

Question 1 – Filing Status

Question 1A: The parties filed a joint federal income tax return for 2018....Did they have any other options?

ANSWER: Other available filing status options would have included Married Filing Separately or Head of Household. Each appears to have met the Head of Household filing status requirements:

- each was considered an “abandoned spouse” by IRS definition on the last day of the year.
- they each paid more than half the cost of keeping their separate homes.
- each provided a residence for a “qualifying person” for more than half the year (they separated on June 11th and each provided a residence for one of the children).

Question 1B: Can the parties now amend their tax return to claim a different filing status?

ANSWER: No. Since they filed jointly, they may not amend to change status. However, if they had initially filed Head of Household or Married Filing Separately, they could have amended their returns to claim Married Filing Jointly status.

Question 2 – Wages

Question 2A: Mr. Happy said he receives a salary of \$1,000 per week....Why is he reporting compensation on Line 1 of Form 1040 (BCC-1) of \$56,400?

ANSWER: Mr. Happy’s W-2 (shown on page BCC-38) indicates \$56,400 for Wages, Tips and Other Compensation in Box 1. This amount represents his salary (\$52,000) reduced by the amount of his 401k deduction (\$5,200) in Box 12 and increased by the amount of health insurance paid on his behalf in Box 14 (\$52,000 - \$5,200 + \$9,600).

Question 2B: If Paradise Inc. is a successful business....Why is Mr. Happy only receiving \$52,000 per year of compensation?

ANSWER: In addition to the \$52,000 Mr. Happy receives in salary, Mr. Happy received \$100,000 in distributions from Paradise Inc. This shows on line 16 (Code “D”) of the K-1 he received (see page BCC-42). His salary may have been kept at a \$52,000 level in order to a) minimize the Social Security and Medicare tax cost to both Mr. Happy and Paradise Inc; and/or b) to minimize Mr. Happy’s taxable income by maximizing his Qualified Business Income deduction on Line 9 of Form 1040 (BCC-1). There may also be expenses paid through the company on Mr. Happy’s behalf including retirement plan contributions, life, disability and/or long-term care insurance premiums, vehicle expenses, social and/or golf club membership dues, travel expenses, entertainment expenses, tax return preparation, and even (believe it or not) personal expenses. These additional items could have a significant impact on both the owner’s personal cash flow as

well as the value of the business (for example, a \$100,000 difference in cash flows at a 20% capitalization rate might result in a \$500,000 difference in value of the business).

The fact that Mr. Happy's personal tax return is self-prepared is a possible red flag. There was not a tax preparer (subject to an ever-increasing array of preparer penalties) to advise/caution on tax related matters.

Question 3 – Self-employment Income

Question 3A: Mr. Happy has reported \$1,200 of directors' fees on Schedule C (BCC-7)...Where else should I look on the tax return for items relating to the directors' fees?

ANSWER: The director fee income should be included on Schedule SE (Self-Employment Tax)(BCC-10). If Mr. Happy made a retirement plan contribution based on this income (to a SEP, SIMPLE or qualified plan), it should be shown as an adjustment to income on line 28 of Form 1040 (page BCC-2).

Question 3B: Does Mr. Happy receive any other benefits as a director of Dream Machine, Inc.?

ANSWER: It is possible that Mr. Happy is a participant in a non-qualified deferred compensation plan or has been granted stock options. Neither of these would be indicated on the 1099-MISC or his personal tax return. A separate interrogatory may be required to determine if there are any other benefits as a result of Mr. Happy's service on the board of Dream Machine, Inc. By the way, are board meetings held at any exotic locations? Does Mr. Happy attend these meetings (at exotic locations) alone?

Question 4 – Gambling Winnings/Losses

Question 4A: Line 21 of Form 1040 (BCC-2) shows \$4,800 of gambling earnings for Mr. Happy in 2018....Is this 100% of his gambling earnings?

ANSWER: Not all gambling winnings are required to be reported to taxpayers on a W-2G. However, taxpayers are required to report 100% of gambling winnings, but frequently do not. Gambling losses up to the amount of reported winnings may be deducted as a miscellaneous itemized deduction on Schedule A, line 16 (see page BCC-5).

Question 4B: What additional steps can be taken to determine how much Mr. Happy gambles?

ANSWER:

- Determine whether he is in a rewards program (where points are awarded based on time or dollars spent). Request copies of available statements via production requests OR subpoena the various casinos in the area directly.
- Inquire as to whether he has received any free items with his points.
- Review deposits and withdrawals on bank statements.
- Review ATM withdrawals including the location(s) of the withdrawals.

Question 5 – Paradise, Inc.

Question 5A: Line 28C of Schedule E (page BCC-9) seems to show that Mr. Happy’s taxable earnings from the business for 2018 were \$50,000 (\$300,000 nonpassive income less a Section 179 expense deduction as shown on his K-1 from the company)...Are these his real earnings?

ANSWER: In addition to the amounts on Schedule E, Box 16 of the K-1 (page BCC-42) indicates a 2018 distribution of \$100,000. Also consider that ordinary business income of \$300,000 in Box 1 may already include other one-time deductions for bonus depreciation allowed by the tax law. The “real” income of the business may be much more than the \$50,000 that was properly reported for income tax purposes.

Question 5B: What else do I need to know about Paradise, Inc.?

ANSWER:

- An independent valuation by a qualified appraiser may need to be obtained to determine the fair market value of the company.
- Tax returns, financial statements, check registers, general ledger and credit card statements for at least the past 3-5 years may need to be reviewed.
- The fair market value of the rent charged by HAP Holding may need to be determined (since the Happys own the LLC which owns the building, rents may not be at market rates).

Question 6 – HAP Holding Co.

Question 6A: The parties each have an interest in HAP Holding Co....Do they receive any cash from HAP?

ANSWER: According to the K-1s (pages BCC-40 through BCC-41), \$50,000 was distributed in 2018 (\$25,500 shown in Box 19 of his K-1 and \$24,500 shown in Box 19 of hers according to their 51% - 49% respective ownership interests). However, despite what the K-1 shows, did Mrs. Happy ever actually receive any of this cash?!?

Question 6B: What else does the Form K-1 tell me?

ANSWER: According to the capital analysis in Section L of the K-1s (pages BCC-40 through BCC-41), there is approximately \$1.5 million of capital in the limited liability company. Mr. Happy has \$778,260 of “capital” and Mrs. Happy has \$747,740. Also, observing the \$306,000 and \$294,000, respectively of “Nonrecourse” debt showing in Section K of the K-1s, it could be concluded that the building owned by the LLC cost over \$2.1 million to build OR there are substantial additional assets other than the building in the LLC (perhaps some cash parked for a rainy day?).

Question 6C: What interrelationships should I be aware of between HAP and Paradise?

ANSWER: Several years of tax returns for each entity should be obtained and reviewed. A real estate appraiser should determine the fair market value of the building(s) and appropriate level of fair market rents. The real estate appraiser should be asked to discuss the income approach specifically. There may also be receivables and/or payables between the related entities. Any settlement should ensure that these related party receivables/payables are properly accounted for.

Question 7 – Tax Payments / Refunds

Question 7A: All of the 2018 tax overpayments have been applied to 2019 estimates....Who will get credit for these in 2019 – Mr. Happy or Mrs. Happy?

ANSWER: According to IRS Publication 504, either can claim all of the payments or they can be divided “in any way on which you both agree.” If there is no agreement, the applied overpayments are credited to each party in proportion to their tax liability for the year of the overpayment (2018).

Question 7B: What else do I need to be aware of relating to income tax payments for 2018 or 2019?

ANSWER:

- Be aware of a strategy whereby a divorcing taxpayer makes a large estimated tax payment to drain the bank account. By doing so, the taxpayer “parks” the cash with the IRS for the year and then draws out the cash later. If he/she is divorced before the end of the year, he/she may receive 100% if this “forgotten” asset.
- Confirm that there are no taxes due but unpaid that your client may get assessed for.

Question 8 – Other Items

Question 8A: What amounts should I use for consideration of spousal or child support?

ANSWER: It depends!! Unfortunately this case study only provides information for one calendar year. Generally, in order to determine appropriate levels of income or cash flow for purposes of assessing levels of spousal or child support, several years of information should be obtained, including whatever information is available for the current year. Given the limited nature of the information provided in this case study, the relevant amounts to consider might be as demonstrated in the Table 8A below.

TABLE 8A

VERY HAPPY & NOT HAPPY			
Gross Income for Spousal/Child Support			
Income Source	Use For Spousal Support	Notes	Use For Child Support
Reported Salary	\$56,400	(1)	\$56,400
Add: 401(k) Deferrals	\$5,200	(2)	\$5,200
Add: Section 125 Deductions	Unknown	(3)	Unknown
Less: Health Insurance Premiums	N/A	(4)	N/A
Reported Interest & Dividends from Pass-thru Entities	\$2,000	(5)	\$2,000
Directors Fees	\$1,200	(1)	\$1,200
Reported Rental Income (Loss)	(\$1,901)	(6)	(\$1,901)
Add: Depreciation Claimed	\$3,501	(7)	\$3,501
Less: Straight Line Depreciation	Unknown	(7)	Unknown
Reported Paradise, Inc. Income	\$50,000	(8)	\$50,000
Add: Section 179 Deduction	\$250,000	(7) (8)	\$250,000
Add: Regular Depreciation Claimed	Unknown	(8) (9)	Unknown
Less: Straight Line Depreciation	Unknown	(8) (9)	Unknown
Less: Income Used in Determination of Business Value	Unknown	(10)	N/A
Reported HAP Holdings Income	\$75,000	(11)	\$75,000
Add/Less: Adjustment of Rents to FMV	Unknown	(12)	N/A
Add: Depreciation Claimed	Unknown	(8) (9)	Unknown
Less: Straight Line Depreciation	Unknown	(8) (9)	Unknown
Reported Farm Income	(\$5,000)	(13)	(\$5,000)
Add: Depreciation Claimed	\$8,000	(8) (9)	\$8,000
Less: Straight Line Depreciation	Unknown	(8) (9)	Unknown
Gross Income			
Less: Pass-thru Income Reported in Excess of Distributions	Unknown	(14)	Unknown
Gross Income for Spousal/Child Support	<u>Unknown</u>		<u>Unknown</u>

Footnotes to Table 8A:

- (1) Amount reported on 2018 Form 1040/IA1040.
- (2) From 2018 Form W-2, Line 12a. This will generally be a discretionary 401(k) contribution. Treatment may be different for child support purposes IF the retirement plan contribution by the employee is mandatory.
- (3) In the instant case, there do not appear to be any pre-tax deductions for health insurance, dependent care plans or medical reimbursement plans. This is not surprising since Paradise, Inc. is an S-corporation and Mr. Happy is a more-than-2% shareholder. Quite often the W-2 will not show deductions that are not subject to Social Security or Medicare tax. Obtaining the year-end pay stubs for the past 3-5 years will generally yield the best information on an individual's earned income and deductions for the year (assuming the pay stubs include year-to-date information).
- (4) From 2018 Form W-2, Line 14. For a more-than-2% shareholder of an S-corporation, this shows the amount of health insurance premiums that were paid by Paradise, Inc. and included in Mr. Happy's earned income (assuming the W-2 is prepared correctly!!!). Note: this amount has NOT been added back here (because Mr. Happy does receive the benefit of the payment); however, the living expenses on his personal financial affidavit should include \$800 per month for health insurance and his child support guideline worksheets should include the dependent portion, as appropriate, for that calculation (as though Mr. Happy had paid the expense directly). In other words, his income includes the \$9,600 so for consistency purposes, his expenses should also.
- (5) From Form 1040 Schedule B. This is interest income (\$510 + \$490 + \$1,000) reported by the Happys due to their ownership in Paradise, Inc. and HAP Holding. These amounts are derived from Line 4 or 5 of the Schedule K-1's received from Paradise and HAP. This does NOT mean that the Happys received these amounts in cash; it is merely their share of interest earned at the entity level and passed through from the S-corporation (Paradise) and limited liability company (HAP). Adjustments to this income may or may not be required (see Footnote 14 below).
- (6) Amount reported on 2018 Form 1040 Schedule E, Line 21.
- (7) According to Jim Meade's outline, there are a number of cases that suggest that depreciation should be adjusted from accelerated tax methods to straight line for purposes of determining income for child support purposes. Deducting all claimed depreciation expense and adjusting to straight line may be appropriate in this case. Note: insufficient information is currently available to determine the amount of straight line depreciation. It's time to request a detailed depreciation schedule for the rental property! Question: - Does it seem reasonable to use the same "straight line" adjusted amounts for alimony purposes?
- (8) Amount reported on 2018 Form 1040 Schedule E, Line 28(C). This is the \$300,000 non-passive income of Paradise reduced by the \$250,000 Section 179 deduction. These amounts are derived from Lines 1 and 11 of the Schedule K-1 received from Paradise. As noted in Question 5 previously, just because this taxable income is reported on the Happys' personal income tax return does NOT mean that the Happys received these amounts in cash; it is merely their share of the income earned at the entity level and passed through

from the S-corporation (Paradise). Adjustments to this income may or may not be required (see Footnote 14 below).

- (9) Neither the amount of depreciation claimed nor the correct straight line amount is determinable from the information obtained. Detailed depreciation schedules for Paradise, Inc. and HAP Holding should be obtained.
- (10) Without getting into an extensive dissertation, the issue here is one of “double-dipping.” Generally, if the earnings of a closely-held business (such as Paradise, Inc.) are used as the basis for determining the value of the business, the same earnings stream should (generally) NOT be used as the basis for alimony. Since we do not have sufficient information to know what is being used from a valuation standpoint in this case, it should just be noted that this is an item that needs to be looked into.
- (11) Amount reported on 2018 Form 1040 Schedule E, Line 28(A&B). This is the \$38,250 for Mr. Happy’s 51% interest plus \$36,750 for Mrs. Happy’s 49% interest. These amounts are derived from the Schedule K-1 received from HAP Holding for each party. As noted in Question 5, just because this taxable income is reported on the Happys’ personal income tax return does NOT mean that the Happys received these amounts in cash; it is merely their share of the income earned at the entity level and passed through from the limited liability company (HAP Holding). Adjustments to this income may or may not be required (see Footnote 14 below). Note: for purposes of this analysis, it has been assumed that Paradise, Inc. as well as the building it occupies (owned by HAP Holding) will be awarded to Mr. Happy.
- (12) Similar to the “double-dipping” discussed briefly in Footnote 10 above, in the valuations of both Paradise, Inc. and the building owned by HAP Holding there may have been adjustments of the rents charged between the related parties to a “fair market” level. Care must be taken to ensure a) the treatment is consistent between the entities; and b) unintended double- (or triple-) dipping does not occur in the analysis of income/cash flow.
- (13) This is income (loss) reported on Form 4835 (Line 7 - \$60,000 less Line 31 - \$65,000). Note, this loss was subject to the passive activity loss limitations and therefore the (\$5,000) actual loss does not tie to the deductible loss of (\$869) as found on Line 34c of Form 4835.
- (14) Whenever “pass-through entities” (S-corporations, partnerships, LLCs, etc.) are in the mix, a determination is necessary as to what the real level of cash flow is to the business owner(s). Even though all of the entities’ taxable income is taxed to the individual owner(s); that does not mean that the business owner gets a similar amount in cash. It could be more but is quite often less. To the extent that the business owner going through a divorce does not have control of the cash flow or there are legitimate, regular on-going needs of the business such that it cannot (and historically has not) distribute all of its income annually, an adjustment to the reported taxable income may be required to fairly represent the business owner’s true available income/cash flow. In this case, Mr. Happy is in control of both Paradise, Inc. and HAP Holding but we do not have sufficient information about the cash flow or cash needs of either entity to make a determination as to whether any adjustments are required in determining income for spousal or child support purposes.

Question 8B: What else can I learn/should I be aware of from the personal tax return and supporting documents?

ANSWER:

- Little or no interest or dividends on lines 2 and 3 of Form 1040 suggest that a lot of cash is being consumed.
- Schedule E shows a loss on the townhouse, but this is mainly due to depreciation, which is a non-cash item. Without the depreciation expense, net income on the property rental was \$1,600. Future cash flow may be required, however, to service any mortgage on said rental property.