Business Income in Divorce Settlements

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Is taxable income good enough for calculating disposable income in determining what a spouse can afford for alimony and/or child support? Well, in the cases where all participants are W-2 employees only, yes it most likely is. However, ownership in partnerships, LLC’s and/or Sub-Chapter S Corporation changes the answer dramatically and here’s why.

Net income is the calculation of all income items less all business expense items. Let’s assume that all income is recognized when cash is received and for the most part, expenses are for cash expended, except for depreciation. We will deal with depreciation separately.

So, it’s simple to understand that cash received less cash disbursed equals cash available for alimony/child support, correct? Well, what if some of the cash disbursed is for personal items, not legitimate business expenses as permitted by the IRS? Is it equitable for one to count these as costs to operate a business? No, because one would have had these expenses as a W-2 employee. Being able to reduce net income by these personal amounts leaves more cash flow available for the business owner, the former spouse. The fact that the IRS has accepted the tax return and has not audited it is moot. We are trying to derive at an equitable divorce settlement, not call for a tax audit. Nonetheless, if personal cash flow increases, should the beneficiary not share that with the ex-partner? These non-business expenses can range from personal food items to personal travel expenses to other personal items such as home utility bills, including access to personal television viewing. Regardless of purpose, we have seen business owners maximize what they can deduct on their taxes categorically just below totals that would possibly subject them to a tax audit. This is not equitable for the ex-partner and is referred to by the IRS as tax evasion, an illegal act.

The largest non-cash tax deduction on business tax returns is depreciation, which is the process used to deduct the cost of long term fixed assets used over many years. If the assets are used exclusively in the business, then it seems reasonable that depreciation be used as legitimate business expenses over some acceptable “useful life.” However, the IRS Code allows businesses to write off some of these long-term assets sooner, in some cases all in the year purchased. This saves taxes by reducing taxable income, which is used to calculate child support/alimony. Is it equitable to the ex-partner to use net income, which has been proven not to accurately reflect business owner cash flow? What if the long-term business asset was financed and not purchased with cash like a traditional cash expense? This is typically the case. So, the business owner may have 5-10-15 years to pay the loan, but saves taxes on 100% of the cost in the year of the purchase. Using taxable net income can harm the business owner’s ex-spouse by reducing alimony/child support.

If you think business owner cash flow is difficult to determine so far, wait until you encounter the Sub Chapter S Corporation (“Sub-S”). While sole proprietors and Limited Liability Corporations ("LLC") will be assessed self employment FICA on the net "taxable" income, the Sub-S similarly calculated net taxable/pass-thru income is NOT subject to FICA/employment taxes. In fact dividends paid to the business owner(s) are generally not taxable, with few avoidable exceptions. So, with a high volume of depreciation sheltering cash net income, this could create a condition where the business owner receives cash dividends that exceed taxable income. In fact, depreciation could cause a taxable loss, decreasing the owner's (s') tax liability (ies). This would make it appear that the business owner(s) do not have the ability to pay child support/alimony. Yet, reality is that they do. High non-cash expenses, in this example depreciation, camouflage their actual cash flow. Ability to pay is not directly correlated to taxable net income on a tax return. See illustration below:

	XYZ Sub-S	Owner Dividend
Cash Income	500,000	
Cash Expenses	-300,000	
Net Cash Income	200,000	125,000
Depreciation Exp	-300,000	
Net Taxable Loss	-100,000	

The owner receives $125,000 dividend, but shows a taxable loss of $100,000. Can the owner afford child support/alimony? The same results could also occur in an LLC or a partnership.

When determining the ability to pay, bankers have always taken business financials/tax returns and added back non-cash entries to determine available owner cash and if their clients could afford to repay them. When considering affordability of alimony/child support, available cash flow should be considered, not just a line item or two off a tax return. There should also be some consideration given to the legitimacy of business expenses. Misallocation of cash flow during a divorce settlement can be a real disservice to your client and their offspring.