Got Divorce? Look at that individual tax return

The detail review of a divorcing couple's tax return can provide attorneys with a plethora of information that may help their clients attain a more financially equitable divorce settlement.

Just a glance at the first page of form 1040 can show if someone is self-employed, has investment income, income from properties, or income from a closely-held business. A detail review of the supporting schedules can provide significant data that can have an impact on child support, spousal maintenance, and the property division.

Self-employed individuals show their income on Schedule C. A review of the form with its supporting schedules can show a *wealth* of information. For example, for a true picture of discretionary income, you will need to examine depreciation. Depreciation is most times not a current period cash outlay. The expense should be added back to the net income of the business.

Are other expenses such as travel, entertainment, gifts, or office supplies legitimate business expenses? Are they reasonable and necessary for the production of income or, are they of a personal nature, which should be added back to determine the true income of the owner? And what affect has the impending divorce had on the gross income of the business? I always recommend the review of at least the prior three year's tax returns to assess the consistency of the income. Was the business growing until the year of separation? For commissioned salespeople, is there a base of income that is paid because of vested renewals or fees? This could lead to an uncovered marital asset.

Schedule E will list income from other business interests. If a partnership interest is shown, a review of the partnership tax return and associated partnership agreement should be examined for clues to purchase or sale options. Along with analyzing and comparing the income and expenses, the value of the partnership could be another marital asset. The same holds true if the spouse is a shareholder in an S Corporation. The evidence of ownership in a closely-held business, either a C or S corporation, may also require a detail review of those company's financial statements and Board Minutes. The examination may reveal additional income recorded as shareholder loans, deferred compensation, deferred bonuses, or additional employee benefits, retirement plans, etc.

What about the rental income or loss that is shown on Schedule E? Are the expenses related to the operation of the rental property or are they personal expenses? What is being depreciated? What is the value of the building (another possible marital asset)? Are there any rental losses that could not be deducted but can be used in future years? Is the rental being charged a "fair value rent"? Was the rental expense charged on the Corporate return also deducted as interest and taxes on the 1040 (I've seen this)?

Comparing amounts on Schedule B, interest and dividends, for the last three years can also be revealing. What's happened to bank account that received interest one year and not the next? What about dividends that have also "disappeared"? A review of the Brokerage statements may reveal additional accounts that have not been listed as a marital asset. An analysis of the related Schedule D may show that stocks or bonds may have been sold. Where were the proceeds deposited? Is the account shown as an asset?

Pertinent to the review of the income tax returns is a quick review of recent mortgage refinancing applications. Most people show their maximum earnings and assets on these to get the best rates. A comparison of the income reported on both documents can be very revealing.

For a quick, “down ‘n dirty” test of true income, on the couple’s form 1040, subtract line 40, itemized deductions and line 71, taxes paid from line 38, adjusted gross income. If there were sales of assets, the net receipts from the sales should also be added to the calculation. The remainder is what the couple had left to pay for living expenses, mortgage principle, and debt. If this amount is negative (I’ve also seen this), then the couple has either borrowed to live or, there may be some misstatements in the return.

Not all divorce cases require this kind of analysis; however, if there is any doubt about a spouse’s income or there is a concern about “hidden” assets, this type of review may provide a more accurate picture of the couple’s finances.

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