

Family Law

Show Me The Money

Analyzing hidden assets and income in divorce

By Jonathan W. Wolfe and Kimber L. Gallo

Attorneys representing parties in divorce frequently are faced with the difficult challenge of discovering and proving the existence of hidden income or assets. Although most prevalent in the context of private business owners, spouses from all career paths are capable of engaging in “divorce planning” designed to minimize their income and/or avoid parting with their assets in divorce.

Start With Your Client

Many parties begin the process of divorce believing that their spouse has “hidden” assets and/or underreported income. Although your client’s belief ultimately may prove to be unjustified, he or she is in the best position to provide you with invaluable information to assess the situation and begin your investigation.

It is essential that you extensively interview your client to obtain an understanding of his or her spouse’s business, assets, liabilities and lifestyle to assess whether your client’s

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concern seems justifiable. Clients that were involved in the operation of their spouse’s business can be particularly helpful in identifying unreported assets/income. It is essential that your client share with you his or her understanding of any such mechanisms utilized during the marriage so that you can appreciate (1) the scope of the undisclosed assets/income during the marriage and (2) the role that your client may have played in the concealment. Of course, your client may face serious criminal and/or civil exposure for tax evasion — whether or not he or she was actively involved in the concealment of income during the marriage. Although technically there are protections afforded to an “innocent spouse,” see I.R.C. § 6013(e), the protections are rather limited and may not protect spouses that knew they were receiving the benefits of undisclosed income.

Whether proceeding in court or by way of arbitration to avoid *Sheridan* concerns, it is crucial that you obtain an understanding of the parties’ lifestyle, the manner in which they paid for their expenses, and whether the assets they have acquired make sense in light of their reported income.

Undisclosed assets and income, however, do not simply arise in the context of cash businesses. Therefore, you should also question your client about their knowledge of the extent to which personal expenses were paid

through his or her spouse’s business, i.e., automobiles, fuel, cell phones and credit cards.

You must also obtain an understanding of the scope of the spouse’s control over the business. Is the business a family-owned operation? Is the spouse a minority owner with little or no control over the company? Is the spouse, although technically only a minority owner, in complete control of the corporate affairs? Does the business operate in a heavily regulated industry that would reduce the spouse’s ability to manipulate his or her income? The more control exerted by the spouse, the more opportunity that he or she will have to manipulate the corporate affairs in an effort to shield assets/income in the divorce.

You and your client should also discuss whether he or she is aware of any disgruntled former employees or scorned business partners, both of whom can be an invaluable source of information. For example, the disgruntled employee or former business partner may be aware, inter alia, of personal expenses run through the business, undocumented cash, steps taken to defer the realization of a significant financial event until after the divorce, and marital funds spent on boyfriends or girlfriends. It is important to interview any such individuals as soon as possible, however, in doing so, you must maintain some level of skepticism. You should request copies of any documents that they have to corroborate their allegations, and ask them if they believe there are others with whom you would benefit from speak-

ing.

You must discuss with your client the serious potential obstacles to discovering and proving hidden assets/income. Advise your client that it will be their burden to prove the existence of such concealed funds and that in many circumstances, no matter how strongly held their belief, he or she may not be able to satisfy their burden. You also must discuss with the client the significant costs associated with litigation, including retaining forensic accountants and other necessary experts. At the end of the day, your client, with your counsel, must perform a cost-benefit analysis to determine whether the potential benefits of proving the existence of hidden funds outweigh the costs of the litigation.

Finally, you must explain to your client that not all seemingly "unreported" income is improper. For example, in the case of a Subchapter S corporation, the spouse may have received a significant distribution and not reported it as income in the year in which it was received. This may be entirely proper, if the distribution represents retained earnings that were previously reported as income to the spouse in a prior year.

Understand Common Methods of Concealing Assets/Income

Although far from comprehensive, understanding the following methods will make you more sensitive to the types of financial chicanery utilized by spouses to conceal assets/income:

Receiving Substantial Perquisites From The Business: An owner of a privately-held corporation may be able to have his company pay for significant personal expenses. This has the result of decreasing personal income and increasing the purported business expenses. It is essential that the business records are reviewed to identify such personal expenses. Otherwise, the owner spouse may seek to establish an artificially low personal income on which his support obligation will be based. Additionally,

failing to identify and segregate the personal payments from the legitimate business will increase the purported business' expenses, which can negatively impact the valuation of the business.

Substantial Reduction of Income: A self-employed spouse may report a substantial decrease in their income around the time of their divorce. If your client's spouse makes such a claim, you must fully explore whether there is a legitimate basis for the income reduction or whether his or her spouse has simply become "divorce poor."

Illegitimate Transfers/Payments to Relatives and or New Spouse: In addition to manipulating their own income, spouses in control of a business can make illegitimate payments to relatives and/or a new spouse in an effort to reduce their own reported income and increase the business' purported expenses.

Sham "Loans" From Company: Spouses additionally may seek to disguise income by characterizing distributions received (or payments made on their behalf) as "loans" received from the corporation. If your client's spouse make such a claim, it is imperative that you request that the spouse produce bank statements, notes payable, tax returns, or other documents to substantiate their claim that the distribution received or money paid on their behalf was indeed a loan (or the repayment of a loan).

Use of Corporations and Trusts To Shield Assets/Income: Spouses familiar with more sophisticated financial planning may seek to utilize corporate structures and trusts to deplete the marital estate and/or disguise their income. In such instances, it is crucial for you to work with your forensic account, and trust expert if necessary, to unravel the various corporate structures and trusts created during the marriage.

Failing To Take Distributions From the Corporation: Whether or not a spouse's retained earnings in a corporation should be considered available personal income is a topic of frequent

debate. Your client's spouse will argue that the retained earnings are appropriate and necessary for the operation and financial viability of the corporation. Your client will argue that earnings are being retained to improperly minimize income and/or reduce marital assets.

To support your position, you should examine both the relevant industry standards and the company's prior practice. If the business traditionally had little retained earnings, this will significantly aid your argument that the recent retained earnings are designed to avoid obligations to your client. Likewise, your client will be well served by the presentation of evidence demonstrating that the retained earnings of the company substantially exceed the industry's standard.

Reduction of Business Income To Decrease Value of Business: Business owners may seek to decrease their income to reduce the value of the business in the divorce proceeding. In order to assess the legitimacy of the spouse's reported business income, it is essential to obtain an understanding of the industry in which the business is operating and its historic expenses and profits. Two methods that a spouse seeking to minimize their business income may utilize are to increase the cost of sales and to carry excessive inventory. See Simborg and Wilkolaski, "Scrutinize The Business Books," 26 Fall FAM. Advoc. 20 (Fall 2003).

Review Documents for Affirmative Evidence of Hidden Income/Assets

Your first goal will be to establish affirmative evidence of unreported income/assets through documents obtained during discovery. In seeking to accomplish this task, you must keep in mind that there are both legitimate and illegitimate reasons for the failing to disclose income

One commonly utilized accounting method for affirmatively demonstrating the existence of hidden income in a business is the "Four Column Proof of

Cash.” See Richard F. Koc, *Forensic Accounting and Valuation In Divorce*, 36428 NBI-CLE 13 (National Business Institute 2007) This approach examines a company’s cash account and compares the beginning balance, deposits made, withdrawals and ending balance, with the sales and expenses reported on the company’s financial statements. This methodology can identify both under reported sales over reported expenses — the combination of which equals the business’ total unreported income.

Although the actual accounting will be performed by your forensic accountant, it is important that you understand the mechanics of the procedure and the significance of its results.

Understand and Utilize Techniques Available Absent Affirmative Evidence

Unfortunately, it will not always be possible to affirmatively prove the existence of hidden assets/income, because they simply will not

be reflected in any of the business accounts. If the cash simply never “hits the books,” there may be no records available to demonstrate underreported sales. In such instances, you must seek to rely upon other techniques to support your client’s position, such as proof that lifestyle is inconsistent with reported income, contradictory representation on credit and mortgage applications, or prior voluntary support payments inconsistent with reported income. ■