

Keepin' It Legal

Income for Support in a 'Down' Economy

by Leslie O. Dawson, CPA

During divorce, determining the "income available for support" for a spouse who is self employed or has fluctuating income is a subjective and highly debated issue. Throw in the economic downturn and the issue becomes increasingly complex yet more interesting.

Review of Income for Support

California Family Code Sec. 4058 defines income for child support as income from whatever source derived. The definition includes gross business receipts less the expenses *required* for the operation of the business. It also may include employment benefits that reduce living expenses (housing and automobile allowances).

In *In re Marriage of Riddle* (125 Cal. App.4th 1075), the appellate court discussed its view of the term "income" as it pertains to family law statutes. It stated that "cash flow is not necessarily income."

"While we recognize that family lawyers and forensic accountants sometimes use the phrase 'cash flow' as a sloppy synonym for the word 'income' as it appears in the support statutes, it isn't. In particular, the support laws are very exacting as to the definition of income. The language was 'lifted' straight from the Internal Revenue Code."

Riddle also discussed that the time samples for determining income available for support must be fair and representative.

Easy, right? Straight from the tax code, right?

Here are some differences between taxable income and income available for support:

1) *Capital gains*. Income for support typically does not include taxable capital gains. Most family courts consider capital

gain a liquidation of assets versus income. While there have been a few exceptions [*In re Marriage of Pearlstein* (137 Cal.App.4th 1361)], the mainstream still excludes capital gains from income for support purposes.

2) *Depreciation*. Depreciation expense is allowed for income tax purposes, but generally excluded for income for support. Often, there is a distinction between assets used and consumed by a business (copiers, computers, equipment) versus real estate investments.

3) *Stock Options*. Courts are typically considering stock options as income available for support. However, there is no consensus or California case detailing when options are income for support and how to quantify that income. Are options income when they vest or when the spouse actually exercises them—which is the taxable event? Are subsequent gains and losses taken into consideration for vested but unexercised options?

Complexities Caused by a Down Economy

In determining income available for support, further discussion is warranted regarding the treatment of depreciation, imputation of income, representative time period and treatment of debt relief.

Depreciation. As indicated above, generally the courts will allow depreciation for the cost of equipment that is consumed by a business, but will disallow depreciation for the cost of real estate. This is under the theory that real estate is an appreciating asset and the cost of the asset is really a form of investment. Given California's real estate market, is this still a valid assumption? If one has a rental property and the asset continues to decline in value, is there now a real cost for producing the rental income? Or does the spouse have an obligation to liquidate that asset and invest in an income producing asset, as in *In re Marriage of Destein* (91 Cal.App.4th 1385)? Under the assumption that California's real estate market will eventually recover, is there any basis for changing the traditional treatment of depreciation on real estate?

Imputation of Income. It is common to see a decrease in a self-employed spouse's business income while the parties

are divorcing. To some degree, this is understandable. The spouse is under emotional stress, focusing on separating the family finances and dealing with changing responsibilities for the children. These distractions are temporary and it is anticipated that income will recover in the near future.

Often, however, a decrease in the business income is an intentional attempt to reduce support obligations. Or the managing spouse may have an epiphany, decide that life is too short and not work as hard.

California family law cases have allowed imputation of income to spouses whether the income decline was intentional or not. However, *In re Marriage of Bardzik* (165 Cal.App.4th 1291 - 9/15/08) emphasizes that it must be proven that a spouse has the ability and opportunity to earn the imputed income.

So how does the economic downturn affect the imputation of income? Most businesses have seen a decrease in income over the last year due to the circumstances beyond anyone's control. Is it appropriate to impute income under these circumstances? How does one prove a spouse has the *opportunity* for receiving imputed income with our current unemployment rates? How does one sort out the portion of the income decrease attributable to temporary distractions, intentional manipulation and pure economic factors?

Representative Time Period. Self-employed spouses in the construction and real estate industry are flocking to family courts requesting support order modifications. Both industries have suffered major losses during the last couple of years. However, this bust followed a number of boom years for these folks. When trying to determine a reasonable income for support going forward, should an average of the last five years be looked at or just the most recent year?

The difficulty with any type of economic downturn is that a spouse may take advantage of the excuse to intentionally manipulate income. Within weeks of the Sept. 11 attacks in New York, divorcing spouses were lamenting how the event negatively impacted their business and ability to earn income. Clearly, anyone in the travel industry had a legitimate claim, but spouses in many other sectors were also claiming a negative impact.

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The other dilemma is that support orders are often of limited duration. For example, child support is generally only valid until the child turns 18 or graduates from high school. Thus, a spouse obligated to pay support can use a "temporary" downturn to depress income long enough for a support order to expire.

So what is a court to do with these construction contractors and real estate agents? Since no one has a crystal ball that will tell us how quickly these industries will

recover, is it fair to charge these spouses with earnings from the boom years? However, as with imputation of income, trying to sort out the intentional versus unintentional decline in income is tricky, if not impossible. It may be helpful to determine how the parties addressed earlier economic downturns when they were a family unit.

Debt Relief. Debt relief has become increasingly commonplace with property foreclosures and short sales. Any debt or portion thereof that was not incurred for the actual purchase or improvement of a

qualified personal residence will probably be considered taxable income.

How should the Court address forgiveness of debt for a line of credit that was used for the party's lifestyle? This represents cash received that will not be repaid. This seems to fit the definition of income, but when is it considered income? When the proceeds were received or when the debt is forgiven? Either way, the funds are now gone, so is it realistic to charge a spouse with support on those funds? Where will the spouse now get the cash to pay that support? Should the courts start including draws on lines of credit as income and then future repayments as reduction of income?

Lack of Answers

This article contains a number of questions and few answers because there is little case law to provide guidance in these areas. Family law practitioners and the courts are approaching these questions with reasoning and a sense of fairness to both parties. These are interesting times for those of us who practice in family law, so stay tuned.

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