *Morgan v. Morgan*, 2005 WL 3533282, slip op. (Tenn.Ct.App. 2005), the Court of Appeals of Tennessee affirmed a lower court ruling that calculated a husband's income for support purposes as the salary he withdrew, plus the amount of money distributed to him from the S Corporation, because it found that his self-appointed salary was too low. At trial, father's own expert witness had testified that hiring a third party to perform the services the husband rendered to his company would cost \$110,000, yet the husband had drawn salary of only \$32,000. *Id.* at \*1. The court was quick to point out that the trial court imputed additional income to the husband, not because the retained earnings of the company were deemed excessive, as husband argued the trial court had done, but because the salary he elected to take was unreasonably low. *Id.* at \*4-5.

Similar income-lowering strategies can be employed by almost any member of an entity where the spouse can exercise control over the amount of money withdrawn from the entity in the form of salary. In each instance, if the salary taken is not reasonable in respect of the industry, the entity, other shareholders, the spouse's ownership interest in the entity, or the spouse's prior wage-earning history, income can be imputed by a court to be used in support calculations.

## **CONCLUSION**

The purpose of this article was to acquaint the reader with only a number of ways in which income tax returns, when considered alone, can distort the reality of income and cash flow in a case. In all cases, even those that seem simple and straightforward, the practitioner must understand that tax returns can hide as much as they reveal and therefore can serve as only one of many sources of financial information to be considered before income and or cash flow can be established accurately for purposes of setting or defending an order for support.

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