VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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INCOME – DO TAX RETURNS TELL ALL?
Part 1

In a word, no. In fact, it has been held that blind reliance on a corporate tax return is an impermissible way to determine income of an S corporation shareholder because it does not allow the court to evaluate the possible manipulation of the numbers contained on the return to conceal income which may be available for support purposes.

The theory behind determining income for support purposes is different from that of stating income for tax purposes. The tax code permits or denies deduction from gross income based on economic and social policy concerns which have no bearing on support. Support guidelines are concerned solely with determining how much money is actually available for support purposes. The economic reality is that all money earned, irrespective of its taxability, is in fact income (available for support).

Under ORC 3105.18, in awarding spousal support, the court shall consider the income of the parties, from all sources. So what is income? The Uniform Interstate Family Support Act under ORC 3115.01(E) defines "income" to include "earnings or other periodic entitlements to money from any source and any other property subject to withholding for support under the law of this state." The statutory provisions are intentionally broad in order to be flexible. Emphasizing this, ORC 3119.01 provides a lengthy laundry list of gross income items, which includes all earned and unearned income from all sources whether taxable or not. The list ends with self-generated income and potential cash flow from any source.

Self-generated income includes gross receipts from self-employment, proprietorship of a business, joint ownership of a partnership or closely held corporation, and rents minus ordinary and necessary expenses incurred in generating the gross receipts. This category also includes expense reimbursements or in-kind payments received from self-employment, operation of a business, or rents, including, but not limited to company cars, free housing, reimbursed meals and any other benefits that reduces personal living expenses. Legitimate business expenses for income tax purposes may also be personal benefits, freeing up other income for possible support distribution.

As such, the W-2 forms are only a starting point when considering the income of an owner of a business. A careful review of the expenses claimed on the business's tax return would be prudent to determine the true income received by the owner. Are the expenses truly legitimate business expenses required for derivation of income? Or are some of the deducted expenses actually personal expenses of the owners or their family members? For example, the cost of vehicles and cell phones used by the owner's children are not legitimate business expenses. Nor are the ski trips to Aspen or the boat in the Carribean.

An area for careful consideration when dealing with business owners is a category called "shareholder loans". Although a shareholder loan normally would not be considered income, the circumstances may suggest otherwise. In one case, appellant used distributions and loans on a regular basis as a means of payment for appellant's personal expenses, without repaying the loans. The record demonstrated an ongoing practice whereby shareholder loans funded appellant's personal expenses in one form or another and, based upon this record, the court concluded that it was appropriate to impute income to appellant based upon the loans and distributions.

Another interesting item to be included in income is funds withheld from a shareholder's paycheck to pay for his or her equity buy-in. The courts have held that it is not necessary to be a shareholder to generate income and therefore, those funds are income that the obligor would have actually received had he not chosen to become a shareholder.

And let's not forget the cash flow from sources that are not reported as "taxable income". A home-based business such as day-care or landscaping is a good example of this. And going back to non-taxable income, earnings from an IRA would be includable income for support purposes. ORC 3119.01 is silent regarding whether to include or exclude pension contributions made by an obligor's employer, which could explain why the courts have been inconsistent in their application of this potential income item.

It is important to remember that income and cash flow can take many forms, not all of which show up on the tax return. Watch for next month's edition, where we will discuss what is <u>not</u> included in income.

If you would like additional information, or have a question, please do not hesitate to call.

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