VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

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INCOME – DO TAX RETURNS TELL ALL?
Part 2

Last month we talked about what is included in income for support purposes. Let's now explore what is not included. First we will start with the laundry list in ORC 3119.01 which include: means-tested government benefits (where eligibility is determined on the basis of income or assets), VA service-connected disability benefits that have not yet been distributed, foster care payments, child support payments received from a different marriage, mandatory deductions from wages such as union dues (but not taxes or social security), and nonrecurring or unsustainable income or cash flow items.

How do you determine if income is nonrecurring? The test is whether the income or cash flow item that has been received for not more than three years is not expected to continue on a regular basis. For example, a nonrecurring or unsustainable income or cash flow item does not include a lottery prize award or automobile accident settlement. A common area of debate under this category is overtime income. With today's economy, many employers do not make overtime as readily available as in years past. Therefore, basing support on historical overtime pay may not be representative of what may be currently available.

Now, let's go back to last month's discussion of self-generated income. This includes gross receipts minus "ordinary and necessary expenses" incurred in generating the gross receipts. Ordinary and necessary expenses are the actual cash items expended, not the depreciation expenses that are allowed as deductions on the federal tax return. In one case, the court allowed a self-employed farmer to deduct from his gross income the purchase of farm machinery. Similarly, the court authorized a self-employed truck driver to deduct both the principal and interest loan payments on his truck as an ordinary and necessary business expense. The truck was necessary for the driver to generate income. However, an obligor's capital contribution for purchase of an equity interest in a partnership did not constitute "ordinary and necessary business expenses".

This leads us to the question of how depreciation expense comes in to play with regards to acquisition of assets used in the business. ORC 3119.01(C)(9)(b) states that ordinary and necessary expenses do not include depreciation expenses and other noncash items that are allowed as deductions on any federal tax return, except as "specifically included in 'ordinary and necessary expenses incurred in generating gross receipts' by division (C)(9)(a) of this section. ORC 3119.01(C)(9)(a) defines ordinary and necessary expenses as "actual cash items expended *** and includes depreciation expenses of business equipment."

Other types of depreciation deductions "are designed to ensure that income is not reduced by any sum that was not actually expended in the year used for computing support.

In order to exclude the depreciation deduction from the calculation of gross receipts under ORC 3119.01(C)(9)(b), the actual cash expenditure must be incurred in the same tax year. Without evidence illustrating that the depreciation deduction represents actual cash expenses in the year the deduction was taken, ORC 3119.01(C)(9) requires the court to include the depreciation deduction when computing gross income for any given year.

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

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.