Show Me the Money –
Identifying Business Income Available For Support

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I. INTRODUCTION:

The calculation of guideline child support and the determination of the appropriate amount of spousal support requires a threshold determination of the payor's ability to pay. While the Internal Revenue Code concept of income is helpful, it does not address whether a particular category of income, which may be recognized as income for tax purposes, actually represents funds that are available to the payor for the payment of child or spousal support.

As a practical matter, the concepts of "income" and "availability" need to be harmonized in order to fairly measure a payor's ability to pay support. This is particularly true when dealing with income or cash flow from the operation of a business. The issue presented is how do we, as family law lawyers, determine "what business income is available for support".

II. THE PROBLEM – INCOME OR CASH FLOW:

In the operation of a business, certain items are included in income and certain items are permitted to be deducted in calculating taxable income. The recognition of income and allowability of deductions for income tax purposes is not the same as what funds are actually available from the business operations. This is the distinction between "income" and cash flow."

We as lawyers have been accused of using "sloppy synonyms" for income. In *In re Marriage of Riddle* (2005) 125 Cal.App.4th 1075, the court was dealing with the determination of the payor's ability to pay child and spousal support. Justice Sills, writing for the majority 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." (Id at page 1080)

Courts and the Legislature have looked at income as defined by the support statutes and income as defined by the Internal Revenue Code. The courts and the legislature recognize that income for tax purposes may not be representative of 'cash flow' or funds that are actually available to meet the needs of the family. This creates the need to develop an approach to determine the payor's ability to pay that begins with the statutory definitions of income, but recognizes the need to adjust that determination of income based on whether those funds are actually available to the payor parent or spouse.

III. "THE INCOME TAX" APPROACH VERSUS THE "CASH FLOW" OR "AVAILABILITY" APPROACH:

A. The Income Tax Approach:

The determination of ability to pay support necessarily involves the Internal Revenue Code definition of taxable income. As the court noted in *In re Marriage of Schulze* (1997) 30 Cal.App.4th 519, 529:

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

In *In re Marriage of Loh* (2001) 93 Cal.App.4th 325, 334 the court stated:

> "A parent's gross income, as stated under penalty of perjury on recent tax returns, should be presumptively correct. (citations omitted) Returns are, after all, ultimately enforced by federal and state criminal penalties. Hence it is not surprising that tax returns are the core component of determinations under the guideline formula.
> …
> The statutory tie to actual tax returns is underscored by the requirement in section 4059 that state and federal income tax liability for purposes of computing a parent's net income must 'bear an accurate relationship to the tax status of the parties.'
> …
> In more commonsense terms, the use of income as stated on a tax return accords with the Legislature's goal of uniformity and expedition."

In *In re Marriage of Riddle (supra)* 125 Cal.App.4th 1081, the court stated:

> "As we pointed out in *In re Marriage of Schultze* (1997) 60 Cal.App.4th 519, 529 the language was 'lifted' straight from the Internal Revenue Code. That means that if the tax laws say you have income because of the forgiveness-of-debt, you have income, and that forgiveness-of-debt income must go into the calculation of adjusted gross income under section 4058, subdivision (a), which in turn is the basis for income under section 4059, subdivision (a)." (Id at page 1080)

In *In re Marriage of Rothrock* (2008) 159 Cal.App.4th 223, the court was dealing with whether certain payments from a personal injury settlement annuity constituted "income" for determining child support. The court again noted:

> "Section 4058's definition of annual gross income is based on the definition of 'gross income' in the Internal Revenue Code. Thus, although federal tax law is not conclusive on the interpretation of section 4058, it is persuasive."

The child support statutes define income much the same way as the Internal Revenue Code. Internal Revenue Code Section 61 provides:

> "Gross income defined
>
> (a) General definition
>
> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
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> (2) Gross income derived from business;
>
> (3) Gains derived from dealings in property;
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> (4) Interest;
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> (5) Rents;
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> (6) Royalties;
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> (7) Dividends;
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> (8) Alimony and separate maintenance payments;
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> (9) Annuities;
>
> (10) Income from life insurance and endowment contracts;
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> (11) Pensions;
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> (12) Income from discharge of indebtedness;
>
> (13) Distributive share of partnership gross income;
>
> (14) Income in respect of a decedent; and
>
> (15) Income from an interest in an estate or trust."

Family Code Section 4058(a) defines annual gross income for purposes of guideline child support as follows:

> "(a) The annual gross income of each parent means income from whatever source derived, except as specified in subdivision (c) [child support and certain public benefit payments] and includes, but is not limited to, the following:
>
> (1) Income such as commissions, salaries, royalties, wages, bonuses, rents, dividends, pensions, interest, trust income, annuities, workers' compensation benefits, unemployment insurance benefits, disability insurance benefits, social security benefits and spousal support actually received from a person not a party to the proceeding to establish child support under this article.
>
> (2) Income from the proprietorship of a business, such as gross receipts from the business reduced by expenditures required for the operation of the business.
>
> (3) In the discretion of the court, employee benefits or self-employment benefits, taking into consideration the benefit to the employee, any corresponding reduction in living expenses, and other relevant facts."

Family Code Section 4059 defines annual net disposable income by requiring the deduction of actual federal and state income tax liability. That section states:

> "The annual net disposable income of each parent shall be computed by deducting from his or her annual gross income the actual amounts attributable to the following items or other items permitted under this article:
>
> (a) The state and federal income tax liability resulting from the parties' taxable income. Federal and state income tax deductions shall bear an accurate relationship to the tax status of the parties (that is, single, married, married filing separately, or head of household) and number of dependents. State and federal income taxes shall be those actually payable (not necessarily current withholding) after considering appropriate filing status, all available exclusions, deductions, and credits. Unless the parties stipulate otherwise, the tax effects of spousal support shall not be considered in determining the net disposable income of the parties for determining child support, but shall be considered in determining spousal support consistent with Chapter 3 (commencing with Section 4330) of Part 3.

(b) Deductions attributed to the employee's contribution or the self-employed worker's contribution pursuant to the Federal Insurance Contributions Act (FICA), or an amount not to exceed that allowed under FICA for persons not subject to FICA, provided that the deducted amount is used to secure retirement or disability benefits for the parent.

(c) Deductions for mandatory union dues and retirement benefits, provided that they are required as a condition of employment.

(d) Deductions for health insurance or health plan premiums for the parent and for any children the parent has an obligation to support and deductions for state disability insurance premiums.

(e) [child or spousal support actually being paid].

(f) Job-related expenses, if allowed by the court after consideration of whether the expenses are necessary, the benefit to the employee, and any other relevant facts.

(g) [hardship deductions]."

B. The Cash Flow Approach – Is the Income Actually Available?

1. Taxable income may not always represent funds available to pay support. Several statutes recognize that a strict determination of income, such as used to determine income for income tax purposes, does not always result in an appropriate calculation of income for support purposes.

a) Family Code Section 4060 states in part:

"If the monthly net disposable income figure does not accurately reflect the actual or prospective earnings of the parties at the time the determination of support is made, the court may adjust the amount appropriately."

b) Family Code Section 4058, subdivision (a)(2) departs from the income tax determination of net taxable income in the operation of a business. In determining net taxable income in the operation of a business, the Internal Revenue Code generally requires the inclusion of all gross receipts less certain "deductions." These deductions may be actual cash deductions or may be tax motivated deductions, such as depreciation. By contrast, subdivision (a)(2) of Family Code Section 4058 defines income from the operation of a business by taking into consideration only "expenditures." That subdivision states:

"(2) Income from the proprietorship of a business, such as gross receipts from the business **reduced by expenditures required for the operation of the business.**" (emphasis in bold added).

c) Family Code Section 4058, subdivision (a)(3) allows the court to include in income for support, employee or self employment benefits that would not otherwise be included in taxable income. That subdivision states:

> "3) In the discretion of the court, employee benefits or self-employment benefits, taking into consideration the benefit to the employee, any corresponding reduction in living expenses, and any other relevant facts."

2. A number of issues impact whether funds that may or may not be included in taxable income are actually available for the payment of support.

a) Depreciation. In *Asfaw v. Woldberhan* (2007) 147 Cal.App.4th 1407, the court was dealing with the question of whether the payor should be allowed to deduct from annual gross income depreciation on certain rental properties. The court concluded that depreciation is not properly deductible under the Family Code section 4058, definition of annual gross income. The court noted that there was no reported California opinion that specifically addressed the propriety of deducting depreciation from annual gross income for purposes of determining child support. The court examined the provisions of Family Code Section 4058(a)(2), which states that income includes:

> "Income from the proprietorship of a business, such as gross receipts from the business **reduced by expenditures required for the operation of the business**." (Emphasis added).

The court noted that there was no mention of depreciation in that definition. The court then analyzed whether depreciation of a rental property constitutes an "expenditure" required for the operation of a business. The court observed that California Revenue and Tax Code Section 17072(b) addressed depreciation. It expressly refers to Internal Revenue Code Section 167(a) that allows:

> "As a depreciation deduction a reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) (1) of property used in the trade of business, or (2) of property held for the production of income."

The court then reviewed the legislative history of Family Code section 4058. The legislature had earlier considered language which expressly mentioned Revenue and Taxation Code Section 17072 and its references to Internal Revenue Code Sections 167(a). That language would have allowed a deduction for depreciation of property held for the production of income. That proposed language was rejected in favor of the provisions of 4058(a)(2), which makes no reference to depreciation or those tax code sections. The final enactment of the statute read "expenditures required for the operation of a business." The court observed that this change suggested limiting the broad language of the earlier draft to expenditures rather than just expenses. The court stated that an "expense", in an accounting sense, may or may not involve the actual payment of money. By contrast, an "expenditure" means to actually pay out or distribute and "…obviously reduces the amount of money available to pay child support…" (id at page 1421). The importance of this decision is that while the

determination of income under Family Code Section 4058 is closely linked to the Internal Revenue Code definition of income, the legislature in using the term "expenditure" recognized that the income had to actually be "available" to pay child support.

b. Principal Reduction Payments. Principal reduction payments raise another issue concerning whether an adjustment from taxable income needs to be made to reflect business income available for support. This can best be demonstrated by considering payments on a note secured by a first trust deed on real estate used to operate a business. In calculating net taxable income from a business, the business is allowed to deduct the interest portion of the mortgage payment. However, the amount of the payment that represents principal reduction is not deducted from the income to determine net profits. While the business may deduct a depreciation expense for the building, the holding in *Asfaw* makes it clear that the depreciation expense must be added back for the calculation of child support and in all likelihood added back for the determination of spousal support. What then is to be done with the actual cash expenditure that is required to be paid by the business in order to keep the payments on the secured real estate loan current. Here again an examination of the language of Family Code Section 4058(a)(2) may control on the issue of child support and be of assistance in analyzing the issue of spousal support.

As discussed above, Family Code Section 4058(a)(2) defines annual gross income from a business as:

> "Income from the proprietorship of the business, such as gross receipts from the business **reduced by expenditures required for the operation of the business.**" (emphasis in bold added)

There can be no question that the payment of the mortgage payment, both interest and principal, is an actual expenditure. The check is being written by the business each month. The interest portion is both an expense and an expenditure. It is an expense because it is being deducted in the calculation of net income for income tax purposes. It is an expenditure because it is an amount that is being paid out of business revenues on a monthly basis. In contrast, the principal reduction payment is not an "expense" in that it is not deducted from revenues to determine net profit. However, it is an "expenditure." It represents funds being paid out of the revenues of the business.

It would seem that the only remaining inquiry is whether it is "required" for the operation of the business. Here it would seem a compelling argument could be made that because the loan is secured by the real estate, the failure to make the principal reduction payment would cause the loan to go into default and, sooner or later, the property would be lost to foreclosure and the business would not be able to operate from that location. The business would then have to rent another location which, presumably, would be in an amount that might equal or exceed what the business was paying in mortgage payments to occupy the business owned property.

An even more compelling argument can be made if the "business" being examined is the business of rental real estate. Consider the real estate developer whose business is to develop, build and then lease out commercial real estate. It is clear from the holding in *Asfaw* that the depreciation deduction will not be allowed. However, in order to generate the income stream from the commercial building, it is necessary for the real estate developer to make the mortgage payments that are secured by the same real estate. Assume that

the mortgage payments being made are the minimum monthly mortgage payments required on a fully amortized loan. It would seem inescapable that making the monthly required principal mortgage payments would have to come within the definition of "expenditures required for the continued operation of the business." The same argument would apply if there are loans on business equipment, secured by the equipment.

It is necessary to determine whether or not principal reduction payments should be deducted from the net operating income reported for income tax purposes to correctly determine income available for support. This is another example where income for income tax purposes may need to be adjusted to take into consideration whether that income is actually available for the payment of support.

c. <u>Phantom Income</u>. A common "availability" issue results from the requirement that shareholders of S Corporations, partners, members of LLCs, and beneficiaries of certain trusts are required to report their proportionate share of the taxable income of the tax reporting entity on their personal income tax returns. This is commonly referred to as "pass-thru" income. This is true even if that income is not distributed to the tax payer. The "pass-thru" income" that is not distributed to the taxpayer is commonly referred to as "phantom income." This is a common example of where "taxable income" and "cash flow" or available income may be drastically different. There is no question that income from the ownership of a Subchapter S Corporation would come within the definition of income under the Internal Revenue Code and Family Code Section 4058(a). However, if the income is not distributed, it is certainly not available to pay child or spousal support.

In *In re Marriage of Kirk* (1990) 217 Cal.App.3d 597, the court was dealing with the issue of whether or not a portion of husband's salary which was automatically deducted to pay a debt owing to his employer was properly includable in the determination of income available for child support. In that case, the court determined that since the record demonstrated that husband had voluntarily agreed to divert that income it should be included in income available for support. However, in dictum, the court noted that if the evidence established that husband had no choice in the matter, and would not have been employed but for his agreement to pay this debt, perhaps the result would be different. This recognized that perhaps income that was not available should not be considered for purposes of child support.

In *In re Marriage of Riddle* (2005) 125 Cal.App.4th 1075, the court cited *Marriage of Kirk* as authority for ameliorating the harsh effects of assessing "phantom income" as imputed by the tax laws under the circumstances of a given case (id at page 1080).

While there is no case in California which specifically addresses the issue of phantom income from a Subchapter S Corporation when dealing with support, opinions from other jurisdictions are helpful.

In a Maryland case, *Walker v. Grow* (2006) 907 A.2d 255, the husband was the chief operating officer of a corporation in which he held a 30% ownership interest. The corporation was an S Corporation, meaning that all of its taxable income was reported on the tax returns of the shareholders. The issue on appeal was whether or not this "phantom income" should be included in determining child support. The court noted that the husband in that case 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. The court went on to state:

> "We have found no Maryland cases, and have been directed to none by counsel, addressing the extent to which pass-thru income or distributions from a Subchapter S Corporation should be considered the actual income of a parent for child support awards. Several courts in sister states have considered the issue. In interpreting their own child support guidelines, several states have determined that pass-thru income should not be included unless the parent is using the corporate form to manipulate his or her income to avoid child support obligations."

The court went on to deal with the issue of distributions to offset Subchapter S Corporation tax liability. The court stated:

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

The court in *Walker v. Grow* concluded:

> "…We are persuaded that, in determining a parent's actual income for child support purposes, a trial court can consider whether Subchapter S income shown on a parent's tax return was actually received by the parent as actual income, or constituted pass-thru income not available for child support…Nevertheless, a court considering such issues must take special care to ensure that a parent is not utilizing the S Corporation to manipulate his or her income to avoid child support obligations."

In addressing the burden of proof, the court held:

> "An express finding that the parent is not using the corporation to shield income to avoid a child support obligation is appropriate and would certainly aid appellate review in the future. The burden is on the parent seeking to exclude pass-thru income from actual income to persuade the court that the pass-thru income is not available for child support purposes."

The court went on to state:

> "In considering pass-thru income, trial courts must ensure that retained earnings and distributions are truly 'ordinary and necessary expenses required to produce income' and not income available to the parent. (citations omitted) Moreover, any amount that is actually received by the shareholder not used for such expenses should be included

> in the calculation of actual income. The fact that a party is a minority shareholder is certainly a factor to be considered by the court, but minority shareholder status, in and of itself, would not always be the determining factor. The nature of the business and governing documents, and the business and non-business relationship among the shareholders would also have to be considered in evaluating the issue of control."

Another case that has dealt with the issue of pass-thru income comes from Florida. In *Zold v. Zold* (2005) 911 So.2d 1222, the issue before the Florida Supreme Court was whether or not pass-thru "phantom income" from an S Corporation that is not actually distributed to the shareholder/spouse is to be considered income for the purposes of calculating alimony, child support and attorney's fees. The court noted that pass-thru income refers to a small business corporation's income, deductions, losses and credits that pass-thru to the shareholders of a corporation in accordance with each shareholder's pro rata share of ownership in the corporation, and is reported on each shareholder's individual federal income tax return under the Subchapter S Revision Act of 1982 (see 26 U.S.C.A. §1366).

In *Zold*, the husband was the chief executive officer of a Subchapter S Corporation. He owned slightly over 57% of the corporation. The trial court included husband's entire pro rata share of the net income from the Subchapter S Corporation, both distributed and undistributed, as income available to husband to pay child support, alimony and attorney's fees. The District Court reversed noting that Subchapter S shareholders do not necessarily receive cash distributions equal to their proportionate share of the corporation's net income that is taxed to them **because a portion of the corporation's net income may be retained for corporate purposes.** The District Court explained as follows:

> "The corporation is not the personal piggy bank for any one shareholder simply because that shareholder may have a controlling interest in the corporation and is also the chief executive officer. Financial responsibilities to creditors and employees must be satisfied before distributions to shareholders take place if a corporation is to remain viable."

The issue before the Florida Supreme Court was whether the portion of the "pass-thru" income of an S Corporation which is not distributed to shareholders, constitutes income within the meaning of Florida's statutes for calculating alimony, child support and attorney's fees. The Supreme Court reviewed provisions of the Florida statutes defining income, and then reviewed cases addressing the issue of whether business income that had been reported on an individual income tax return but not received by the spouse constitutes income under the Florida statutes.

While the decision in *Zold* was based upon the specific Florida family law statutes and Florida corporate law that requires the corporation to retain sufficient funds to pay creditors and other expenses, it is a useful analysis of the difference between the "income tax approach" and the "cash flow" or availability approach. The Florida Supreme Court concluded that undistributed pass-thru income that has been retained by a corporation for

corporate purposes (i.e., the phantom income) does not constitute income within the meaning of Florida's statutes for determining income for child support, alimony and attorney's fees. The court held that where undistributed pass-thru income has been retained for non-corporate purposes, such as to shield the income from the reach of the other spouse during dissolution, the improper motive for its retention makes it available income for support purposes. The court noted that income reported on an individual federal income tax return for a shareholder-spouse of an S Corporation is not necessarily equivalent to income available to that shareholder spouse.

The Florida Supreme Court declined to establish a bright line rule in these circumstances. The court was concerned that establishing a bright line rule that undistributed pass-thru income can never constitute income for purposes of alimony or child support would encourage a shareholder spouse to manipulate an S Corporation's pass-thru income in order to shield the income from the reach of the other spouse during dissolution proceedings. On the other hand, the Florida Supreme Court said that establishing a rule that undistributed "pass-thru" income always constitutes income for support purposes ignores the fact that an S Corporation may have legitimate business reasons for retaining its income. The court placed the burden of proof squarely on the shoulders of the shareholder spouse stating:

> "We conclude that when the issue of whether undistributed 'pass-thru' income was retained for corporate purposes is contested, the shareholder-spouse should have the burden of proving that the undistributed 'pass-thru' income was properly retained for corporate purposes rather than impermissibly retained to avoid alimony, child support or attorney's fees obligations by reducing the shareholder-spouse's amount of available income. The burden is properly on the shareholder-spouse because he or she has the ability to obtain information to establish the propriety of the corporation's actions."

The court then listed some of the factors that should be considered on this issue stating:

> "In determining whether the shareholder-spouse has met his or her burden of proving that undistributed 'pass-thru' income was retained for corporate purposes, the trial court should consider (1) the extent to which the shareholder-spouse has access to or control over 'pass-thru' income retained by the corporation, (2) the limitations set forth in [Florida statutes] governing corporate distributions to shareholders, 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."

d. <u>Reserves for Operations</u>. In a recent California case the issue of whether funds necessary for continued business operations should be considered income available for child support was addressed. In *In re Marriage of Blazer* (2009) 176 Cal.App.4th 1438, the court addressed this issue.

In *Blazer*, husband operated an agricultural business with substantial income. Husband argued the business was thinly capitalized and needed to retain its earnings to expand and vertically integrate in order to compete and remain viable. Wife argued that it was husband's choice to spend the business income in this fashion and it should be considered income for support purposes.

The trial court accepted the testimony of husband and husband's accounting expert and found that the funds used to capitalize the vertical integration were reasonable expenses that should not be included in husband's income for purposes of support. The Court of Appeal affirmed. Wife contended on appeal that the trial court's failure to use the total of husband's income in setting support was an abuse of discretion.

The Court of Appeal noted that the spousal support statute does not define income where, by contrast, income is specifically defined in the child support statutes. The court noted that the question of setting aside reserves for additional capital requirements was one of first impression.

The court held that the standard on appeal for the trial court determination of spousal support was the abuse of discretion standard. The court noted that so long as the trial court's determination was supported by substantial evidence, it would be upheld by the Court of Appeal. The Court of Appeal noted the trial court had determined that there was a "need to diversify the company's work" and that funds spent for that purpose were "reasonable expenses" properly chargeable to the business, not to husband [Id at page 1447]. The court determined that the trial court's decision was supported by the testimony of the husband that the company would not continue to exist if it did not diversify and vertically integrate. This conclusion was also supported by the husband's expert. The Court of Appeal also held that the trial court's determination was legally proper. Here, the court stated that to the extent the child support statute might offer guidance, it supports the trial court's decision in that case [Id at page 1448]. The Court of Appeal pointed out that Family Code Section 4058(a)(2) in defining income available for child support would allow the court to exclude from funds generated by the operation of a business "expenditures required for the operation of the business." Based on this authority, to the extent a trial court is persuaded that certain capital expenditures are "required" for the continued operation and viability of the business, the court acts within its discretion to not include those funds in the payor's income.

e. <u>New Spouses Share of Community Income is Not Includable in Income Available for Support</u>.

In re Marriage of Knowles (2009) 170 Cal.App.4th 35

In this case, mother sought to modify a 1995 order some 10 years later in 2005. Father had remarried and he and his new wife had accumulated community

property assets that included a brokerage account and a real estate development investment. The trial court, over father's objection, imputed income to 100% of the brokerage account and real estate development investment and used all of that income as father's income for determining support. The trial court in analyzing Family Code Section 4057.5 ("the income of the obligor parent's subsequent spouse or non-marital partner shall not be considered when determining or modifying child support…") stated, "There is an exception to the rule that the income of a party is available for child support when that income is earned by the [subsequent] spouse. However, no statutory or case law has been presented or identified that stands for the proposition that capital gains, or other passive community property income of a party, such as interest income, or dividends income, should be divided for support purposes with a new spouse, making half of it unavailable for child support. Public policy points directly in the opposite direction." [Id at page 40].

The Court of Appeal reversed. The Court of Appeal held that Family Code Section 4057.5 expressly prohibits courts from considering a subsequent spouse's income when determining or modifying child support, except in very limited circumstances [Id at page 40]. The court noted that income generated from community property is community property and an equal undivided interest in that income is attributable to each spouse. On this basis, the Court of Appeal held that the trial court erred by including father's new spouse's half of the community income when calculating father's income for child support purposes.

Mother argued that Family Code Section 4008, which permits the obligor parent's community interest in income to be used to discharge a child support obligation points to a public policy that income should be available for determining child support. The Court of Appeal rejected this argument and noted a distinction between what income might be available for discharging a child support obligation as opposed to income that should be available for calculating the child support obligation. The Court of Appeal held that inasmuch as Family Code Section 4057.5 was directly on point, that statute represents the public policy that controls. The court held, "Family Code section 4057 is the law that prohibits the use of community income attributable to the subsequent spouse, **whether the income is earned or a return on investments**, in calculating a child support obligation." (emphasis in bold added) [Id at page 42].

In analyzing the issue of business available for support, a determination needs to be made as to whether or not any portion of that business represents community property and therefore whether or not any portion of the income generated by that business should be excluded under the holding in *In re Marriage of Knowles*.

f. <u>Capital Gains</u>. Often the business income will include capital gains income. Capital gains income may not always be included in income for support purposes. While not dealing with capital gains in the context of the operation of a business, the court in *In re Marriage of Pearlstein* (2006) 137 Cal.App.4th 1361 examined whether or not capital gains, even though required to be reported on a party's income tax return, should properly be included in the calculation of income available for child support. The court held that if capital gains were actually consumed (used for living expenses), the court had the discretion to include the amount so used in the calculation of income available for child support. The court also held that to the extent capital gains were reinvested, and therefore not used for living expenses, it would be an abuse of discretion to include such capital gains as income available for child support.

IV. APPLICATION:

A. Our Approach to Determining "Business Income Available for Support":

Taxable income does not always reflect what is available to meet the family's needs and, as a result, further analysis of what might be considered income available for support is necessary. This approach is authorized by Family Code Section 4058(a)(2) and Section 4060 and the cases cited above dealing with whether income is actually available for support.

The three-part financial statement highlights these issues. Note: for a financial statement to be complete, it needs to have all three components. These are:

1. Balance Sheet. The balance sheet provides a snapshot of the business' assets, liabilities and owner's equity at a given point in time. It will include cash, stocks, accounts receivable, inventory, and prepaid expenses. It will then list current liabilities, such as notes payable, lines of credit, long-term debts, accounts payable to trade creditors, accrued expenses. The balance sheet then provides a representation of the owner's equity, which generally represents the total amount invested by the owner, plus accumulated profits or losses.

2. Income Statement. The income statement reports revenues versus business expenses for a given time period. By way of example, it would be sales less costs of goods sold, less operating expenses, including depreciation. The income statement provides a determination of net profit, usually before income taxes.

3. Statement of Cash Flow. The statement of cash flow is designed to convert the accrual basis of accounting used to prepare the income statement and balance sheet back to a cash basis. The accrual basis of accounting is generally preferred for the income statement and balance sheet because it more accurately matches revenue sources to the expenses incurred generating those specific revenue sources. The cash flow statement is important to be able to analyze the actual level of cash flowing into and out of the business. The cash flow statement measures financial activity over a period of time and tracks the effects of changes in the balance sheet accounts.

Without all three components, you do not have a complete picture.

B. Start With the Tax Return – Then Consider Adjustments to Taxable Income in Order to Determine Whether the Business Income is "Available" for Support:

The following adjustments need to be considered to harmonize taxable income with income that is actually available to pay support:

1. Depreciation.

Whether depreciation is appropriately considered as an item that would reduce business income available for support turns on whether or not it represents or reflects an actual expenditure required for the continued operation of the business. In *Asfaw (supra)* 147 Cal.App.4th 1407, the court was dealing with the issue of depreciation on rental real estate properties. The court noted that while depreciation on rental real estate was permitted under tax

laws and accounting principles, it did not actually reduce funds available for support. As a practical matter, that is true with respect to rental real estate. The property is not being "worn out" and maintenance and repair items are expensed as they are incurred. As a result, the depreciation on real estate that is allowed in determining net income for income tax purposes does not reflect an actual cash expenditure.

However, there are circumstances where depreciation may more closely track the actual expenditure or capital reserves required to replace business equipment. If the business is required to have a certain piece of equipment, and that equipment will be obsolete and valueless in five years, the cost of purchasing or replacing that equipment should be spread out and recognized over the same five year period. That would be the case if the business utilized a "straight line" depreciation method.

However, if the depreciation is being taken at a rate that is not consistent with the equipment's useful life an adjustment needs to be made. In certain circumstances businesses are allowed to use Internal Revenue Code section 179 to expense the entire acquisition price in one year. In other cases, a business is entitled to use MACRS (modified asset cost recovery system) to take a larger amount of the depreciation in the earlier years of the equipment's life. Perhaps the clearest way to present the adjustment is to add back the depreciation that was deducted and then subtract a proportionate amount of the purchase price and/or replacement cost of the asset over the asset's useful life. In the case of equipment that cost $300,000 and will have a five year useful life, it could reasonably be argued that $60,000 of the company's net operating profits each year should be set aside and not considered as income available for support so that there will be funds available to replace the machine in the sixth year.

In a very real sense, this would reflect, over an appropriate time period, "expenditures required for the operation of the business" under Family Code Section 4058(a)(2). It also reflects the holding in *In re Marriage of Blazer* (2009) 176 Cal.App.4th 1438 that recognized that reasonable expenses required for the continued operation and viability of a business can, in the court's discretion, be excluded from income used to calculate support.

2. <u>Principal Reduction Payments</u>.

Principal reduction payments on real estate provides a clear example of how principal reduction payments impact business income available for support in a very real way. Assume a business owns the land and buildings where the business operates. There is a $500,000 amortized mortgage. Assume the mortgage payment is $8,000 per month of which $5,000 is interest and $3,000 is principal reduction. Also assume the reasonable rental value happens to also be $8,000 per month. The $5,000 per month in interest is deducted to determine taxable income. Assume the payor also deducts $24,000 per year, or $2,000 per month in depreciation to determine taxable income. However, the principal reduction payment is not deducted as an expense in determining taxable income.

Under the holding in *Asfaw*, we know depreciation on real estate is not allowed to be deducted from income for support purposes. As a result, it will be added back to taxable income to determine business income available for support.

We also know that the terms of the promissory note and the deed of trust require the payor to pay the full $8,000 per month payment or the creditor can foreclose on the property. Therefore, this actual <u>expenditure</u> of $5,000 in interest and $3,000 in principal is <u>required</u> for the continued operation of the business.

In this example, the holding in *Asfaw* requires depreciation to be added back, raising business income available for support by $2,000 per month. However, Family Code Section 4058(a)(2) would require that the principal reduction payments be subtracted, reducing business income available for support by $3,000 per month.

The outcome seems particularly logical and defensible with the assumed fact that the reasonable rental value equals the entire mortgage payment. If that assumption were changed so that the reasonable rental value of the property were only $4,000 per month it might well impact the determination of whether the expenditure of $3,000 in principal reduction payments were actually "required."

3. <u>"Phantom income."</u> "Phantom income" is the term used to describe the difference between the amount an individual taxpayer must report on his individual income tax return as a result of his ownership interest of a pass-thru entity, such as a Subchapter S Corporation, LLC or partnership, and the amount of distributions actually received by that taxpayer from the pass-thru entity. Assume a shareholder in a Subchapter S Corporation has $500,000 of pass-thru income attributable to him from the company. As a result, he must report $500,000 on his individual income tax return and will be required to pay tax on that amount. However, if that shareholder receives only $300,000 in distributions on account of his ownership interest in the entity. This $300,000 pays income taxes of $200,000 and provides a surplus of $100,000.

While the shareholder's individual income tax return shows that he has $500,000 of taxable income, it does not accurately reflect the amount of income that is actually available to him to pay child support.

However, if the only adjustment is to reduce taxable income from $500,000 to $300,000, the picture is still not accurate. That is because the shareholder has to pay tax on $500,000. For the purposes of this example, the tax on $500,000 at 40% would be $200,000 whereas the tax on $300,000 at 40% would only be $120,000 – an $80,000 difference.

To properly account for this discrepancy, the $500,000 should be input in a DissoMaster type calculation as "other taxable income." That will cause the tax impact on that $500,000 to properly be taken into consideration. To then reflect that the $500,000 is not being paid but instead $300,000 is being paid, a negative $200,000 should be included on the line for "other <u>non</u>-taxable income." In this way, both actual income received and the actual tax consequences to the payor are properly taken into consideration.

4. <u>Capital requirements/retained earnings</u>. This is the *Blazer* issue. The application of this concept depends on the evidence presented and the court's determination concerning the necessity for the capital requirement. Assuming that a court is convinced that it is reasonably necessary for a business to retain $100,000 of its $500,000 in net operating income to update equipment or expand in order to remain competitive or viable, then the court has the discretion to reduce the $500,000 in income by the $100,000 reserve and use only the remaining $400,000 in net operating profit in the calculation of income available for support.

5. <u>Inventory adjustments</u>. For the purposes of considering business income available for support, there are two areas in which inventory adjustments should be considered. They are costs of goods sold and LIFO/FIFO adjustments.

a. Costs of Goods Sold.

Cost of goods sold ("COGS") is a component that must be used in determining gross profit and therefore net profit for a business that sells inventory. In the most basic terms, cost of goods sold represents the cost of the items that were sold in order to generate gross receipts of the business.

In order to accurately determine cost of goods sold, it is necessary to have both an accurate beginning and ending inventory. This usually requires a physical inventory. If the physical inventory has not been prepared or has not been accurately prepared, it will result in the inaccurate reporting of gross profit and therefore inaccurate net profit after operating expenses. The effect is easily seen on a Schedule C to a federal tax return. For example:

Gross Sales (Line 1)	$800,000
Costs of Goods Sold (Line 4)	$550,000
Gross Income (Line 7)	$250,000
Less Total Expenses (Line 28)	$ 20,000
Net Profit (or Loss) (Line 31)	$230,000

Cost of goods sold is determined as follows:

Start with beginning inventory
Add purchases during the year
Equals total available inventory
Less ending inventory at year end
This equals costs of goods sold

To have an accurate COGS you must have an accurate beginning and ending inventory. The difference between reality and what is reported can be illustrated as follows:

	As Reported	**The Reality**
Beginning Inventory	$200K	$200K
Plus Purchases During the Year	$400K	$400K
Equals Total Available Inventory	$600K	$600K
Less Inventory at Year End	**$ 50K**	**$200K**
Costs of Goods Sold	$550K	$400K

Note: If "the reality" is plugged into the Schedule C above, it would increase net profits by $150K from the $230K reported to a total net profit of $380K.

b. LIFO/FIFO Adjustments.

The second inventory issue that requires consideration is that of LIFO/FIFO. FIFO refers to a method of accounting where the assumption is the first item purchased is the first item sold. FIFO stands for "first in first out." LIFO is an inventory method of accounting where the assumption is that the last item purchased is the next item sold. LIFO stands for "last in first out." In an inflationary economy, it is assumed that the first inventory purchased was at a lower cost than the last inventory purchased. Under that assumption, if the business purchased inventory several years earlier and sold it in the current year but purchased the same amount of inventory in the current year to replace the inventory that was sold and then reported its net income using the FIFO accounting method, taxable income would be appropriately determined but it would not accurately reflect the cash flow from the business' operations.

This can be demonstrated somewhat dramatically in the wine industry where you actually know what vintage of wine is being sold in a given year. By way of example:

In 2009, a winery sold its 2005 vintage for $1,000,000. The cost that was incurred in 2005 to produce the wine and bottle it was $600,000. The company also has in storage its 2006, 2007 and 2008 vintage, and in 2009 it produced and bottled its 2009 vintage at a cost of $800,000. Using FIFO and knowing that in fact it was the 2005 vintage (first in) that was sold in 2009 (first out), the profit for the winery as reported using FIFO on the 2009 tax return would be:

Gross Receipts	$1,000,000
Less Costs of Goods Sold (the cost of producing the 2005 vintage)	$ <600,000>
First in First Out Gross Profit	$ 400,000
Less Other Operating Expenses Paid in 2009	$ <100,000>
Net Profit	$ 300,000
Assume Tax at 40%	$ <120,000>
Net Cash After Income Taxes	$ 180,000

However, the reality of what funds are actually available for the year 2009 is dramatically different. The actual funds available at the end of 2009 would be calculated as follows:

Gross Receipts	$1,000,000
Less Costs of Producing and Bottling the 2009 Vintage in 2009	$ <800,000>
Gross Cash Flow	$ 200,000
Less Other Operating Expenses Paid in 2009	$ <100,000>
Net Cash Flow	$ 100,000
Less Income Taxes that Had to be Paid on the $300,000	
Net Operating Profit on the FIFO Inventory Reporting	$<120,000>
Net Cash	$ <20,000>

The FIFO approach results in $180,000 in net income after income taxes, while the LIFO approach demonstrates there is actually $20,000 in negative cash flow after income taxes.

V. CONCLUSION:

As family law lawyers we will need to advocate these positions for our payor and payee clients. The practical approach to analyzing business income available for support would be:

Step 1 Start with taxable income.

Step 2 Adjust for add-backs, such as:

a) Tax motivated depreciation;

b) Inventory adjustments.

Step 3 Then, consider any availability factors:

a) Principal reduction payments.

b) "Phantom income."
Liquidity
Control
Capital requirements.

Step 4 The result – "business income available for support."

A checklist or chart of these issues would look like this:

Availability Considerations	Payor's Position	Payee's Position
Depreciation	· Use ITA · Add back tax motivated depreciation. · Subtract real depreciation	· Use CFA · Add back all depreciation · Do not subtract even real depreciation
Principal Payments	· Use CFA · Subtract principal payments	· Use ITA · Do not subtract principal payments
Phantom Income	· Use CFA · Subtract phantom income	· Use ITA · Include all pass-thru income for support
Capital Requirements (a subsection of phantom income)	· Use CFA · Subtract income that is needed for capital requirements	· Use ITA · Include all income for support

We, as family law lawyers, need to be careful not to use cash flow as a "sloppy synonym" for income. For child support purposes, income in California has a statutorily defined meaning. Although there is no statutory definition of income for spousal support, the definition of income used for child support can be of assistance. While the purposes of child support and spousal support are different and serve different public policies, we might consider that a unified approach to determining "business income available for support" for both child support and spousal support would be of assistance to lawyers, forensic accountants and the courts. Then the different public policies that apply to child support and spousal support, and the different purposes for each, can be appropriately recognized in making decisions concerning how much of that income should be applied to either child or spousal support. The important concept to remember is that "business income for support" must, in most cases, also be "available" for support, otherwise an equitable result will be difficult to achieve.

- End of Outline -