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Show Me the Money

Defining income in marital dissolutions

By Ronald L. Seigneur & Kevin R. Yeanoplos

Often valuation analysts are challenged to determine proper amounts of owner-employee compensation in conjunction with marital dissolution matters. A starting point in the process involves the effort made to define, identify, and properly classify income at the enterprise level.

The Internal Revenue Code (IRC or the Code) provides for a general definition of income as follows:

- Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
 - Compensation for services, including fees, commissions, fringe benefits and similar items
 - Gross income derived from business
 - Gains derived from dealings in property
 - Interest
 - Rents
 - Royalties
 - Dividends
 - Alimony and separate maintenance payments
 - Annuities
 - Income from life insurance and endowment contracts
 - Pensions
 - Income from discharge of indebtedness
 - Distributive share of partnership gross income
 - Income in respect of a decedent
 - Income from an interest in an estate or trust

Internal Revenue Code, section 61, Gross Income Defined.

The related regulations (IRC Treasury Regulations, Regs. Sec. 1.61-1. Gross Income) go on to indicate gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as cash. These regulations go into great detail to distinguish and define how the various elements, such as alimony, child support, per diem payments, insurance proceeds, and the like are handled. For example, death

benefits received by the estate of an astronaut whose death occurs in the line of duty are addressed.

The IRC continues with Code section 63 to define “taxable income” to mean gross income (under IRC section 61), minus the deductions allowed by the Code, with extensive provisions provided within the Code detailing the allowable deductions, which go beyond the scope of this article. While the Code and related regulations do specify all income, from whatever source derived, is included in gross income, unless specifically excluded by law, the Code provides a number of exclusions, and the IRS and courts have added some exclusions as well. Nontaxable items include:

- Life insurance and death benefits
- Gifts and bequests
- Interest on state and local bonds
- Compensation for injuries and sickness
- Reimbursements for sickness and disability benefits
- Discharge of indebtedness income
- Lessee construction allowances
- Scholarships
- In the case of corporations, contributions to capital
- Meals and lodging provided by an employer
- Gain from the sale of a principal residence
- Insurance reimbursements for certain living expenses
- Amounts paid under an education-assistance program
- Amounts paid under a dependent-care assistance program
- Foster care payments
- Certain de minimis working-condition fringe benefits under Code section 132
- Bond interest and savings for higher education
- Amounts paid under adoption-assistance programs
- Carpool expense reimbursements
- A child’s contribution to household expenses
- Certain relocation payments
- Receipt of frequent flyer miles
- Cost-sharing payments
- Amounts received by victims of certain tragedies

According to Dr. Shannon Pratt in *Valuing a Business*, (p. 952, Irwin Press, 5th edition), using “marital income” that is not paid in the form of compensation may be considered an investment in the nonmarital asset. An attorney may want to discern whether the value of a nonmarital business has been enhanced because the owner spouse has not withdrawn adequate compensation from the company.

In *Understanding Business Valuation* (p. 538, AICPA, 3rd edition), Gary Trugman states:

The normalization process is intended to restate the reported earnings of the business to an economic basis that a prospective purchaser would receive. In divorce valuations, the

restating of the reported income also is considered in the business owner's ability to pay support. Frequently, the discretionary items become part of the business owner's ability to pay support or reduce the need to receive support. Normalization adjustments are generally made to the income statement to present the results of the company's operations as they might be in the hands of the prospective buyer of the company.

Valuing Professional Practices and Licenses (p. 5–4, Ron Brown, editor, Aspen Press), notes that:

[W]hether or not an item is deductible or not for federal income tax purposes is not what determines whether that item is a perquisite for matrimonial accounting. This is so because the Internal Revenue Code's interpretation as to what is a perquisite may differ with the interpretation of a perquisite as additional "compensation" used in matrimonial valuation accounting.

The payment of an owner's personal expenses by the business is quite common and can be both intentional and unintentional. There is a common misperception that it is inappropriate for a business to pay personal expenses and excess perquisites (benefits paid only to the owner and not employees) on behalf of the owner. However, it is not the payment of the expenses that is inappropriate and creates problems. Rather, it is that the payments are inappropriately classified on the company's books as business expenses, thereby understating business and taxable income.

These expenses should generally be classified as owner advances or owner draws. Unless adjustments are made to correctly classify these expenses, the company's income will be understated for income tax purposes as well as for determining spousal maintenance and child support. In addition to the impact on income taxes and maintenance/support, this commingling of business and personal expenses can effectively negate any protection otherwise afforded by an entity's legal structures.

Excess perquisites and misclassified personal expenses represent additional income to the owner to the extent that they are not already picked up as income on a Form 1099 or a W-2 to the owner. Some companies pay the excess perquisites and personal expenses of the owner and simply classify the payments as additional compensation to the owner. Generally speaking, this is appropriate and requires no additional adjustment to business income.

Misclassified expenses

Following are common examples of misclassified personal expenses:

- Commingled personal travel and business travel;
- Rent in excess of market paid to a related party;
- Loans at below-market interest rates;
- Family holiday parties and wedding costs;
- Phantom "employees" who are family members;
- Overpaid family-member employees;

- Personal usage of company vehicles;
- Business supplies used personally;
- Personal usage of company telephone;
- Petty cash withdrawals;
- Legal and other professional fees paid for personal matters, such as a divorce;
- College tuition for children of employees;
- Nonbusiness costs of cell phones and Internet usage;
- Golf, yacht, and social club dues and usage costs, including lessons;
- Maid and cleaning services for nonbusiness properties;
- Payment of copays and deductibles of owner, but not other employees.

Phantom income

Business income available to the owner also can be understated when “phantom income” is unreported. Unfortunately, it is quite common for the small business owner to understate business income by not reporting cash or barter sales. These transactions frequently are not reflected on the records of the company. Some business owners mistakenly believe that the tax laws allow the owner to legally do such. All sales should be reported, and to do otherwise misstates the income available to the owner as an investor in the enterprise.

Phantom income presents a number of challenges. The owner may deny the existence of such, and a professional may be required to perform costly forensic procedures to determine the existence of misreported income. This can involve tracing spending, analyses, or other time-consuming methods.

The owner may readily admit the existence of unreported income and provide an estimate of the amount. A professional should perform some type of analysis to determine the reasonableness of the estimate. To the extent that unrecorded income exists, it represents additional income in determining spousal maintenance or child support.

The concept of phantom income also can arise in flow-through business enterprises, such as partnerships and subchapter S corporations, when funds from income sources are utilized to repay enterprise debts or otherwise recapitalize the business instead of being distributed to the owner-employee. Often this type of phantom income can be traced to prior periods when funds were distributed to the owner-employees from sources that did not constitute income (e.g., bank borrowings and increase in trade payables).

It generally is important to determine reasonable compensation related to the business owner’s profession as part of a business valuation and determining maintenance and support. Often the most important variable in a business appraisal assignment is the selection of what constitutes reasonable compensation for employee-owners. For closely held businesses, in many instances, no single operating expense impacts the bottom-line profit as much as officers’ compensation. Clearly, an expense that is discretionary to the owner in terms of its magnitude, timing, and method of payment may represent not only compensation for services rendered, but may also be a disguised dividend or a

distribution of profits. The amount of profits determined to be “reasonable” for tax reporting purposes can easily be manipulated by adjusting officers’ compensation.

Obviously, owners’ compensation should be evaluated closely for business valuation purposes because the overstatement of officers’ compensation can lead to an understatement of the value of the business enterprise within the application of several commonly used valuation methodologies.

The ultimate opinion of value can turn on the ability to support compensation for the controlling owner or professional practitioner. The expense that is deducted should represent the compensation that would be paid to the practitioner in an arm’s-length arrangement for the duties and services performed. The following characteristics should be considered in addressing reasonable compensation:

- Experience of the owner/practitioner,
- Hours worked on a daily or periodic basis,
- Responsibilities of the position,
- Primary and ancillary duties performed,
- The age of the owner/practitioner,
- Nature of the business/professional practice,
- Geographic setting of the business/professional practice,
- Demographic characteristics of the area served by the enterprise/professional practice, and
- Sustainable revenues of the practice.

Rev. Rul. 68-609 provides some guidance in the selection process:

The past earnings to which the formula is applied should fairly reflect the probable future earnings. Ordinarily, the period should not be less than five years, and abnormal years, whether above or below the average, should be eliminated. If the business is a sole proprietorship or partnership, there should be deducted from the earnings of the business a reasonable amount for services performed by the owner or partners engaged in the business.

The term “reasonable compensation” is actually derived from section 162(a) of the Internal Revenue Code. Section 162(a) provides for a corporation to deduct as a business expense “a reasonable allowance for salaries or other compensation for personal services actually rendered.” Although tax courts have frequently addressed the reasonable compensation issue, divorce courts have not routinely devoted as much attention. The importance of this issue should not be understated. The valuation of a business or professional practice may be greatly affected by the absence or existence of excess owners’ compensation.

The adjustment for reasonable compensation is critical. At the same time, it is one of the most difficult adjustments to quantify. The goal is to set the salary to an amount that is what someone would be paid to perform the same services and duties as the current manager/owner. To determine a fair salary, one needs to determine what a hypothetical

replacement employee would be paid to perform the same services with the same skill level, education, and so forth.

It is important to remember that “comparability” does not necessarily mean a “perfect match” is required. In many cases, it may be impractical or impossible to find a perfect match for replacement compensation. At the same time, analyzing the underlying characteristics of the subject practitioner allows the valuation analyst to select replacement compensation that is both reasonable and defensible.

Using a professional practice as the premise, the valuation analyst should select a replacement compensation that is deemed most comparable in terms of:

- type of professional service(s) offered (some foster more repeat business than do others; some specialties foster more referrals than do others);
- type of specialty, if any;
- practice location;
- age and health of the professional;
- nature and duration of the
- professional’s practice, either as a sole proprietorship or as a member of a partnership or professional corporation;
- how fees are billed, i.e., insurance, government programs, patient/ client pay, etc.;
- specific practitioner’s hours worked and production;
- other management and administrative responsibilities of the practitioner;
- economic and demographic
- conditions in the practice’s market area; and, number of locations the practice utilizes.

These are some of the key concepts involving income and owner-employee compensation in dissolution-of-marriage-related engagements. Readers are encouraged to seek appropriate professional counsel when necessary.

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