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# THE DIFFERENCE BETWEEN GROSS INCOME AND GROSS CASH FLOW

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There are many experts in Los Angeles County who entitle their reports regarding spousal and child support as "Gross Cash Flow Available for Support". There are other experts, including myself, who use the title of "Gross Income Available for Support". In practice, neither position follows their title in all situations, but their titles do indicate their general thinking. This article will explain the differences of opinion.

Family Code 4058, in discussing child support, uses the term “gross income" or "income" several times, and does not use the term "cash flow" even once. Family Code 4320 uses the terms “earning capacity" and “earned and unearned income", but again, no mention of "cash flow”· Therefore, all other considerations being equal, the proper terminology would be gross income rather than gross cash flow, simply because that is the language used by the legislature.

The concept of income alone being used to calculate support often creates very unfair situations, as will be explained shortly. This caused some experts to use cash flow. However, as will be explained shortly, the concept of cash flow alone being used often creates unfair situations as well. This convinced other experts to remain with the legislature's term of gross income. Both groups of experts then address each unfair situation in their own way, as will be explained shortly.

It is common for people who own an interest in a real estate partnership to receive K-1s each year that reflect a loss. Year after year, they receive these reports of losses, and yet they do not invest any additional funds into the partnership to cover the losses. Similarly, many people have investments in other types of partnerships that send them K-ls reflecting income, year after year, but the investors never receive any funds from the partnership. The real estate losses arise from depreciation of the originally acquired real estate and do not require an actual new outflow of funds. The partnership therefore has losses but may even have positive cash flow. The other types of partnerships may have positive cash flow, and income, but the general partners choose to keep the money in the partnership to provide capital for the growth of the business. Therefore, even though there is income, there are no distributions to the partners. The investor in the above partnerships may therefore have losses without any negative cash flow, or the investor may have income without any positive cash flow.

To the gross income purist, the above creates a very unfair situation. The real estate investor will report a loss to the court, and will ask for a reduction in support owed (this article assumes that the payor is the investor), when the "loss" is really a theoretical concept that has no bearing to the payor's wallet. On the other hand, the investor in the other income-earning partnership will also face an unfair situation. He will have to report income from that partnership, and pay support because of that income, without actually receiving any cash from the partnership with which to pay the support.

To resolve this dilemma, the gross income experts decided to get away from gross income in its purity, and in situations like the above, they use cash flow - even though their reports use the terms "gross income". Their heading really means: gross income except where that is unfair, in which case we mean gross cash flow.

The gross cash flow experts have their own problems. Assume that the property division has taken place, and the husband received the business and the wife received the mansion with no debt. After the property division, the husband uses the business line of credit to borrow $300,000 which he immediately distributes to himself. Assume for the year that his salary was $200,000 and the line of credit funds were $300,000. The cash flow purists recognized that from a cash flow perspective, they would have to report $500,000 of cash flow to the husband, which they intuitively recognized was unfair. Similarly, if the wife refinanced the mansion and borrowed $750,000 from the equity, the cash flow purists recognized that it was somehow unfair to say that the wife's cash flow was $750,000 while the husband's was $500,000 and that the wife would therefore owe the husband support.

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So far, it looks like the matter is balanced. Both opinions have obvious problems, which they skirt by simply joining the other team whenever it is convenient. However, there are various other issues that come up that make the dispute more complicated.

A simple example would be perquisites. An owner of a business earns an annual salary of $100,000. His business pays for, and deducts as business expenses, various personal expenses that add up to another $100,000. From a cash flow perspective, the business owner received only $100,000 in cash. To that, the cash flow purist would say that the business owner sort of received the second $100,000 as well, because it is as if the business paid him the cash, and he then forwarded the cash to the vendors who provided the personal expenses. So it becomes an "as if" he received the cash situation.

The gross income purist has no problem with perquisites. An analysis of the business would reflect that there are $100,000 of "expenses" that are not really expenses, and so those "expenses" would be added back to income. The resulting gross income available for support would be the salary of $100,000 with another $100,000 of income net earned by the business.

This leads us to another example. Imagine an incorporated lawyer with gross receipts of one million dollars, real expenses of $500,000, and who then pays himself a salary of $300,000 - leaving $200,000 in the business. The cash flow purist must admit that the cash flow to the lawyer is only $300,000. It is the lawyer that is ordered to pay the support, not his corporation, and he received as pure cash flow only $300,000. The cash flow purist would then be forced to say that if the lawyer's corporation retained profits that it could have distributed, then it is "as if" those profits were paid out as cash flow to the shareholder lawyer.

The gross income purist would have no problem with the retained profits in the corporation. Gross income means the increase in the net worth of the person, and that would include the increase of the net worth of his major asset, which would be his corporation.

We therefore have examples where the cash flow purist has to leave the purity of actual cash flow, and to resort to "as if" thinking, whereas the gross income purist would be perfectly happy with his theoretical model.

We now turn to another example, but this time in favor of the cash flow purist. Imagine a person who owned 100,000 shares of Microsoft, which during the last 12 months fell from over $100 per share to under $50 per share. Assume that is his only source of income. Assume further that he lives frugally with his parents, and for his living expenses, he sold $20,000 worth of stock at a price of $80 per share which he acquired a long time ago at $5 a share. He therefore sold 250 shares (20,000 divided by 80) at a profit of $18,750 (250 times 75). The cash flow purist would say that his cash flow is a positive $18,750 (or perhaps $20,000 as will be discussed shortly). The gross income purist would be faced with a real dilemma. This person just lost almost five million dollars in net worth, but he will report a gain of $18,750 to the taxing authorities, and maybe to the divorce court as well. He won’t report any loss because he only sold 250 shares. How can he report a gain in divorce court when his net worth just dropped by five million? True, the market may go back up, but until then, how can the court ignore the massive unrealized loss? On the other hand, what number should be used? Given the very frugal lifestyle, this person can hold on to his stock for a long time. To report a gain is contrary to the concept of gross income, since he actually lost a tremendous amount, but to report a loss is contrary to what might be the ultimate reality.

The above, of course, leads us yet to another example. Imagine a simple situation where in 1991 a person acquired 10,000 shares of stock for $10 a share, or $100,000. He gets divorced, and in the year 2001, he sells the stock for $20 a share, or $200,000. To the cash flow purist, there was a cash outflow in the year 1991, and a cash inflow in the year 2001. For support purposes, one typically looks at the cash flow over the past 12 months. In that case, the conclusion must be for the cash flow purist that this person had a positive cash flow of $200,000. (In my previous example above, I used $18,750 but it probably really is $20,000 from a purist perspective.) To report cash flow of $200,000 is virtually impossible even for a cash flow purist. They intuitively recognize the gross unfairness, and acknowledge that in this case, gross income must be used instead. Now there is not even an "as if". It's simply a matter that their theoretical model fails in this situation.

There are other situations where the difference between income and cash flow becomes apparent. Sometimes, one position wiggles their way around a theoretical problem, and ends up using the same theory as the other side, and sometimes, the different positions lead to different conclusions.

For example, assume that a person was informed that he would receive $20,000 during the next year from his parents as a gift. For the cash flow perspective, that would probably be included in the gross cash flow available for support. For the gross income perspective, gifts are not income.

Finally, we come to situations where both positions theoretically collapse. Imagine a son who works in his father's very successful business. The son earns a respectable salary but because he is the son, he has access to certain privileges. He therefore is provided with the company's yacht for several weeks a year, fully stocked and with a full staff to serve his every whim. (The yacht is used by the business on a regular basis to entertain corporate clients; the son gets to use the yacht when it is not being used by the business.) He is provided with free access to use the corporate jet, so long as it is not needed, so that he often flies to and from New York for the weekends. While in New York, he stays at the company's suite, fully stocked. Entertainment is provided by tickets that were given as gifts to the company by corporate clients. To the cash flow purist, the son did not receive any cash except for his salary and the above benefits face even more problems than the typical perquisites. In this situation, most of the expenses are perfectly legitimate expenses of the father's business. The costs of the yacht and the jet are necessary business expenses. The staff on the yacht are year-round employees and would be paid whether the boat is at the dock or at sea. The real perquisite might only be the cost of the fuel and the cost of the food eaten by the son, a cost paid by the business. To the gross income purist, the company's yacht and plane are legitimate business expenses of the father's business. Theoretically, it seems illogical to add to the son's income a bona fide expense of another entity. On the other hand, the son has frequent all-expense paid vacations, as well as free travel and entertainment during the year. Were he to pay for all that, it might cost him $100,000 per year. To ignore that benefit seems unfair -- illogical to include it, unfair to ignore it.

Another example: A real estate developer buys some land in year 1 at a cost of one million, builds a beautiful apartment building on it for a cost of two million, and then refinances the entire property in year 3 for four million. The total cost was three million, and the refinance proceeds were four million. The cash flow purist says that indeed, there was new cash inflow of one million, but that was from a refinance, a loan, and loans are not really to be included in cash flow. A few years later, in year 5, the developer sells the land and building for four million, pays off the loans and receives no net proceeds. The cash flow purist says that in year 5, there certainly was no cash inflow, since there were no net proceeds. Therefore, there never was any cash flow available for support, even though there was a one million profit on the development project. The gross income purist points out that the above is absurd, since there was one million dollars of income. The only problem is when to recognize the income.

In year 3, when the cash was received, there was no income on the act of refinancing. It may even be that when the building is sold, it will be sold at a loss. 5o no income is included for year 3. In year 5, there will be income reported on the tax returns of one million dollars, but there won't be any cash. Nonetheless, the gross income purist would most likely report gross income of one million in year 5, because the alternative is to recognize no income ever, and that is incorrect.

One last example. The person operates a restaurant and he eats all of his meals there. Assume that the typical cost of a meal of a restaurant is around 40% so that if a meat and potatoes meal sells for $20, it costs the restaurant $8 for the actual meat, potatoes and chef's services. Assume that the person eats three meals a day at the restaurant - with a market value of $60 per day and an actual cost of $24 per day. The cash flow purist would have to say that the cash flow received would be $24 per day, because the cash spent by the restaurant on his behalf was $24, even though that clearly seems unfair, since the benefit received is $60 per day. The replacement value of those meals is $60 per day for everyone except owners of restaurants. The cash flow purists are therefore left with a dilemma. The gross income purists would also have a problem. The initial reaction would be to simply add the $24 per day to the reported net income, just as one would for all other perquisites. However, in a typical perquisite, the cost and the benefit are the same. One charges a personal meal as a business expense; that meal at market price is added as a perk, the cost and the benefit are the same. Where the cost and the benefit are very different, the gross income purist will also face a dilemma.

From all of the above, one can see that neither position has the upper hand from a purely theoretical point of view. Fairness often comes in and pushes the theoretical aside. In my opinion, that is precisely the optimum result - choose what is truly fair, regardless of one's theoretical perspective, and sometimes, regardless of the legislature's choice of words.