A PRIMER ON BUSINESS ENTITIES AND THEIR IMPACT ON DIVORCE

By: Barry A. Schatz, Esq.
Berger | Schatz
161 North Clark Street
Suite 2800
Chicago, Illinois 60601
(312) 782-3456
Email: bschatz@bergerschatz.com

Date: January 16, 2006

Introduction

This Article will discuss the ways in which various business entities impact income and cash flow for purposes of calculating maintenance and child support. Traditionally, individual income tax returns and the tax returns of partnerships or corporate entities, where relevant, have been the primary source of information lawyers and judges use in ascertaining net income for purposes of setting support. In reality, tax returns, and other financial documents prepared for small business entities 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, in an effort to minimize support obligations, as opposed to money actually received. It is also the case that a party's tax return may, in some cases, create the impression that the taxpayer is receiving far more income than the taxpayer really does receive. The important thing to remember is that the contents of individual and small business tax returns can be used to distort reality either to the financial benefit, or detriment of the taxpayer.

Schedule C: The Sole Proprietor

The sole proprietor of a business reports 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 pays personal expenses through the business (such as his car, insurance, lease payments, personal meals, or family vacations) and deducts them on Schedule C, the taxable income generated by the business 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. And, any enumerated depreciation expense 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.

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?
- How is compensation paid – by salary with taxes withheld or with distributions?
- How are distributions determined and when have they been paid historically?
- Are all partners, members or shareholders treated the same, similarly or unequally?
- If differently, when, why and how?

These questions only skim the surface of what areas that should be examined carefully. Each expense must be analyzed individually, and general ledgers, charts of accounts, capital accounts and K-1 statements must be closely scrutinized.

Subchapter S Shareholder

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 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. 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 reported 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 state court decisions have been consistent with Tebbe.[1]

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

---

[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).

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 the 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.

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.

Most recently, the Tennessee Supreme Court ruled in Taylor v. Fezell, 158 S.W.3d 352 (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. 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. 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. Finally, the Court acknowledged the need for expert testimony to ascertain the appropriate level of retained earnings from industry to industry.

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 uniformly 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 (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 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.

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 a 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.

<u>Reasonableness of Compensation</u>

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-Corp, 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 taxpayers 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 (Tenn.Ct.App.)(slip opinion), the Tennessee court of appeals 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. 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.

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.

Shareholder Loans

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 trends of the company. For example, one should learn 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.

Other Considerations in Determining Overall Income

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.)

Often, a support payor may have a substantial non-marital estate, or may receive gifts or "loans" 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).

Conclusion

The purpose of this Article was to acquaint the reader with only a few of the ways in which corporate structuring and the related 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. In particular, practitioners should be alert to the possible manipulations of salary, capital accounts, and partnership income as offset by retained earnings when arriving at an income figure for calculating support.