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UNREPORTED INCOME AND HIDDEN ASSETS

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Unreported income and hidden assets are often alleged in divorce proceedings, with the spouse who is not running the business claiming that unreported income should increase both the spousal support award and the valuation of the family business. In civil litigation, it is often a partner or shareholder that is alleging that someone in his business is hiding income. The process of finding and proving unreported income or hidden assets is often one of the most difficult assignments of a forensic professional, and the costs must be weighed carefully against the potential benefits. However, in some cases, the process is much easier than one might think, as the following case histories illustrate.

Unreported Beer Sales

A large restaurant sold Southern food and beer, with the beer being sold in a prominent part of the restaurant. The beer sales were a major part of the business. The owner reported approximately $50,000 of annual income from the business, and yet he and his wife drove expensive cars, their children attended private schools, and he was buying significant amounts of real estate.

Records of the local beer distributors were subpoenaed. Those records detailed exactly how much beer, and what types of beer (kegs, bottles, etc.) were sold to the restaurant during the prior two years. A member of our firm went to the restaurant, ordered a drink at the bar, and took note of all of the prices of the beer by type (Bud, Miller, regular, light, etc) and size (8 oz, 12 oz, etc). The amount of beer purchased per the subpoenaed records of the beer distributor was then priced out. For example, if 1,000 cases of Miller ten-ounce light were purchased each year, and each case held 24 bottles, and that item would sell in his restaurant for $2.00, then the sales for that item would amount to $48,000 per year. After pricing out each item of the purchased beer, we arrived at an expected total sales for the year. (Inventory was assumed to have remained constant at the beginning and the end of the year, and we adjusted the current prices to reflect probable lower prices for the prior year.) We then compared this computed total sales of beer with what was reported on the books, and found that the reported sales was around five hundred thousand dollars lower than our computed amount.

As a result, at trial the court found that the gross income available for support was vastly higher than what was reported on the tax returns, and the value of the business was much higher due to the higher level of income and profits that were previously not identified.

The Hidden Factory

We were asked to value a certain California manufacturing company. The document production was going very slowly, and then we were provided with approximately thirty boxes of documents at the opposing attorney's office. As expected, many of the boxes contained useless information, and we went through those quickly. However, one box contained miscellaneous files, including correspondence between the company and its patent attorney. The file contained a letter from the company's patent attorney pointing out that the trademark of a particular unrelated Florida company was similar to a trademark of a product made "in the Atlanta facility". Until then, there had been no mention of an Atlanta facility and nobody was aware of any business location besides the California facility. We notified counsel, and soon enough, full details of the "hidden factory" were produced.

Home Improvements

A manufacturer of personal products made massive improvements to his home, so that the additions were larger and more costly than the original structure. Extensive landscaping was also done, including the transplanting of large trees. An analysis of the personal banking records showed that the remodeling was not paid from personal funds. The business records were then analyzed, and it was noted that there were many corporate payments to home remodeling contractors and landscapers, but the supporting invoices all indicated that the work was done at the company. Even the massive landscaping invoices showed that the work was done at the company's office, which was located in an industrial park that had virtually no landscaping. Furthermore, the industrial park was not even owned by the company, so it was peculiar for the company to be apparently paying for the landscaping of someone else's property. Something was obviously out of order, but the necessary proof was missing.

The document production procedure being followed was that all of the documents requested were provided in xerox form. Because the home remodeling was apparently not paid by the homeowner or his business, which was bizarre, and because of the unusual landscaping situation, we specifically demanded the original home remodeling invoices. We were eventually shown the original invoices for all of the home remodeling, and it was clear that the job locations and some of the work descriptions had all been whited out and changed. When the whited out documents were held up to a light, the original writing was legible, and it showed that the remodeling work and the landscaping were done at the family residence. The remodeling deductions were added to the gross income available for support and to the valuation calculations.

Techniques Used to Find Unreported Income and Hidden Assets

The above examples demonstrate that finding unreported income and hidden assets is not a matter of guesswork. While success is never guaranteed, the use of certain techniques may produce successful results. Here are a few tips to consider:

1. Look at the lifestyle

One of the first steps is to look at the lifestyle of the person earning the income and match it with the income being reported. What kind of car does he/she drive and how was it paid for? What kind of clothes are being purchased, where does he travel and what hotels does he stay at? If there is a disparity between the lifestyle and the reported income, then one must look at the person's debt to see if the lifestyle is paid for by borrowed money. If the debt has not increased, one must look for other possible explanations, such as a recent inheritance. If nothing seems to justify the lifestyle in excess of the reported income, then there is a good possibility that unreported income is funding the lifestyle. This hypothesis, with its justifications, may not, by itself, be convincing to the court, but it will lend significant support to other evidence.

2. Look at the expenses

Certain expenses are indicative of the nature of the business, and often they can be verified. In the above example of the restaurant, that business sold a huge amount of beer. Since there are only a small number of beer distributors and their records are computerized, it is relatively easy in such a situation to determine the volume of beer being purchased. The same technique was used in a case involving unreported pastrami sales. The key to the case was determining the amount of raw beef navels purchased. Once one knows the amount of goods purchased for sale or manufacture, the actual sales can be determined fairly accurately after one determines the usual markup.

Similarly, certain manufacturing processes may require certain usage of utilities. A product that has water as a main ingredient will have production in direct relationship to the amount of water being used by the factory. A review of the company's utility bills may demonstrate whether production is going up or down. If the business records show that sales are down, production is down, but water usage is up, then someone will have to explain the disparity.

3. Look at the cash flow

How does the money come in and who receives it? If a certain person opens the mail, records what payments came in, and then delivers the checks to a second person, who actually makes the deposits, then there is good internal control over the funds. In that situation, it is probable that all receipts are being recorded. In smaller businesses, such as in professional practices, it is possible for the same person to open the mail and to make the deposits, and it is not unusual for the owner himself to get the mail once in a while. Furthermore, payments are often made out to an individual instead of the formal business name. Particularly with a professional practice, the name of the person is often the name of the business, or a client may issue payment in the name of the partner who provided the services. In situations where the owner might open the mail and where checks could be payable to the owner, one should review the accounts receivable records with the cash receipts records. All write-offs of significant amounts should be reviewed to see if the write-offs are merely cover-ups for receipts that were simply deposited into a personal bank account instead of the business account. The write-offs should be supported by documents indicating attempts to collect, such as correspondence, letters from the company's attorney, lawsuits, etc.

4. Look at the business operations

A visit to the business premises is very helpful, and sometimes it helps rule out certain areas which might otherwise he explored. For example, a business with gas stations has less of a probability of unreported income than a supermarket. A visit to the gas stations will show that all sales, in dollars, is reported by each gas pump. If the owner does not work at the gas station, he would not want the pump to malfunction, because that is his only way to determine that his employees are not stealing from him. Therefore, the pump equipment itself is very useful in determining the actual sales. In a supermarket, an owner could simply arrange that certain cash receipts are simply not deposited. It is essential to understand how the business is run, how often the owner comes to the business, what is his relationship with his employees, etc.

5. Look at the industry

There are statistics available for many businesses, and the statistics of the subject business should be compared with others similar to it. In particular, the gross profit margins should be compared, and the overall profitability should be compared. If in the industry, it costs fifty cents for each dollar of sales, and in the subject business, it costs sixty five cents for every dollar of sales. then one should examine the expenses to see if they are inflated by personal or unusual expenses. It may be that there is a logical explanation for the variance of the subject business from the industry norm, but the variance itself is an indication that something is unusual, and deserving of special analysis.

Summary

In summary, while it is often very difficult to find unreported income and hidden assets, sometimes clues are left that are very meaningful to a trained eye. The problem then becomes a matter of proving the allegation, rather than determining it.