"*Riddle* Me This"

1

"Sloppy Lawyers, Sloppy Forensics"

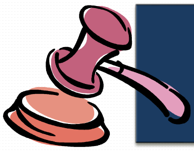
In re Marriage of Riddle (2005)
125 Cal.App.4th 1075, 1080:
"While we recognize that family lawyers and forensic accountants sometimes use the phrase '**cash flow**' as a
sloppy synonym
for the word '**income**'
as it appears in the support statutes, **it isn't.**"
[OUCH!]

2

Pot indictment: "Kettle is BLACK!"

We will see how consistent **legislatures** and **appellate courts** have been regarding taxable income vs. cash flow

3



Three Acronyms

4

Business
Income
Available for
Support

"BIAS"

5

Two Approaches to BIAS:

Income Tax Approach "ITA"	Cash Flow Approach "CFA"
Income	**C**ash
Tax	**F**low
Approach	**A**pproach
"ITA"	**"CFA"**

6

Overview of Facts

7

In re Marriage of Payor and Recipient

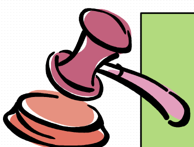
Pat Payor and Robin Recipient are divorcing.

Payor, a 40% member in the ophthalmology LLC called "Payor Eye Care," receives "guaranteed payments" and K-1 distributions.

Robin, the children's primary custodial parent, will receive child support and spousal support.

Issue: What LLC income should Judge Solomon attribute to Payor when calculating support?

8



Overview of our Five Issues

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#1: Loan Principal Payments

Loan principal payments defined:

Payments that reduce the outstanding balance of a loan. These are not deducted in determining the taxable income of the business. But they are cash expenditures.

10

#1: Loan Principal Payments

LLC makes **Principal Payments** and interest payments on a loan it used to purchase a new Lasik machine.

- Under ITA (which Recipient favors), the **Principal Payments** don't reduce BIAS.
- Under CFA (which Payor favors), the **Principal Payments** do reduce BIAS.

11

#2: Depreciation

Depreciation defined:

The allocation of a capital expenditure over the useful life of the asset.

It is deducted in determining taxable income for a given period.

#2: Depreciation

The LLC's new Lasik machine has a five-year useful life, with no salvage value.

- Under ITA (which Payor favors), **depreciation** reduces BIAS.
- Under CFA (which Recipient favors), **depreciation** is added back and increases BIAS.

#3: Phantom Income

Phantom income defined:

That portion of the taxable income from a pass-thru entity (e.g., partnership, LLC or Sub-S corporation) that is not distributed.

#3: Phantom Income

Although Payor's K-1 shows $480,000 in LLC income, Payor only received distributions of $300,000 – resulting in **phantom income** of $180,000.

- Under ITA (which Recipient favors), Payor has $480,000 in BIAS.
- Under CFA (which Payor favors), Payor has only $300,000 in BIAS.

Mirror Images (Both Sides of Your Mouth)

PAYOR CONTENDS:

#1 Deduct Principal Payments? **YES** - (CFA)
#2 Add Back Depreciation? **NO** - (ITA)
#3 Ignore Phantom Income? **YES** - (CFA)

RECIPIENT CONTENDS:

#1 Deduct Principal Payments? **NO** - (ITA)
#2 Add Back Depreciation? **YES** – (CFA)
#3 Ignore Phantom Income? **NO** – (ITA)

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Let's hear
more facts . . .

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Three Concepts:

"**To expense**" **means t**o deduct an item as a cost of doing business to determine taxable income for a given period.

"**To capitalize**" means to recognize the **a**cquisition of an asset expected to last more than one year.

"**To expend**" **means to p**ay out money for something.

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“Expense” vs. “Expenditure” in Kansas

Kansas’ *In re Marriage of Lewallen*
21 Kan. App. 2d 73 (1995):

The term “reasonable business **expenses,**” as used in the Kansas child support guidelines, is limited to actual “**expenditures**” necessary for the production of income.

19

“Expense” vs. “Expenditure” in Delaware

Delaware’s *Turner v. Turner*
586 A.2d 1182 (1991):

Accelerated depreciation is an **expense** which does not involve any **expenditure** of funds and, therefore, was not an appropriate deduction from income when determining child support.

20

“Expense” vs. “Expenditure” in California

California’s *Asfaw v. Woldberhan*
147 Cal.App.4th 1407, 1420 (2007):

“. . . an **expenditure** involves the paying out of something, usually cash, for, by way of example, rent, equipment or inventory.

By contrast, an **expense** is the cost of doing business and may or may not involve an actual payment of money.”

21

Where Are These Three Concepts Reflected on the Financial Statement?

Expense – income statement

Capitalization – balance sheet

Expenditure – balance sheet, income statement and/or statement of cash flows

22

Principal Payments Issue:

Recipient favors ITA: Principal Payments Should Not Be Subtracted to Determine BIAS

23

Kentucky Revised Statutes § 403.212(b):

“**"Gross income" includes income from any source**, except as excluded in this subsection, **and includes but is not limited to** income from salaries, wages, retirement and pension funds, commissions. , bonuses, dividends, severance pay, pensions, interest, trust income, annuities, . . .

24

Infernal Rev. Code § 61:

"Gross . . . income means all **income from whatever source derived, including (but not limited to)** the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items . . . . (2) Gross income derived from business . . . ."

25

IRMO Schulze 30 Cal.App.4th 519, 529 (1997):

"…the operative language in subdivision (a) [of Family Code § 4058] i.e., 'annual gross income… means income from whatever source derived,' **was lifted straight from** the definition of income in section 61 of **the Internal Revenue Code**."

26

IRMO Loh 93 Cal.App.4th 325, 334 (2001):

"A parent's gross income, as stated under penalty of perjury on recent tax returns, should be presumptively correct. * * * Returns are, after all, ultimately enforced by federal and state criminal penalties. Hence it is not surprising that **tax returns are the core component of determinations under the guideline formula**."

27

IRMO Riddle 125 Cal.App.4th 1075, 1080 (2001):

"... **if the tax laws say you have income** because of the forgiveness-of-debt, **you have income**, and that forgiveness-of-debt income must go into the [child support] calculation."

28

Kentucky: ITA Presumed Wrong

Kentucky Revised Statutes § 403.212(c):

"Income and expenses from self-employment or operation of a business **shall be carefully reviewed** to determine an appropriate level of gross income available to the parent to satisfy a child support obligation. In most cases, this amount **will differ from a determination of business income for tax purposes**. "

29

Alaska: Two "No Reduction" Rationales

R. Eagley v. L. Eagley 849 P.2d 777 (1993) states two reasons why principal payments should not reduce BIAS:

"... principal payments constitute an investment which increases [payor's]equity in the business."

"... the amounts of principal required to be paid by [payor] are negotiable and can be manipulated to shelter income during the minority of the child."

30

Principal Payments Issue:

Payor Favors CFA: Principal Payments Should Be Subtracted to Determine BIAS

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ITA Creates Harsh Results

"Forgiveness of debt taxable income" is the harshest example of the conflict between ITA and CFA.

For tax purposes, forgiveness of debt is recognized income.

However, for cash flow purposes, under no circumstances does it provide cash to pay living expenses.

32

Principal Reduction Payments: An Example of the Problem

Consider principal payments made by a commercial real estate landlord.

Aren't these payments **REQUIRED** to continue in the commercial rental business?

33

Cal. Fam. Code § 4058(a):

"The annual gross income of each parent . . . includes, but is not limited to . . . : * * * (2) **Income from** the proprietorship of **a business**, such as gross receipts from the business **reduced by expenditures** required for the operation of the business."

34

Principal Payments are "Expenditures"

Principal reduction payments are "**expenditures**" . . .

. . . and many states (including California) recognize that "**expenditures**" should be deducted in determining BIAS.

35

Payor vs. Recipient Contentions:

Pat Payor (CFA):

- Payments are necessary expenditures
- Cash is currently unavailable
- Cash was unavailable pre-divorce

Robin Recipient (ITA):

- Loan proceeds weren't BIAS
- Payor is building equity
- Principal payments can be manipulated

36

Depreciation Issue

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Depreciation Issue:

Recipient favors CFA:
Depreciation Should Be Added Back
to Determine BIAS

38

A Question for you . . .

How many of you believe that the investment real estate you buy today will be worthless in 27½ yrs. (residential investment) or 39 yrs. (non-residential investment)?

39

Adding Back *Real Estate* Depreciation Makes Sense Because:

Real property is not "consumed."

There is no loss of value by the continued use of the asset.

Maintenance and repairs are being expensed.

40

California disallows real estate depreciation

Asfaw v. Woldberhan 147 Cal.App.4th 1407 (2007) prohibited a father from deducting **rental property depreciation** from his gross income for purposes of child support calculation.

Since depreciation is not an "expenditure," it cannot be subtracted from BIAS.

41

Add It Back!

The *Asfaw* court observed that since depreciation **has been deducted** in the tax return to determine taxable income, the depreciation **must be added back** to determine BIAS.

42

Delaware disallows accelerated depreciation, but allows straight-line depreciation

Delaware's *Turner v. Turner* 586 A.2d 1182 (1991):

Accelerated depreciation is an expense which does not involve any expenditure of funds and, therefore, was not an appropriate deduction from income when determining child support.

The court noted this ". . . '**cash flow**' **approach** resulted in a substantial . . . increase the child support . . . ."

43

Alaska disallows accelerated depreciation, but allows straight-line equipment depreciation

R. Eagley v. L. Eagley 849 P.2d 777 (1993) holds that accelerated depreciation, which exceeds actual (economic) depreciation, must be added back to income to determine BIAS.

"Depreciation is a means of reflecting on an annual basis the costs of capital equipment. Such costs are real and should not be disregarded . . . ."

44

Iowa disallows IRC § 179 deduction, but allows straight-line depreciation

In re Marriage of McKamey 522 N.W.2d 95, 99 (1994):

"Under the circumstances of this case, [payor] should be allowed a deduction for depreciation; however it should be determined by using the straight-line method of depreciation rather than . . . [a] same-year section 179 expense deduction."

45

The IRC § 179 deduction

An IRC § 179 expense deduction allows a party to elect to deduct the entire cost of certain business assets from current income rather than depreciating the assets over the length of their useful life. (26 USC § 179.)

The entire cost is deducted as an expense in the year of acquisition.

46

Depreciation Issue:

Payor Favors ITA: Depreciation Should Not Be Added Back to Determine BIAS

47

Should *Personal Property Depreciation* Be Added Back to BIAS?

"Our opinion addresses only depreciation deductions from rental income. The parties do not raise, and **we have not considered, other types of depreciation, such as for equipment . . . .**"

Asfaw v. Woldberhan (*supra*) at p. 1426, fn. 12

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Webster on "expenditure"

"... '**expenditure**' is derived from 'to expend' which **means** 'to pay out or distribute: spend; ... **to consume by use**.' (Webster's 3d New Internat. Dict. (1981) p. 799.) (*Asfaw, supra*. at p. 800.)

Adding Back *Personal Property* Depreciation Doesn't Make Sense Because:

Personal property IS "consumed."

Personal property wears out and becomes obsolete.

Personal property has a limited useful life ("economic depreciation").

Consider the Lasik machine.

Keep in mind:

IRC § 179:

Allows business to expense all in one year, instead of capitalizing

MACRS:

"Modified Asset Cost Recovery System"

Allows business to accelerate depreciation in early years.

Phantom Income Issue

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Phantom Income Issue

Phantom income is:
pass-thru income
less distributions

Where does it show up?
Look at the K-1.

53

Phantom Income Issue:

Payor Favors CFA:
Phantom Income
Should be Subtracted
to Determine BIAS

54

Phantom Income Issue:

Recipient favors ITA: Phantom Income Should Not Be Subtracted to Determine BIAS

55

IRMO Blazer 176 Cal.App.4th 1438 (2009)

Husband operated an agricultural business with substantial income.

Husband (thanks to AAML fellow Lowell Sucherman) argued the business was thinly capitalized and **needed to retain its earnings . . . in order to compete and remain viable.**

Wife argued that it was husband's choice to use the business income this way, and the income should be included in BIAS.

56

IRMO Blazer

The trial court accepted the testimony of husband and his accountant, finding that **vertical integration was a reasonable expenditure that should be subtracted in determining husband's BIAS**.

Wife contended on appeal that the trial court's failure to use all of husband's income in setting support was an abuse of discretion.

The court of appeal disagreed with wife and affirmed the trial court.

57

California has lagged behind Maryland and Florida on the phantom income issue

A pair of great cases:

- Maryland: *Walker v Grow* (2006)
- Florida: *Zold v. Zold* (2005)

58

Maryland's *Walker v. Grow* 907 A.2d 255 (2006)

Husband was the chief operating officer of an S Corporation in which he held a 30% ownership interest. The **trial court disregarded Husband's phantom income** when calculating child support.

The Maryland Court of Special Appeals noted that **husband**, a minority shareholder, **had no right to force the corporation to make distributions**.

The appellate court affirmed, stating . . .

59

***Walker v. Grow* (at p. 268)**

"We have found no Maryland cases . . . addressing the extent to which pass-thru income or distributions from a Subchapter S Corporation should be considered the actual income of a parent for child support awards. * * *

In interpreting their own child support guidelines, **several states have determined that pass-thru income should not be included unless the parent is using the corporate form to manipulate his or her income** to avoid child support obligations."

60

What about tax distributions?
Walker v. Grow (at p. 269)

"Courts have held that distributions that are for the purpose of **offsetting an S Corporation shareholder's tax liability should not be considered income** to the shareholder because such distributions do not increase the shareholder's ability to pay child support."

61

Walker v. Grow (at p. 270)

"We are persuaded that, in determining a parent's actual income . . .

. . . 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-thru income not available for child support. * * *

Nevertheless, a court considering such issues must take special care to ensure that a parent is **not utilizing the S Corporation to manipulate** his or her income to avoid child support obligations."

62

Who bears the burden of proof?
Walker v. Grow (at p. 270)

"The **burden is on the parent seeking to exclude** pass-thru income from actual income to persuade the court that the pass-thru income is not available for child support purposes."

63

Some helpful findings
Walker v. Grow (at p. 270)

"An express finding that the parent is not using the corporation to shield income to avoid a child support obligation is appropriate and would certainly aid appellate review in the future."

64

Factors to Consider
Walker v. Grow (at pp. 270-271)

"The nature of the business and governing documents, and the business and non-business relationship among the shareholders would also have to be considered in evaluating the issue of control."

65

Factor to Consider
Walker v. Grow (at p. 270)

"The fact that a party is a minority shareholder is certainly a factor to be considered by the court, but **minority shareholder status**, in and of itself, **would not always be the determining factor.**"

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And now,
Florida's
Zold v. Zold

67

Zold v. Zold 911 So.2d 1222 (2005)

Husband, chief executive officer of a Subchapter S Corporation, owned **57%** of the corporation.

The trial court **included husband's entire pro rata share of the net income** from the Subchapter S Corporation, **both distributed and undistributed**, as income for child support, alimony and attorney's fees.

68

Zold v. Zold

The district court reversed, noting that Subchapter S shareholders do not necessarily receive cash distributions equal to their proportionate share of the corporation's net income, because a portion of the corporation's net income may be retained for corporate purposes.

69

Zold v. Zold (at p. 1226)

"The corporation is **not the personal piggy bank for any one shareholder** simply because that shareholder may have a **controlling interest** in the corporation and is also the chief executive officer.

Financial **responsibilities to creditors and employees** must be satisfied before distributions to shareholders take place if a corporation is to remain viable."

Zold v. Zold

The Florida Supreme Court affirmed, concluding that **undistributed pass-thru income** [i.e., phantom income] that has been **retained for valid corporate purposes does not constitute income** within the meaning of Florida's support statutes.

S Corporation income reported by a shareholder-spouse is not necessarily income available for support.

Zold v. Zold

The Supreme Court held that where undistributed pass-thru income has been **retained for non-corporate purposes, such as to shield the income** from the reach of the other spouse during dissolution, the improper motive for its retention makes it **available income for support purposes**.

Zold v. Zold (at p. 1233)

"Although a shareholder-spouse's **ownership interest** should be considered, it **is not dispositive** even where the spouse is a sole or majority shareholder in the corporation and has the ability to control the retention and distribution of the corporation's income."

73

What about burden of proof? (at p. 1234)

". . . when the issue of whether undistributed 'pass-thru' income was retained for corporate purposes is contested, the **shareholder-spouse should have the burden** of proving that the undistributed 'pass-thru' income was properly retained for corporate purposes rather than impermissibly retained to avoid . . . support . . . obligations."

74

Factors to Consider (at p. 1233)

"In determining whether the shareholder-spouse has met his or her burden of proving that undistributed 'pass-thru' income was retained for corporate purposes, the trial court should consider: . . .

75

Factors to Consider

"... (1) the extent to which the shareholder-spouse has access to or **control over 'pass-thru' income** retained by the corporation,

* *

(3) **the purpose(s) for which the 'pass-thru' income has been retained** by the corporation."

76

Payor vs. Recipient Contentions:

Payor – BIAS Should EXCLUDE Phantom Income:

"The non-distribution wasn't within my control"

"The non-distribution was a business necessity"

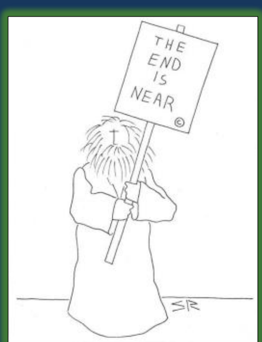
Recipient – BIAS Should INCLUDE Phantom Income:

"It fits the definition of income"

"Payor is 'investing' in her own future"

"Payor still has the phantom income in the LLC"

77



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Income and cash flow

- Cash flow is NOT a merely a “sloppy synonym” for income.
- Income and cash flow concepts are both important in deriving a fair support order.
- In order to accurately determine what income from a business is actually available for support, the income concept and cash flow concept must be analyzed and harmonized.

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THE

END

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