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Chapter 4

The Hunt for Hidden Assets – Red Flags, Schemes, Scams, Lies, and Damn Lies

Many books and articles have been written for lawyers and forensic accountants about searching for hidden assets in divorce. Experienced forensic accountants know what to look for and where to look for them. This chapter is crafted to help lawyers obtain needed documentation, to explain why certain documents are essential, to demonstrate how to listen for red flags from clients, to make it easier to interface with the accountant working the case, to aid in explaining the work to the client, and to enable lawyers to understand the role of the forensic accountant's report.

At their most basic, like any other type of lie, financial lies come in two forms: commission and omission. Financial statements can be false because of both types of lies. A very simple lie of commission is lying on an interrogatory concerning the balance of an investment account. Lies of omission constitute nondisclosure. An example of nondisclosure is a failure to disclose that a brokerage account exists. Nondisclosure can be the most challenging type of lie to explain to courts. Without a brokerage account statement, how do you prove the account exists? Understanding lies and their overall importance in divorce cannot be separated from an understanding of human nature. Evidence comes from documents. Many documents come from discovery. Without discovery, there may be no evidence. What comes first, the chicken or the egg? It may well be the documents.

In divorce, some bad actors refuse to provide even basic discovery, such as credit card statements and cell phone records. In a motion to compel, a judge may ask you why certain documents are needed. Your opposing counsel might claim the document search is a fishing expedition or is otherwise unduly burdensome. The judge may then go one step further, asking whether there is evidence of wrongdoing or an affair. This is human nature—curiosity. At its most basic, where will the evidence of adultery or dissipation most likely be found? In credit card statements and cell phone statements. Then it's up to you to be a strong and relentless advocate for your client.

The Continuum of Lies

Some targets[1] lie. For the purposes of this book, business owners and their businesses are collectively referred to as targets. The two cannot be separated because of the control owners have over their businesses. The target is capable of coordination. Is deferring income recognition hiding assets? What about inappropriate expenses? What if the IRS does not object to deduction of travel and entertainment expenses paid by the target at a conference? What if the target's girlfriend is an employee? The forensic accountant's investigation must take into account all of these aspects. One of the first steps to putting the investigation into context is understanding that there is a continuum of lies. Some lies are worse than others. If caught, some lies come with harsher penalties than others. You need to ask your client early on this important series of questions: Is the target is bold enough to:

- Lie on company expense reimbursement forms?

[1] As discussed in Chapter 3, in the context of this book, the "target" of a lawyer and forensic accountant is, collectively, the opposing party/business owner and related closely held entities.

- Manipulate company books?
- Conspire with a low-level employee to alter company books?
- Lie on state sales tax returns?
- Create dummy vendors and pay expenses from the company to the dummy?
- Enlist co-owners' help to secrete nontaxable income in cash?
- Form offshore legal entities to hold siphoned cash?
- Conspire with the company's inside CPA?
- Conspire with the company's "independent" CPA?
- Lie on financial statements to banks providing credit facilities (*overstating* income and net worth)?
- Lie on financial statements to banks providing credit facilities (*understating* income and net worth)?
- Lie on written discovery under oath?
- Lie on tax returns (with or without help from a tax preparer)?
- Lie at deposition while looking in the eye of opposing counsel?
- Lie at trial in front of a judge?

Some lawyers may have a hard time understanding that targets perceive certain lies as more dangerous than others. For example, some targets believe that failing to report cash receipts (understating income) on a federal income tax return is much more egregious than claiming exaggerated personal meal deductions and entertainment expenses. Some may say IRS agents expect some fudging on "business" dinners. That's why they are only partially deductible. But if the cash receipts are not recorded and the amount is meaningful, the agent may consider initiating criminal prosecution.

One serious dividing line for targets is the deposition. Will the target lie in deposition? Some won't. The involvement of their spouse's forensic accountant may keep the target honest. If the forensic accountant has been through the general ledger and examined canceled checks and invoices, that may be enough to keep the target honest. That is why it can be beneficial to disclose the expert's existence as soon as possible. For other cases, a target's honesty may depend on the reputation of the forensic accountant. If word gets back to the target that the CPA is very talented, the target may throw in the towel, admit the manipulation, and salvage what credibility remains.

Some targets will continue to lie even when caught. If the manipulation is not detected prior to the deposition, you can bet the farm the target will lie. The target may even be emboldened to lie. In those circumstances, the mere act of getting the target on the record and under oath creates a benchmark to work against. One concept resonates with clients: "Even though your spouse may lie, we are going to ask him the right questions under oath and make him commit perjury to do it." Proving the perjury may be a tremendous challenge. But if the lie is ever proven, there will likely be hell to pay.

In the Disney movie and theme park ride *Pirates of the Caribbean*, a nefarious voice calls out: "Dead men tell no tales." From the first audit classes in college, accountants are taught to think like thieves. Audit courses cover both simple and complicated theft schemes. After becoming a CPA, seminars and books continue training in fraud detection. Most CPAs will tell lawyers that, if given the right documents and enough time, almost all fraud schemes can be detected. At its most basic, if revenue received by a business is recorded in an accounting system, pulling cash out leaves a paper trail—somehow, somewhere. Some trails are easier to discover than others. If the revenue received is never recorded in the first place, however, all of the investigative methods and techniques in the world won't catch it on the company books. This is because the recording was never there in the first place. Some situations create hints. These hints suggest problems. They are called red flags. A really, really smart scheme tells no tales and leaves no red flags. But thankfully, such schemes are rare.

Red Flags

Family lawyers must be able to spot red flags. Some red flags may be known by clients but be misunderstood. By its very definition, a red flag should be the basis for reasonable concern and suggest the need for investigation. Unfortunately, red flags are often imbedded in very emotional facts. Some clients know their spouses are greedy and usually know when they're lying about something. Others only suspect the lies.

In order to be effective, divorce lawyers and CPAs need to be students of fraud. Movies can be important teachers. Watch *The Sting*, *The Grifters*, *House of Games*, or *Ocean's 11.* As you will learn from these movies, all successful fraud and theft schemes share the following common elements:

1. They play on the victim's greed.
2. They involve a diversion.
3. They rely on one or more deceptions.
4. They deflate the victim.

The victim is often in on some aspect of the fraud, hoping to receive a serious profit in return for little effort or risk. The diversion and deception can be either elaborate or simple—it doesn't matter. Some call this the difference between the "long" or "short" con. But for fraud schemes to have real elegance, there must be deflation. The victim truly believes the money is gone and is unrecoverable.

In the Academy Award winning *The Sting*, the victim, mobster Doyle Lonnegan, left $500,000 in cash at a gambling hall while attempting to escape suspicion for the murder of Robert Redford's character. The murder never actually happened. Doyle believed he was in on a horse-racing gambling fix. He believed he couldn't lose the bet. Fortunately for the perpetrators of the fraud, leaving the cash behind meant leaving it in their hands. The victim simply walked away from a lot of money. Doyle believed that, if he made an inquiry to the police about the missing money, he would be required to explain his presence at an illegal gambling facility at the exact time a person died.

In divorce actions, simple plots involve handing cash or transferring ownership of valuable assets to buddies, siblings, or parents to hold for the divorcing party until sometime after the final decree. Well thought-out scams usually come with deceptive cover stories, financial statement manipulation, and lying under oath. Better cover stories involve failing businesses, gambling addictions, and other personal failures. The more believable the story is that the money is gone, the more likely the victim will give up looking for it.

For example, if the target's business owns a vacant building, the target may complain that the property taxes are long overdue and the building is worth less than the cost of paying them. Prior to the divorce filing, the target brags that the business sold the building to a stupid investor in exchange for the investor getting "stuck" with having to pay the overdue taxes. While the business may be rid of the purported albatross, the business and marital estate is purportedly saved thousands of dollars. The reality is quite different. The taxes were never behind, and the purchaser was the target's nefarious financial advisor and personal friend. The transfer was recorded, but the handshake deal will result in the stockbroker and target splitting the profits from its sale a year or so after the divorce.

Divorce victims mirror fraud victims. Fraud victims are often too embarrassed to report the crime. Spouses married to persons lying, cheating, and stealing in the divorce become demoralized. The target counts on the victim's will breaking down. Victims blame themselves and want to settle for less than a reasonable settlement. Your role as psychologist comes into focus here. When you know that proving the fraud is likely just around the corner, counseling your client becomes essential. Issuing one more subpoena, arguing another motion to compel, or simply taking a key deposition can turn the tide. In divorce, though, optimism is often a commodity in short supply.

To detect schemes using financial statement manipulation, timing is important. Benchmarks are key. At one point in time, the target was not scamming, the marriage was solid, and generating income was a good thing. Finding that benchmark point in time helps the CPA figure out ways to "triangulate" what is truth and what is deception. Red flags describe noticeable changes in the financial *status quo.* Somewhere between the cause and effect, the red flag sticks out. The following is a list of red flags, offered to give you a flavor of what your legal team should be listening for when talking with a client:

Pre-filing red flags include the following situations:

- The spouse maintains complete control of bank account information and on-line passwords.
- The spouse is secretive about financial affairs.
- The spouse has a P.O. Box or private mail drop box, which receives account statements and bills.
- The spouse has meaningful unreimbursed business account expenses.
- The spouse has deleted one or more personal financial programs, Quicken or Quickbooks.
- A computer containing important financial records has mysteriously crashed, and the spouse has removed the hard drive for a data retrieval attempt, never to be seen again.
- The spouse begins to engage in cash transactions for larger purchases.
- The spouse stockpiles or stores cash.
- Business tax returns cannot be reconciled with financial records.
- The spouse is pushy when obtaining signatures on important documents, like tax returns and deeds—"I need to get this to our accountant *today.*"
- There is an execution of mutual durable power of attorneys for "estate planning" purposes.

- The spouse uses a fly-by-night tax accountant, not a CPA.
- The spouse brags about his bartering ability.
- The spouse and the business switch accountants just before filing for divorce.
- The spouse goes on out-of-town business junkets with his befriended, slippery financial advisor.
- There are elaborate trusts, possibly including "generation skipping" trusts.
- SIDS (Sudden Income Deficit Syndrome)—"My business is failing"—crops up.
- The spouse suffers an income decrease without a corresponding reduction of expenses.
- The spouse makes unusual purchases of flashy items, such as a car and jewelry.
- Marital and/or business investments have suffered a dramatic decrease in value.
- The spouse is making outrageous allegations against your client.
- The spouse is always busy and hard to contact.
- The spouse exhibits a raging anger when not in complete control.
- The spouse has multiple cell phones or numbers over a relatively short period of time.
- The spouse makes frequent trips to countries with relaxed banking laws.
- The spouse exhibits childish greed and claims of entitlement.
- The spouse makes unusual purchases of toys or art that could be sold later.
- The spouse has recently been drawing on large amounts of debt.
- The spouse is involved in drug abuse.
- The spouse is involved in more frequent gambling than usual and is placing money "on account" with casinos.
- The spouse has multiple business or personal bank accounts without obvious reasons for having that many.
- The spouse has undertaken a new business venture with distant partners and is vague on the details.
- The spouse is bragging about the ease with which personal expenses are run through his business.
- The spouse's personal debt has been improperly paid by the spouse's business and fudged in financial records.

Post-filing litigation tactics include the following ploys:

- The spouse accuses your client's attorney (you) of "just running up the bill."
- The spouse badmouths your client's forensic accountant as incompetent and/or wasteful.
- The spouse refuses to produce obviously relevant documents, such as bank statements, credit card statements, financial statements, and investment account statements.
- The spouse claims that basic financial documents do not exist, or even worse, never existed.
- The spouse initiates scorched-earth tactics to frustrate discovery.
- The spouse's business refuses or fails to produce particular basic financial records, such as the general ledger, the cash receipts journals, or inventory records, which can be used to substantiate management claims of poor financial performance.
- The spouse and/or the spouse's business promises discovery but never produces.
- The spouse continues to claim that his business is failing.

Severity of Lies

Not all lies are equal. Some lies are more important than others. To borrow a baseball analogy, an example of a "home run" lie might be an interrogatory answer denying infidelity, combined with finding in the car glove compartment of the spouse a jewelry store receipt for a Rolex Lady-Datejust (with diamond dial and bezel, of course), complete with a Christmas card including a sexually graphic thank-you note that predates the interrogatory answer. An example of an uncovered lie that is a "double" is the good old business credit card statement with the Victoria's Secret charge. Finally, an example of a "single" lie might be a business owner deducting personal meals and entertainment expenses through the business. "Single" lies are illegal, unethical, and dishonest. But, unfortunately, judges hear a lot worse every day and are not moved by them. For small "single" lies, there are two keys. First, proving any lie with a document, especially a document signed by the target, is more powerful than any other proof. And second, if you string enough "single" lies together with a meaningful amount of dissipation, your client can achieve the same credibility destruction as with a "home run" lie.

Financial Lies Come in Many Flavors

Targets usually have very specific predictable objectives. In committing fraud in a divorce, the target's goals are to:

1. Hide, understate, or undervalue certain assets;
2. Overstate debts;
3. Report lower than actual revenue; and/or
4. Report higher than actual expenses.

Some tactics are predictable. As with any scheme, there are, from the perspective of the target, various advantages and disadvantages. Predictable strategies include:

- Hoarding unrecorded cash.

Advantage: Removing cash (currency) lacks a paper trail, and offshore bank accounts are relatively easy (from a legal standpoint) to open.

Disadvantages: Laundering over $100,000 in currency can be time consuming and will likely require travel. Depending on the circumstances, this tactic could involve the very serious criminal acts of money laundering, violation of cash transfer reporting requirements, federal income tax fraud, and perjury.

- Secreting already recorded cash receipts.

  Advantages: This can be completed as part of a complex accounting scheme, which may be too complicated or expensive to discover.

  Disadvantages: Once cash is recorded, its absence or transfer is discoverable.

- Understating revenue.

  Advantage: The target has lots of options from which to choose. Some are simple and easy. Deferring revenue by manipulating the timing of revenue or accounts receivable may not constitute tax fraud.

  Disadvantage: Depending on the business owner's sophistication, this can require a fairly predictable co-conspirator. If the co-conspirator is placed under oath, the scheme could result in perjury charges for the target.

- Excessive bonuses or perks.

  Advantage: This is easy for the boss to pull off.

  Disadvantage: Bonuses and travel and entertainment expense accounts are the first places accountants look in investigations. Excessive bonuses will stick out if the target is claiming a disastrous year. Regarding excessive perks, the IRS requires particular supporting documentation for travel, entertainment, meals, company car, fringe benefits, and credit card receipts. The failure to maintain that documentation is another red flag and could easily result in the target's loss of credibility.

- Payment to fictitious vendors and employees.

  Advantage: This can be hard to detect.

  Disadvantage: If the non-business-owner spouse has a "Deep Throat" or snitch inside the business, the forensic accountant or business valuation expert might know exactly where to look. The scheme may require a co-conspirator (controller, payroll clerk, or accounts payable clerk) to assist with the criminal tax fraud. Plus, the fictitious employee rarely actually shows up to work. Fictitious vendors can be more of a challenge. Some forensic accountants may have software that performs statistical analyses to help spotlight suspicious transactions.

- Overstating debts or making a creative bad-debts expense adjustment.

Advantage: The manipulation will be "camouflaged" among many other transactions. This can be an effective method of hiding money in plain sight. Cash need not be moved to accomplish this.

Disadvantage: If a forensic accountant performs a comparative financial analysis and the manipulated amount is meaningful, these non-cash adjustments should stand out. Plus, there may be no backup documentation for these adjustments.

- Overstating accruals.

  Advantage: It is very easy to overstate the amount owed to a vendor. For example, recording three months of copier lease payable in December rather than one month.

  Disadvantage: If a forensic accountant compares payables to supporting documents, the misstatement is easy to catch. Like many manipulations, for it to be successful, the target may create its own fictitious paper trail. It takes creativity, determination, and discipline to manufacture supporting documents.

- Nondisclosure of tangible assets.

  Advantage: This is a simple shell game. The target pays money for assets and expenses them instead of showing them as assets.

  Disadvantage: The existence of tangible assets can be observed. Capital leases may involve monthly payments for assets, leaving a paper trail.

- Inventory "errors" that depress net income.

  Advantage: By delaying the recording of certain inventory transactions, making pricing "errors," and miscounting inventory, the cost of goods sold can be easily manipulated, resulting in artificially depressed profits.

  Disadvantage: Forensic accountants can compare previous financial periods. Spikes (or valleys) in inventory as a percentage of gross revenue compared to benchmark years can illuminate this problem. Plus, if the divorce drags on and covers an additional period, the "errors" may reverse themselves out, causing more income in the subsequent period.

- Nondisclosure of intangible assets (intellectual property or trade secrets).

  Advantage: This is very clean. Due to the difficulty in valuation, GAAP may require that intangible assets not appear on books or tax records until sold.

  Disadvantage: Valuable intangible assets or intellectual property may be disclosed in company marketing brochures (e.g., bragging about a newly developed process), in newspaper articles, or on bank loan applications.

- Manipulation of retained earnings and capital. This could be the company holding more cash than was its practice before the divorce and not paying excess profits to owners. Another type of manipulation involves strange, one-time equity account transfers involving debt or cash.

Advantage: The owner has actual authority to control and manipulate distribution to and from capital accounts.

Disadvantages: Depending on the circumstances, transactions with equity can be fairly transparent to forensic accountants. For example, a forensic accountant reviews 2008 and 2009 operations, and in both years the company had around the same amount of profit. On December 31, 2008, cash reserves were $300,000. On December 31, 2009, cash reserves were $600,000. Given that profit was about the same and no major investment decisions or capital outlay was required, the divorce itself becomes the obvious reason for the cash accumulation, resulting in lowered "wages" to the owner.

- Creation and maintenance of trusts.

  Advantage: Assets in trust can have income. The income tax can be paid by the trust, and its income will not flow into the beneficiary's personal income tax return. Trusts can exist for years, lying undetected by the other spouse.

  Disadvantage: Most standard interrogatories ask about the existence of trusts. Usually, the target's regular CPA will prepare the tax returns. If the target fails to list the trust in an interrogatory answer and the client discovers the trust through a subpoena to the CPA, the scheme can be detected.

"What Is Best in Life?"

In *Conan the Barbarian,* the Wu Master asks Conan, played by Arnold Schwarzenegger, as they sit around a roaring campfire, "Conan, what is best in life?" Conan replies, "To crush your enemies. To see them driven before you. And to hear the lamentation of their women." In the courtroom, catching the target in a lie made under oath is good. Catching the target in a lie with an obvious intent to lie is great. But ultimately, the best in life is for the trier of fact to crush the business owner spouse in a ruling. Trial courts can vindicate the non-business-owner spouse by

- Granting the non-business-owner spouse substantially more than 50 percent of the assets,
- Valuing the assets in favor of the non-business-owner's valuation expert, and/or
- For alimony or child support, declaring the target's income much closer to the target's real income rather than the target's purported income.

More on Bad Debt Manipulation

To understand **bad debt expense** manipulation, you must understand business. Businesses sell goods and services. Customers should pay. Some don't. When customers don't pay, certain accounts receivable adjustments can be made to reflect the non-payment after income has been realized. But how does an accountant know when a customer will not pay? In accrual-basis accounting, businesses record revenue when the goods or services are provided and invoices are issued. In many accrual accounting businesses, collection is fairly predictable. Recording the revenue when sales are made is not a big deal.

As an example, consider family law firms. Most family law firms are cash-basis taxpayers. The reason is simple. Lawyers want to pay taxes only on revenue actually received. Who would want to pay taxes based on a receivable that may never be collected? This is different from many companies that sell products to customers who eventually pay their bills. It's just the timing of the payment that creates the accounting issue.

Those companies selling goods and services with accrual-basis accounting can usually estimate a certain percentage of uncollectible revenue and write it off. This estimation is based on collection results from prior years. This "write-off" or "write-down" reduces accounts receivable and reduces income by increasing an account called bad debt expense. This happens even though no one knows precisely which debt will not be collected. This practice helps prevent the overstatement of profits, which is a very legitimate accounting goal, even outside a divorcing year. The business's revenue stays the same, but the bad debt expense increases. By increasing the amount of bad debt expense (which is an estimate anyway), the target effectively reduces personal income in the divorcing year through the exercise of accounting judgment.

When testing for bad debt expense manipulation, forensic accountants can perform a multi-period analysis. Before the CPA performs the analysis, a forensic accountant may ask questions similar to the following:

1. What is the pattern of write-offs? Over a period of several years, analyze the amount compared to gross revenue.
2. Which items were referred to a collection agent or collection attorney?
3. Were all items referred to a collection agent or attorney made in the ordinary course of business?
4. Trace particular accounts written off. After the receivable was written off, was it ever collected? Was it received in cash? Was it received off the books? Or was it paid to a middleman?
5. Does the target continue selling to the business responsible for the bad debt?
6. What is the industry standard practice for recording and writing off bad debt?
7. Is the timing of write-offs suspicious in relation to the divorce timing?

When calculating bad debt as a percentage of gross revenues over a multi-year period, the forensic accountant is looking for a big jump in bad debt expense in the divorcing year. For example, consider the following chart:

Year:	2007	2008	2009
Sales:	$550,000	$600,000	$650,000
Bad Debt Expense:	$11,000	$15,000	$42,500
Percentage:	2%	2.5%	6.5%

If the divorce was filed in late 2008, there was probably no manipulation at that time. If the business is on a calendar year, the entries for adjusting bad debt are likely made from January to March. The forensic accountant can and will ask questions. The target's accountant may have plausible answers. In the end, the detail follow-up may tell the tale. If there was one really bad account from one particular business, check out that business. In prior years, was there a collection issue? Did the debtor company go out of business? Is that business owner a friend of the target? Was there a lawsuit filed?

End of excerpt.

Chapter 8

Determining Income

Clients usually know right off the bat when income determination is going to be an important issue. For obvious reasons, it's most often the less propertied, supported spouse raising the concern. In those cases, temporary support also almost always seems to be an issue, and temporary support is always important because it's early in the case. And if it's mishandled, the case will become much more difficult for the supported spouse. What's the easiest way temporary support gets bungled? The supported spouse can't prove what the supporting spouse earns. The risk of not being able to prove income is always highest early in the case before the best documents have been exchanged or researched.

Depending on the level of conflict and complexity of earnings, determination of income affects the following:

1. Temporary support;
2. Alimony; and
3. Child support.

Alimony focuses on need and ability to pay. Ability to pay means available cash after taxes and expenses. Determining the obligor's ability to pay begins with income determination.

For child support, even though every state has its own guidelines, the attentive family lawyer should study, meditate on, and contemplate the sometimes subtle but important differences between her particular state's definition of income and the definition of taxable income under federal income tax law. A state's definition of income will be much broader than the interpretation of federal income. For example, take Illinois's definition of net income: "The total of all income from all sources."[2]

Tax returns are often the first documentation of income the family lawyer reviews. But tax returns don't always show the whole truth, especially for business owners and those with cash businesses. At a minimum, what documents are needed for temporary support disputes? Last year's tax return, W-2s, and a current pay stub. Obviously, more detail is better. The 1040, W-2s, and other income reported therein become the beginning of the inquiry, not the end. You must put into context the documents, their analysis, and the help a CPA may need to provide when dealing with the almost infinite number of possible legal issues. For example, in Illinois, income disbursed from a spendthrift trust,[3] IRA withdrawals,[4] and Social Security Disability benefits[5] all present unique problems. You must obtain the documents, understand them, and seek to admit evidence in the context of your state's law. For a more complete legal discussion of what is and what is not includable as income for child support across jurisdictions, see Chapter 2, "Construction of the Guidelines: Defining 'Number of Children' and 'Income,' " from *Child Support Guidelines: Interpretation and Application*, by Laura Morgan, available through Aspen Publishers.

When dealing with challenging money issues, you must consider people's behavior, different types of investments, their tax ramifications, hostile motives, varying degrees of honesty, principles of finance,

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[2] 750 ILCS 5/505(a). There are enumerated deductions considered as part of the determination of income for child support purposes.
[3] Sharp v. Sharp, 860 N.E.2d 539 (Ill. App. Ct. 2006).
[4] O'Daniel v. O'Daniel, 889 N.E.2d 254 (Ill. App. Ct. 2008).
[5] Truhlar v. Truhlar, No. 2-09-0536, 2010 WL 3667117 (Ill. App. Ct. Sept. 17, 2010).

and financial reporting requirements, all at the same time. Looking at income from just one angle gives the nefarious spouse too much room to cheat. Comparing documents reporting the same information is one very good way to limit the cheater's room to get away with it. For many, it's a game. Luckily for family lawyers, forensic accountants love to expose cheaters.

At this point in the book, there has already been much discussion about income determination:

1. The discussion of financial statements and accounting in Chapter 3;
2. Nefarious business owners in Chapter 4; and
3. Review of tax returns for hidden assets in Chapter 7.

Know that, as you are looking for hidden assets, those assets often continue generating additional income. Also, consider that tax returns show many categories of taxable income, but not all income is taxable. The returns may, however, contain information describing assets that generate non-taxable income that can be included in income determination for support purposes. If you are looking for taxable income first, you can easily miss non-taxable income simply because it may not appear on the face of the 1040 itself. Chapter 7 provides a guideline for using the 1040, its supporting schedules, and its attachments to ferret out these assets.

Documented Income

Finding documented income is important. There are several sources for finding this income. Think of the following as pieces of a larger puzzle:

1. Tax returns,[6] W-2s, and current pay stubs;
2. Declarations of income in discovery, such as interrogatory responses and produced documents;
3. Declarations of income on Statements of Income and Expenses submitted during the divorce process;
4. Declarations made as part of loan applications;
5. Financial statements submitted as part of loan applications;
6. Financial statements generated as part of financial planning and budgeting found on home computer programs, such as Quicken and QuickBooks;
7. Imputed income methods discussed below, including adding up deposits on bank statements;
8. Bankruptcy filings; and
9. Past salaries listed on job applications.

Claimed Income versus Documented Income

Claimed income on discovery responses and on Statements of Income and Expenses is always an admission. Claimed income will usually be the starting point for challenging the credibility of the declaring spouse. If a spouse lies, or seriously understates income, some triers of fact will absolutely cream the spouse by discounting whatever else that spouse says during the case. Most believe that, if a spouse will lie about something as basic as income, the spouse will lie about anything and everything. Reported income refers to statements declared on external documents completed by borrowers and taxpayers. Comparing and

[6] See Chapter 7's discussion of what the term "tax returns" should mean. It should always include 1040s, state income tax returns, W-2s, 1099-INTs, 1099-DIVs, supporting schedules, attachments, etc.

contrasting claimed and reported income usually involves the technique of ICE (internal, control, and external documents), described in Chapter 6. Once you find conflicting statements of income, you must take advantage of that. Often, the testimony of the forensic accountant is the best way to do so.

Most of the time, reported income is factual and straightforward. Other than tax returns, income is usually declared as a part of loan applications. Financial statements and tax returns are provided as supporting documentation as well. Fortunately, borrowers normally list all income, not just taxed income. Understanding what documents lenders require is very helpful.

Loans are usually earmarked as business or personal, even though most small business loans are personally guaranteed by the owners of the business. Also, loans are often securitized by one or more assets. Almost all securitized loans will result in certain documents being publicly recorded. For example, loans securitized by real estate include documents such as mortgages and trust deeds. Regardless of how the law of your particular state describes such instruments, all loan transactions securitized by real estate should be recorded with the county register of deeds or its equivalent. If a financial institution can secure a sizable loan with real estate, it will most likely require that that be done. There's no requirement that loan applications themselves be recorded, but you should always try to learn who made the loan, when, and for how much. For example, some spouses who borrow fail to produce the loan application in discovery. That loan application may include financial statements. If it does and you can acquire it, you can then use the information to issue a subpoena to the financial institution, thereby obtaining the loan application package and any supporting financial statements submitted to the lender. Then compare the reported income to the spouse's claimed income. If there is a material difference, the spouse may have lied regarding his claimed income. That lie may be a crime in his state.

You may often use many of these same steps for business loans securitized by assets other than real estate. If inventory or other business assets are used as security, there may be a publicly filed UCC-1 or financing statement listing the securitized collateral. When filed, this legal document gives formal notice to the world that the lender has a superior right to the asset. Securing loans against other assets may be less formal or complicated. For example, a car loan will be documented by the lender's lien appearing on the face of a car's certificate of title. The loan may have been obtained by completion of an application at the car dealership. A car loan application is often comprised of a simple declaration of the borrower's income and a credit report review. Copies of car loan applications, though, may not be maintained by the borrower or the lender. Once the loan is made, the car is the security. When all payments are made, the state reissues the title with the lien removed. If payments aren't made, there can be repossession. The larger the financial institution making the loan, the more likely it has retained the application.

For most small business loans and lines of credit, all of the business's assets are usually pledged, and all of the owners/borrowers are usually individually and personally liable for the debt of the business. When a business takes out a loan, it is for a specific amount of money. For a line of credit, the loaned amount can fluctuate up to a preapproved limit. The higher the limit, the higher the annual fee the business is charged. For example, with lawyers, accounts receivable may be the largest asset on the books and may be the asset primarily securitized for a business loan. Note that accounts receivable are not reported on cash-basis taxpayers' tax returns. This may mean that the list of accounts receivable must be reported separately to the lender.

Financial institutions usually have strict and formal procedures and documentation requirements for making loans, which will be adhered to unless the borrower has a long-term relationship with the lender. Having borrowed and paid back large sums of money over periods of years usually means the borrower has such a relationship. Nevertheless, business borrowers are almost always required to update financial disclosures annually. For small businesses, the annual update will usually involve production of at least the following:

1. Business financial statements (income statements and balance sheets);
2. Business and personal tax returns;
3. Personal financial statements signed by the borrowers/owners; and/or
4. Formal loan application forms listing income and net worth.

The greater the amount of the business loan, the more documentation will be required for review. The personal financial statement may or may not list income. Claimed income, in some cases, may be supported only by tax returns. But for the forensic accountant, there are two unique aspects to business loan applications that the personal loan application will not have:

1. Business financial statements are often prepared by a CPA.
2. Business and personal tax returns can be compared to financial statements.

When financial statements are issued by the business's CPA, it means that the CPA firm probably has even more in its files for the client's forensic accountant to dig through. The financial information, and forensic accountants love this, can include tax returns, general ledgers, asset and depreciation schedules, state and local tax returns, sales tax returns, and more. There may be many years of this type of documentation in the CPA's files. If the personal tax returns aren't current, and for some unknowable and incalculable reason they often seem to be late in a divorcing year, the lender usually must do something to paper its file regarding income. You can try to discover what documentation of income was provided. The client's forensic accountant can compare the completed tax returns to those years' financial statements line by line. CPAs eat up this type of financial information buffet to learn the secrets divorcing business owners don't want opposing family lawyers to know.

You can also issue subpoenas to credit card companies (or other sources of unsecured credit) for credit applications, but if you decide to do so, good luck. The general consensus among experienced family lawyers is that issuing subpoenas to credit card companies for applications and statements is a hit or miss proposition that is mostly "miss." Many credit card applications and subsequent applications for credit limit increases are taken over the phone and aren't really based on proof of claimed income, but rather credit scores. In any event, note that a business owner who has substantial credit card debt likely has that much debt for one of three reasons:

1. The business owner can't obtain conventional financing and is desperate because conventional loans are much less expensive than credit cards.
2. The business owner can't stop overspending.
3. The business owner intentionally wants to look poor and/or rack up debt to cut off his nose to spite his face.[7]

Granted, significant credit card debt and people's lives shouldn't be summed up in discrete cookie-cutter, armchair-psychologist psychobabble. But this view suggests an important facet of forensic accounting. Understanding the "why" something was done can be as important as knowing the "what" that was done. Never lose sight of the ultimate goal in divorce—the favorable settlement. To find the path to the

[7] Use of money reveals much about a person's character and decision-making values. Why would a divorcing spouse rack up debt neither spouse can afford to pay? Exploring the answer to that question could be a book in itself. Why does anyone overeat? Why does anyone drink too much? As a divorce strategy, self-destructive behavior presents its own reward, often achieving retaliation and retribution. In the movie *Tombstone*, Johnny Ringo is portrayed as a vicious, psychotic, and very quick-draw gunslinger. Near the end of the movie, Wyatt Earp asks Doc Holliday, "What makes a man like Ringo . . . do the things he does?" Doc replies, "A man like Ringo has a great empty hole right through the middle of him. He can never kill enough or steal enough or inflict enough pain to fill it." Wyatt asks, "What does he need?" "Revenge," says Doc. Wyatt asks, "For what?" Doc answers, "Being born."

favorable settlement, often the "how" to negotiate is discovered only after understanding the "why" the other party does the things he does.

Imputed Income

Imputed income is one of the most important, but challenging, calculations to get into evidence. In general, there are three ways to impute income:

1. Use of a Detailed Transaction Listing and Analysis;[8]
2. Proof of luxury spending which is clearly inappropriate for the amount of claimed income; and
3. Use of the Net-Worth Method.

In the context of imputing income, the Detailed Transaction Listing and Analysis can be used in two ways. First, you can add up all deposits to calculate actual after-tax earnings and compare that amount to claimed earnings. Second, you can use it to compare actual spending with the obligor's claimed after-tax income. The forensic accountant can determine whether the expenses greatly exceed known sources of funds. If the proven lifestyle of the parties during the marriage is greater than known sources of income, you may be able to establish that the claimed income has been understated. The predictable problem with this method can be disproving the obligor's explanation for spending more money than what has been, or is, claimed as income. Usually, the obligor spouse's claim is that the divorcing parties overspent.

Thinking an additional move ahead on the chessboard, if the result of the claimed overspending is a bunch of debt, well, that explanation might stand unless the forensic accountant can disprove it. On the other hand, if there is little or no debt, the forensic accountant must determine whether cash assets, investments, or savings were encroached upon. Regardless, thoroughly reviewing all financial documents is necessary for disproving the obligor's claimed explanation. The forensic accountant must have sufficient relevant documents accounting for all transactions. If there are sufficient relevant documents, the forensic accountant may be able to testify that, to a reasonable degree of accounting certainty, there must be other income to explain the spending pattern.

Proof of luxury spending can be straightforward.[9] It begins with an important, but arguable, assumption: "People spend money they can afford to spend." Rolex markets its watches, like many name brands, to symbolize success and affluence. The general consensus is that luxury-purchasing spouses who claim during the divorce to be not as wealthy as they otherwise appear to be are apt to fudge on claimed income. That fudging is more critically viewed in child support matters than alimony cases because the children are seen as victims. In any courtroom, the more outrageous the luxury item, the more difficulty the obligor may have claiming impoverishment.[10]

From a different angle, proof of luxury spending can be very similar to proving unrecorded income in the form of perks paid by the employer. For example, some doctors' medical practices make lease payments for doctors' luxury cars. Medical practices deduct the lease payments and, for whatever reason (legally or not), the lease payments are not included on the doctor's W-2 or 1099. The amount paid by the practice could be more than $1,000 per month and should be included in the doctor's income considered for support.

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[8] In the context of forensic accounting techniques, see the discussion of the Detailed Transaction Listing and Analysis in Chapter 6 and Example 6-2.

[9] Check your state's child support guidelines to see if it references luxury spending in the context of imputing income.

[10] Every experienced family lawyer has an arsenal of stories about luxury spending around the time of filing for divorce. Many of the spending binges are the stuff of melodramatic novels, such as luxury vacation time-shares, bracelets, diamond engagement rings, and elective plastic surgery.

Net-Worth Method

The Net-Worth Method is used to impute income based on a change in known net worth over a period of time. If someone earns a great deal of money and does not spend it, that person's net worth should increase. If the person spends more than he earned, that person's net worth should decrease. To apply the Net-Worth Method, the forensic accountant must know several things:

1. The person's beginning net worth;
2. The person's reported income;
3. The person's expenses;
4. The person's ending net worth; and
5. The appreciation of and depreciation applied to listed assets.

The IRS uses the Net-Worth Method to catch tax cheats with untrustworthy accounting records.[11] It has also been used in family law cases.[12] One specific definition of the Net-Worth Method is the following:

> The net worth method calculates income by determining a taxpayer's net worth at the beginning and end of a period.
>
> The difference is the increase in net worth. An increase in net worth, plus nondeductible expenditures (such as personal living expenses), less nontaxable receipts, may be considered taxable income. If the resulting figure for any year is substantially greater than the taxable income reported by the taxpayer for that year, the IRS claims the excess represents unreported taxable income.[13]

The IRS calculates unreported taxable income using the Net-Worth Method. In family law cases, forensic accountants can use this method to calculate understated income. If the claimed amount of income cannot explain the increase in net worth, the income must have come from an unknown source. Many of the adjustments described by the IRS that relate to taxation need not be made for determination of income available for support. The Net-Worth Method calculation relies upon the relationship among assets, debts, reported income, and expenses in order to back into, or reverse engineer, the person's total income, including unrecorded income.[14] The Supreme Court of Arkansas outlined the following procedure:

> [F]or self-employed payors, the circuit court should first consider the last two years' federal and state income tax returns and the quarterly estimates for the current year. A self-employed payor's income should include

[11] For more information about the Net-Worth Method, see the IRS' *Internal Revenue Manual*, Part 9, "Criminal Investigation," Section 9, "Methods of Proof," available at www.IRS.gov. This is exactly the kind of financial analysis which causes forensic accountants to get all jacked up on Red Bull and party like it's 1999.

[12] For examples, see Tucker v. Office of Child Support Enforcement, 247 S.W.3d 485 (Ark. 2007) (accepting Net-Worth Method for calculation of income), and Schoenbachler v. Minyard, 110 S.W.3d 776 (Ky. 2003) (affirming trial court's rejection of use of method based on insufficient proof, but impliedly

[13] Schoenbachler v. Minyard, 110 S.W.3d 776, 785 (Ky. 2003) (quoting Yoon v. Commissioner of Internal Revenue, 135 F.3d 1007, 1009-10 (5th Cir.1998)).

[14] Recall the key accounting equations: Assets – debt = net worth (the balance sheet equation reflects the financial positions at a moment in time, like a photo); Income – expenses = net income (income statement reports events over a period of time).

> contributions made to retirement plans, alimony paid, and self-employed insurance paid. Depreciation should be allowed only to the extent that it reflects actual decrease in value of an asset.
>
> If the circuit court determines that the tax returns are unreliable, then it shall make specific findings explaining the basis of its determination. The circuit court shall then proceed using the net-worth method. The circuit court shall establish a beginning net worth at the start of the relevant period and an ending net worth at the end of the period, considering living expenses and allowable deductions for the same period. Additionally, the circuit court shall consider the following factors: (1) the impact of inflation or deflation on the payor's net worth; (2) liquidity of the payor's assets; (3) the payor's cash flow; (4) the payor's current and long-term financial obligations; (5) the payor's lifestyle; and (6) any other relevant factors. After determining the payor's disposable income, the circuit court shall calculate child support in accordance with the child-support guidelines.[15]

The Net-Worth Method makes lots of sense to forensic accountants. Depending on the relative financial and accounting sophistication of the trier of fact, the method can be very challenging to explain in the courtroom. One important key is having a "locked down" net worth statement from which all other analysis can be judged.[16] There must be a point in time when a precise net worth is known. A typical way this occurs is when, on an annual basis, business owners create and produce personal net worth statements for business loan applications on which the business owner is personally liable.

The following is a hypothetical example of the Net-Worth Method being used to prove income greater than the obligor's reported and claimed amount:

In 2007, the IRS audited Mr. and Mrs. Kirk. Pursuant to a request from the special agent, Mr. Kirk furnished a personal financial statement prepared by the parties' CPA dated December 31, 2006. Mrs. Kirk kept a copy. At all relevant times, Mrs. Kirk was a stay-at-home mom. The parties' Net-Worth Statement was as follows:

Assets:

Cash	$50,000
Cars and personal property	25,000
Investments – Wells Fargo	50,000
Marital residence FMV	400,000
Business – FMV Spock, Inc.	100,000
Total Assets	$625,000

Debt:

Credit card	$25,000
Mortgage	200,000
Total Debt	$225,000

[15] *Tucker*, 247 S.W. 3d 485, 489-90 (Ark. 2007) (citations omitted).

[16] *Schoenbachler*, 110 S.W.3d 776, 785 n.27 (Ky. 2003) (citing Holland v. United States, 348 U.S. 121, 132, 75 S. Ct. 127, 134, 99 L. Ed. 150, 162-63 (1954)), which reads as follows: "We agree with petitioners that an essential condition in [Net-Worth Method cases] is the establishment, with reasonable certainty, of an opening net worth, to serve as a starting point from which to calculate future increases in the taxpayer's assets."

Net Worth:	**$400,000**

In 2009, Mr. Kirk filed for divorce. But on June 30, 2010, he filed a Net-Worth Statement with his bank for a line of credit with the following information:

Assets:

Cash	$50,000
Cars and personal property	75,000
Investments – Wells Fargo	225,000
Marital residence FMV	450,000
Business – FMV Spock, Inc.	300,000
Total Assets	$1,100,000

Debt:

Credit card	$50,000
Mortgage	190,000
Total Debt	$240,000
Net Worth:	**$860,000**

During the relevant time frame, 2007 through 2009 and half of 2010, Mr. Kirk claimed to have earned $50,000 per year (after taxes) each year. Mrs. Kirk's forensic accountant can prove that, during this 3½ year period, Mr. and Mrs. Kirk spent $215,000. This means the parties spent $40,000 more than the $175,000 ($50,000 x 3.5 years) Mr. Kirk earned. How should the situation be analyzed?

The forensic accountant first determines the change in net worth. The overall total increase in net worth is $460,000 (see below). This increase in net worth is the result of increased values of assets and payments reducing debts, or amounts spent to increase the value of investments.

Next, the analysis must consider appreciation in the claimed value of the business, investment portfolio, and house. In this case, the change in the value of the cars and personal property is a result of transactions, not appreciation or depreciation. If there were appreciation or depreciation, those amounts would have to be removed from the change in net worth. The business, investments, and house assets all appreciated, but not as a result of Mr. Kirk's use of income or cash used to improve the assets. Mr. Kirk claimed, and the business records confirmed, that he had not invested money in the business or withdrawn any money in the form of loans or capital withdrawals. Also, Mr. Kirk's stock portfolio showed he removed no funds from his stock portfolio at Wells Fargo but added one check of $75,000 from an undisclosed source. In order to remove the appreciation of the stock portfolio on its own, the analysis must add back the $75,000 contribution. For the investments, the change in net worth resulted from increases in value of investments, except for the appreciation and contribution. To remove that item, it is added back to the reduction for appreciation. Finally, the fair market value of the house increased $50,000, but not from an addition, improvement, or other source of income or use of funds.

Net Worth June 30, 2010	$860,000
Net Worth Dec. 31, 2006	(400,000)
Overall increase in Net Worth	$460,000
Spock, Inc. value Dec. 31, 2006	100,000
Spock, Inc. value June 30, 2010	(300,000)

Investments—Wells Fargo Dec. 31, 2006	50,000
Investments—Wells Fargo June 30, 2010	(225,000)
Investments—additional contribution	75,000
Marital residence FMV—Dec. 31, 2006	400,000
Marital residence FMV—June 30, 2010	(450,000)
Adjusted Increase in Net Worth	**$110,000**

In the next step, the forensic accountant adds living expenses and reduces the amount of the increase in net worth from income from known sources. Here, the known income source is Mr. Kirk's business. The business' records show that Mr. Kirk paid himself only $50,000 after taxes each year, and no other distributions of profit were made during that time to Mr. Kirk from the business. The after-tax amounts are used because the amounts paid for taxes are not available to the Kirks to purchase assets, reduce debts, or pay for living expenses. This allows the forensic accountant to reverse engineer the increase in net worth from unknown sources. The calculation looks like this:

Adjusted Increase in Net Worth	$110,000
Reported living expenses:	$215,000
Reported income (3.5 years x $50K)	(175,000)
Increase in Net Worth from Unknown Sources	**$150,000**

What about depreciation? Since the goal of the exercise is calculating a change in net worth to determine income, depreciation of assets during the period must be excluded. But no asset depreciation was included in the example.

Mr. Kirk claimed to have earned only $175,000 during this 3½ years. But his net worth increased $325,000 after removing non-income-related changes in net worth. Mr. Kirk must have earned an additional $150,000 from unknown sources. Assuming Mr. Kirk dared not risk perjury in the divorce (by having failed to disclose a separate source of income or cash account to which only he has access), the increase in net worth must have come from somewhere. Where? We don't know for sure, of course. Likely, though, it came from unrecorded, undisclosed, and untaxed distributions from Mr. Kirk's business. If that was the case, Mr. Kirk was willing to commit federal income tax fraud in order to lower his child support and alimony obligations.

Problems with Cash and "Cash Businesses"

As described in the example above involving Mr. Kirk, an increase in net worth over time can occur in unexplained ways. Cars, boats, and even second homes can be purchased with income obtained with secreted cash. Restaurant and bar owners, lawn-service companies, and painting and drywall subcontractors are all often paid by customers with cash, which is often not reported on tax returns. (Unfortunately, some lawyers even transact business this way.) Understanding the type of business and how it is transacted is one key to investigating an unexplained increase in net worth. Some spouses of business owners may have a clue about this tax fraud and whether it occurs on a regular basis. During the marriage, there may have been a time when cash was paid for items in the presence of the non-business-owner spouse, and the owner may have even bragged about this particular shortcut "saving" money on taxes.

Your duty, as a family lawyer, is to be a zealous advocate. Nevertheless, no matter how much information you gather in an investigation, no matter how many financial statements, general ledgers, tax returns, bank statements, canceled checks, credit card statements, and receipts you obtain and analyze, some nefarious cash-based business owners will be able to get away with seriously understating their income.

There are very few feelings worse for a family lawyer than walking out of a courtroom after failing to prove the opposing spouse's cash income. Working with a talented forensic accountant who can make a professional attempt at catching the cash-based business cheat, means that you know that you've done everything that could have been done.

Family law attorneys representing spouses of cash-based business owners not reporting all their income on tax returns must use one of the methods of imputing income, or a combination of these methods, to prove the lie. For example, like many firemen, Mr. Goodman cuts lawns while off duty. His customers, like most lawn-cutting customers, pay in cash. If Mr. Goodman testifies that his lawn service earnings "make an extra $4,000 maximum per summer after costs," Mrs. Goodman knows this is a lie. But how can she prove the lie?

Based on some known information,[17] the forensic accountant can estimate and assume certain facts, such as assuming that an average price for lawn cutting is around $50 per lawn, that there are around 18 or so weeks of cutting time during the season (not just the summer), and that Mr. Goodman cuts around 30 lawns per week. If these assumptions are reasonable, the fireman earns an additional $27,000 in gross income per cutting season. Estimating costs of 25 percent for assistants, gas, maintenance, and average annual equipment replacement, Mr. Goodman is left with a net income of $22,500. Combine this with testimony of Mrs. Goodman that her husband bragged about the business earning enough for him to purchase his bass boat[18] for $20,000 cash in the fall of 2009, and the forensic accountant's testimony will likely hold water.

Money In and Money Out of a Business

If a business owner wants to infuse capital into a business, there are several ways to do so:

1. Contribute cash capital,
2. Transfer non-cash assets as capital or as a loan, or
3. Loan the business money or repay an existing loan.

Transfers of cash are traceable among bank accounts. Transfers of non-cash assets as capital or loans to the business present some challenges. Was the transfer for fair market value? During a divorce, a great way to hide personal assets may be to transfer (sell) a $35,000 car to the business, with the owner receiving only $2,000. If his business is not valued, the owner realizes an unrecorded windfall through that business. Forensic accountants know to look for transfers, sales, and related-party transactions and determine whether or not the deal was conducted at arm's length. The forensic accountant may be able to testify that the transfer resulted in dissipation to the marital estate.

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[17] Owners of sole proprietorships should include business operations in Schedule C of the federal income tax return. If the spouse of the business owner signed joint tax returns with the business-owner spouse and earnings were underreported, you should refer the spouse to a competent CPA or tax lawyer for advice to discuss legal obligations and opportunities for innocent spouse relief.

[18] One chancellor in Shelby County, Tennessee, (now retired) often imputed overtime income to fathers for child support purposes even if there were no additional hours actually being worked because, in his words, "Fathers can work overtime or a second job in order to buy a bass boat." With a stony glare, the chancellor would then look directly at the father, pause, and ask, "Don't you agree that your children are more important than a bass boat?"

If a business owner wants to remove cash from a business, there are a finite number of options:

1. Compensation,
2. Loan,
3. Return of capital,
4. Retained earnings distribution, or
5. Theft.

All salary or wages paid to all employees, including owners, should be recorded on a W-2, on a 1099, as a draw on a K-1, or the like. Taxes must be withheld, either as part of the regular payroll or through estimated quarterly payments.

Businesses may loan owners or other employees money. It's certainly very easy for an owner to approve a personal loan or obtain permission from co-owners for that loan. Accounting for the employee loan transaction is not terribly difficult. In general, loans to owners or employees do not result in taxable income, nor are they deductible to the business.

Return of capital is also simple. For example, if an owner contributes \$100,000 to begin the business and the business loses \$25,000 its first year, the business still has \$75,000 of owner's equity. Note that that doesn't mean there is \$75,000 of cash available. If the owner withdraws \$15,000 from capital and it is not compensation, the owner's equity is reduced to \$60,000. Depending on the circumstances, the owner may or may not owe taxes on the return of capital.

Retained earnings is a capital account, assembling an accumulation of profits. For example, if the business with \$60,000 of owner's equity earns \$200,000 in net profits, the total owner's equity will be increased to \$260,000. Of that amount, \$60,000 is in a contributed-capital account, and \$200,000 is in a retained-earnings account. If the owner chooses to distribute \$100,000 in earnings, it should be removed from the retained-earnings account first, and taxes may be owed as capital gain on the excess of distribution over the original amount contributed. Without question, this is a rather simplistic example. In the real world, the tax consequences of capital contributions, return of capital, and distribution of profits and the determination of whether such transactions result in taxable income can be ridiculously complex. Tax lawyers and CPAs with tax practices get to make those calls. A good first step is recognizing when you must call for help in interpreting the ramifications of these transactions.

Theft is included in this discussion as an option because it happens. Whether a restaurant owner pulls cash out of the till or a lawyer accepts a cash fee from a client and puts it in her pocket without depositing or recording it, it's all the same to the IRS and the defrauded support obligee.

There is one final aspect of money coming into and money going out of a business that you must consider. What happens if the business owner-obligor fails to take money out of the business that he could otherwise take out? Corporations pay taxes on the income when the income is realized, and owners of corporations are taxed on income when it is paid to them in the form of dividends. If the business owner is paid a low salary and does not remove profits through the salary, the corporation retains the profits, and no additional tax is charged to the owner. This is sometimes referred to as excess retained earnings. By retaining the undistributed profits within the corporation, the owner's income reported on personal tax returns can be significantly understated, as compared to what the business and the owner earn together—the real amount of income. For purposes of support, the corporate and personal income should probably be combined. In this situation, a forensic accountant can be very helpful explaining why this is so.

End of excerpt. End of materials for Miles Mason, Sr.