What Can You Glean from a Subchapter S Tax Return?

What's Included, What's Missing, and Does it Really Tell You What You Think it Does?

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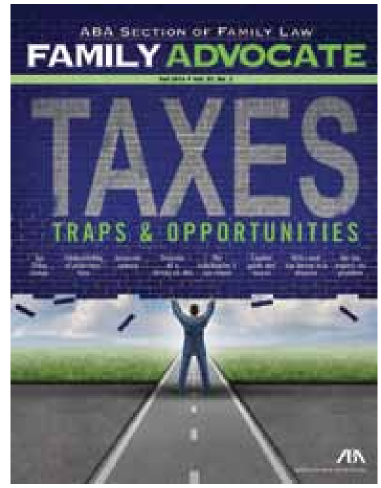

Partnerships, limited liability companies, and sub-chapter S corporations are tax-reporting entities. They do not pay tax on the income they generate. Instead they report the activity by filing "informational" income tax returns. Subchapter S corporations file Form 1120S, whereas partnerships and LLCs file Form 1065. Each owner is issued a Form K-1 to advise the owner (and the IRS) of what the owner is required to report on a personal tax return.

In divorce cases, the court is required to determine the amount of child support that parents must pay, and the amount of spousal support/alimony/maintenance that spouses or former spouses must pay. These determinations require a calculation of the amount of income that is available to a party for support. When a support litigant has an ownership interest in a business, the judicial officer must determine the litigant's "business income available for support" (BIAS).

"Phantom income" is created when an owner of a business is required to report and pay tax on his or her proportionate share of income generated by the business, but the owner does not actually receive all of that income.

Either litigant—payor or recipient—may have BIAS. For ease of reference, let's consider the calculation of "Patrick Payor's" BIAS. A judicial officer calculating "Rene Recipient's" BIAS would perform the same factual analyses and apply the same legal principles.

Patrick Payor, whether a partner, an LLC member, or a subchapter S corporation shareholder, is required to report his proportionate share of the entity's taxable income on an individual Form 1040, and is required to pay income tax on this "pass-through income." This is true whether all (or any) of the pass-through income actually has been distributed to Payor. That portion of the pass-through income that has not been distributed to Payor is called "phantom income."

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Taxable income versus cash flow

Understanding the distinction between Payor's cash flow (money that is available for support) and income (an accounting determination, which does not necessarily reflect money available for support) is important when analyzing phantom income. Family law attorneys and forensics have been accused of blurring the distinction between income and cash flow. In *In re Marriage of Riddle* (2005) 125 Cal. App. 4th 1075, 1080, the California Court of Appeal, dealing with the determination of a litigant's ability to pay child and spousal support, stated:

> 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.

Pass-through income can cause Payor's cash flow and taxable income to differ drastically. Payor's pass-through income (i.e., pro rata share of pass-through entity profit) comes within the definition of "gross income" under Internal Revenue Code (I.R.C.) section 61.

The I.R.C.s definition of gross income does not address the issue of whether sums Payor is required to recognize as income for tax purposes represent funds that are actually available to Payor for the payment of child or spousal support. The fact that monies are available for support doesn't necessarily mean they are taxable as income, and the fact that monies are taxable as income doesn't necessarily mean they are available for support. Differences between tax law and support law may be illustrated by two examples: municipal bond interest and phantom income.

Municipal bond interest is not taxable to Payor, but is available to satisfy Payor's support obligation. The $10,000 in municipal bond interest that Payor receives during a given tax year will be available for support payment purposes despite the fact that it is not subject to income taxation.

Phantom income is taxable to Payor but unavailable to pay Payor's support obligation. If during a given tax year, Payor is required to report $10,000 in pass-through income, but receives no distributions from the business, his tax return will show $10,000 in income, but none of it will be available to pay support.

When income generated by a business is not fully distributed to the owner, a careful analysis must be done to determine why. If the Payor has manipulated distributions by the pass-through entity to artificially reduce his BIAS, it may be appropriate for the court to consider the phantom income as available when determining Payor's ability to pay support. As explained above, BIAS law must distinguish fraudulent nondistribution of profit from bona fide nondistribution of profit.

Payor bears the burden of proving that the nondistribution of phantom income was bona fide

Some states begin with a presumption that support income is different from taxable income. Other states begin with a presumption that support income is the same as taxable income. As a prerequisite to understanding phantom income, the family law attorney should appreciate the differences between taxable income and cash flow.

Others determine profit distribution

What happens to phantom income as BIAS to Payor when the decision not to distribute profit was made by someone other than Payor? Consider the Maryland case of *Walker v. Grow*, 907 A.2d 255 (2006), in which the husband was the chief operating officer of a subchapter S corporation in which he held a 30% ownership interest. The issue on appeal was whether corporate phantom income should be included when calculating the husband's appropriate level of child support. The court noted that the husband did not receive the phantom income because, first and foremost, he was a minority shareholder and had no right to force the corporation to make distributions. However, *Walker v. Grow* places on Payor the burden of proving that he hasn't manipulated business distributions in order to avoid his support obligation. If Payor carries that burden, his phantom income will not be included as BIAS.

It is common for a pass-through entity to make a distribution to Payor only sufficient to pay the income tax liability on Payor's pass-through income. A serious complication is created when there is pass-through income to be reported, but there are no distributions to the owner, or distributions are less than the tax on the pass-through income. Not only is the pass-through income not available for the payment of support, but also the taxes that have to be paid actually reduce cash that would have been available from other income sources.

Pass-through income

Consider the situation in which Payor is a medical doctor who is also a member of a partnership that owns the building where his practice is located. Assume that he has net *after-tax* earnings from his medical practice of $240,000 per year. Ignoring Payor's ownership of the partnership interest, he would have net-after-tax income for support of $20,000 per month. However, as a partner, he must report and pay taxes on $100,000 in annual pass-through income from the partnership and, through no fault of his own, he received no distributions from the partnership.

Assuming a 36% tax rate, Payor will have to use $36,000 of his net after-tax medical practice income to pay the tax on the partnership pass-through income. As a result, Payor will not have $20,000 per month available to pay support; he will only have $17,000 per month as after-tax income available for support.

The issue before the Florida Supreme Court in *Zold v. Zold*, 911 So. 2d 1222 (2005), was whether phantom income should be considered income for purposes of calculating a husband's child support, spousal support, and attorney's fees. The husband was the 57% owner, and chief executive officer, of a subchapter S corporation. The trial court included husband's entire pro rata share of the corporation's net income, both distributed and undistributed, as BIAS. The Florida District Court reversed, noting that a subchapter S shareholder does not necessarily receive distributions equal to his proportionate share of the corporation's net income because a portion of the corporate income may be unavailable for distribution. The Florida Supreme Court listed factors that a trial court should consider when measuring BIAS:

> (1) the extent to which the shareholder-spouse has access to or control over "pass-thru" income retained by the corporation…and (3) the purpose(s) for which the "pass-thru" income has been retained by the corporation. 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. Ownership of capital stock does not entitle shareholders to income that has been retained by an S Corporation because shareholders do not have a right to an interest in the corporation's income…Thus, more important than the shareholder spouse's ownership interest is the purpose for which the undistributed "pass-thru" income has been retained by the corporation. (*Id.*, at p. 1233.)

Zold v. Zold echoes *Walker v. Grow*'s holding that Payor bears the burden of proving that the nondistribution of phantom income was bona fide. *Zold v. Zold* further holds that, even if Payor holds a majority interest in a business (and, thus, may decide how much pass-through income will be distributed), valid business obligations to creditors and employees may prevent distribution.

Necessary business capitalization

California's *In re Marriage of Blazer*, 176 Cal. App. 4th 1438 (2009), concerned the spousal support obligation of a husband who owned a profitable agriculture brokerage company. Husband presented expert trial testimony that the agriculture brokerage industry was endangered because produce buyers and sellers were increasingly "cutting out the middle man" by contracting directly with each other. Husband's expert testified that in order to remain viable, husband's business needed to retain earnings and use them to invest in berry-growing operations (thereby expanding "down" into the production side of agriculture commerce) and buy warehouses (thereby expanding "up" into the distribution side of agriculture commerce). Wife argued that it was husband's choice to spend the business profit in this fashion and that the business's entire profit (unreduced by sums the business used to diversify) should be considered husband's BIAS.

The trial court accepted the testimony of husband's expert and found that earnings retained, then used to capitalize "vertical integration," were reasonable expenses that should not be included in husband's BIAS. The California Court of Appeal affirmed, noting the trial court's findings that: (a) the company would not continue to exist if it did not diversify through vertical integration, and (b) funds spent for that purpose were "reasonable expenses" properly chargeable to the business, not to the husband.

Financial statements

Attorneys dealing with the issue of BIAS will analyze the business's financial statements. A complete financial statement has three components:

1. **Balance Sheet.** The balance sheet provides a snapshot of business assets, liabilities, and owner's equity at a given point in time.
2. **Income Statement.** The income statement reports revenues and business expenses for a given time period. The income statement provides a determination of net profit, usually before income taxes.
3. **Cash-Flow Statement.** The statement of cash flow converts the accrual basis of accounting used to prepare the income statement and balance sheet back to a cash basis. The cash-flow statement is important to be able to analyze the actual level of cash flowing into and out of the business.

Without seeing all three components, the practitioner will not have an accurate picture of what should be considered as BIAS. Occasionally, the family law attorney will encounter a balance sheet and income statement without an accompanying cash-flow statement. The attorney should insist on production, or generation, of the cash-flow statement. The cash-flow statement in many ways holds the factual "key" to BIAS analysis.

Expert testimony

The central issue in BIAS litigation is how much pass-through income should the business have distributed? *Zold v. Zold* teaches that the needs of business creditors and employees must be considered. *In re Marriage of Blazer* teaches that business capital-improvement and capital-investment requirements also must be considered.

A trial court will need expert testimony to properly evaluate these issues. The expert should be knowledgeable about operating expenses and capitalization needs within the particular industry. The litigation team presenting the more compelling expert witness testimony is likely to win the BIAS competition.

Conclusion

Although each jurisdiction's precedent may contain different rules, certain phantom income principles are emerging:

1. Unless profit distribution has been manipulated to permit Payor to avoid paying support, phantom income isn't BIAS because it isn't "available" for payment of support.
2. The trial court must scrutinize business finances and practices to ensure that no manipulation has occurred.
3. To facilitate appellate court review, the trial court should make an express finding on the issue of whether manipulation has occurred.
4. Payor bears the burden of proving that the phantom income should not have been distributed.
5. Valid reasons for nondistribution of profit include obligations to creditors, duties to employees, and business capitalization requirements.

As family law attorneys, we should study the person and business tax returns as well as phantom income precedents and practices. We must understand the differences between taxable income and cash flow, as this is the only way to properly present what Business Income is Available for Support (BIAS)—and woe unto the hapless advocate who uses cash flow as a "sloppy synonym" for income. **FA**

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Sidebar

Beware the Tax Traps of U.S. Savings Bonds

Many people have acquired U.S. Savings Bonds during their marriages. The bonds represented a secure way to save for the future, with some added advantages. Interest on the bonds is exempt from state income tax. Typically, interest on Series E and Series EE United States Savings Bonds is not subject to current taxation because, although interest accrues, it is not paid until the bond is redeemed, and the tax on the interest can be deferred until the bonds are redeemed. However, the division of Series E or Series EE U.S. Savings Bonds represents a tax trap for the unwary in connection with a divorce. Under section 454(c) and regulation 1.454-1(a), the increase in redemption value of the bond must be included in gross income for the taxable year in which the bond matures, is redeemed, *or is disposed of*, unless the taxpayer reports the interest income each year. Counsel should inquire whether the parties reported the interest on the bonds as income as it accrued, but that seldom occurs.

Lawyers and clients who overcome the hurdle of assigning a value to the bonds—keeping in mind that neither the face value nor the original purchase price is likely to be the actual current value—may mistakenly assume they have no other difficulties to address. The remaining tax trap arises out of the nature of the bond's appreciation in value: it is accrued interest income *not* capital gain. The concept is that income is taxed to the person who earns it, and that one who has accrued the right to receive income cannot avoid the taxes by an assignment of the right to receive that income to another.

This principle comes from the United States Supreme Court case of *Lucas v. Earl*, 281 U.S. 111 (1930), and has been repeated in subsequent decisions and in IRS regulations, § 1.454-1(a). The trap for the unwary is that the assignment-of-income principles apply not just to employment earnings, but also to other types of income, such as interest or dividends that may be accrued but not yet received or taxed.

Under the assignment of income doctrine, the transferor remains obligated to pay taxes on the accrued income he or she has assigned. This trap with respect to U.S. Savings Bonds differs from the situation that arises when a savings account with accrued interest is divided in this key respect: the interest accrued in the typical savings account was taxed annually; by contrast, the interest accruing on the savings bonds has typically not been reported and taxed.

In Rev. Rul. 87-112, the IRS addressed the transfer of Series E and EE bonds to a former spouse incident to a divorce. The conclusion of that Revenue Ruling is that § 1041, which operates to insulate from tax most property transfers incident to divorce, does not apply to the transfer of these savings bonds. The IRS noted that the income at issue was accrued but unrecognized interest rather than gain; therefore, section 1041 does not shield the income from recognition. In short, the transaction constitutes, in part, an assignment of accrued income rather than a transfer of appreciated property.

The Revenue Ruling used the example of a Wife who held Series E and EE bonds in her name and purchased entirely with her funds, with a maturity date after the date of divorce. She had not previously reported and paid the tax on any interest that accrued on the bonds. In connection with the divorce, she transferred the bonds to her former Husband who redeemed the bonds the following year. The Revenue Ruling concludes that the Wife must include in her income in the year of transfer the deferred accrued interest, from the date of the original issue of the bonds to the date of transfer. Husband's newly acquired basis in the bonds was equal to the Wife's basis in the bonds immediately prior to the transfer plus any income recognized by the Wife as a result of the transfer of the bonds. By contrast, the IRS indicated that the Husband would be required to include in his income only the deferred, accrued interest in the bonds from the date of the transfer from Wife to the date of his redemption of the bonds.

The problem is not entirely averted if the bonds were held by the spouses jointly and are transferred to one of them incident to the divorce. In that case, the spouse transferring interest in the bonds would be required to report his or her share of the accrued income up to the date of the transfer.

—Kathleen A. Hogan