

***DEVELOPING INCOME INFORMATION
FROM A SCHEDULE C AND AS A SHAREHOLDER
OF A CLOSELY HELD CORPORATION**

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Individual income tax returns are the most accessible source of information that lawyers and judges use in ascertaining net income for purposes of setting support. In reality, however, tax returns can be deceiving, and net taxable income may not be at all similar to the payor's net cash flow. It is common for a payor of spousal or child support to execute financial affidavits that list reported taxable income, as opposed to income actually received, in an effort to minimize support obligations. Payors of 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. Conversely, a party's tax return can create the impression that the taxpayer is receiving far more income than he really does. The important thing to remember is that the contents of a tax return, depending on the nature of a party's income and the type of return he or she files, can be used to distort reality either to the benefit, or detriment of the taxpayer.

Consider the following: when an individual is the sole proprietor of a business, he reports business income using Schedule C. The Schedule C form provides several lines (lines 8 through 18) for expenses, such as an automobile expense, depreciation, several categories of travel expenses, and office expenses, including a deduction for a home office. If the business owner

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pays personal expenses through the business (such as his car, insurance, lease payments, personal meals, or family vacations) and reports them on Schedule C, the taxable income generated by the business would be reduced by the cost of these personal expenses, and would appear much lower on the tax return than it is in actuality. And, any enumerated depreciation expense does not represent an actual cash outlay. Indeed, under certain circumstances, depreciation expenses can be added back to the business to determine cash flow.

The Indiana Courts, for example, are attuned to the potential distorting effect of Schedule C deductions on income and cash flow. In Beardsley v. Heazlitt, 654 N.E.2d 1178 (Court of Appeals of Indiana, 1994), the Court of Appeals of Indiana considered modifying a child support order based upon Mr. Beardsley'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, Mr. Beardsley was a self-employed attorney. He testified that he did not receive a salary, but was paid strictly in the form of dividends from his corporation. The Court 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 reasonable expenditures is a reasonable yearly deduction for necessary capital expenditures. Id., at 1181.

Not all jurisdictions have the foresight that Indiana displayed in the Beardsley opinion. In most states an attorney 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 skim 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 (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. 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. 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, they

represented a valuable benefit to the father that enhanced his wealth and facilitated his ability to support his child. Id., at 137.

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).

It is important to note, however, that tax returns can sometimes present an inflated picture of a taxpayer's income. Subchapter S corporate shareholders often file tax returns indicating 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. 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 2004).

Many times, income from S-corporations are not a form of cash flow, but instead a disbursement used simply to offset pass-through shareholder liability. Tebbe v. Tebbe, 815 N.E.2d 180 (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 received from TBI should be included when calculating his child support obligation. The appellate court reversed, stating that if TBI had 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., at 184. 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., at 184. Other decisions have been consistent with Tebbe.*

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 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.

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

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. 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, had complete control over distribution of the retained corporate earnings, while Mr. Anderson held only a minority interest. Id., at 269.

Many courts throughout the country have 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 (1988); see also In re Marriage of McGowan, 265 Ill.App.3d 976, 979, 638 N.E.2d 695 (1994) (stating that "income" for tax purposes is not synonymous with "income" for determining child support.)

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 does 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. (internal citations omitted.)

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. 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. The trial court ignored the obligor's actual cash flow and ability to pay child support, the trial court committed a reversible error. Taylor v. Taylor, 118 N.C.App. 356, 364, 455 S.E.2d 442, 448 (1995) *rev'd on other grounds*.

In Brand, 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.

Illinois courts have yet to address the issue of retained earnings and their relation to support awards, but other states unanimously 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 In re Marriage of Lendman, 460 N.W.2d 781, 157 Wis.2d 606 (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. 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 court by the corporate mechanism. If some extraordinary loss is incurred, or if bad years turn 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 p.614-615, citing Fletcher Cyclopedia of the Law of Private Corporations (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. p.615. 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. 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, 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 made an election to disburse to its shareholders” and (capital expenditures) were “unnecessary disbursements made to shelter cash flows from the support obligation.” 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 p. 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.

The purpose of this article was to acquaint the reader with only a few of the ways in which 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 can be established accurately.