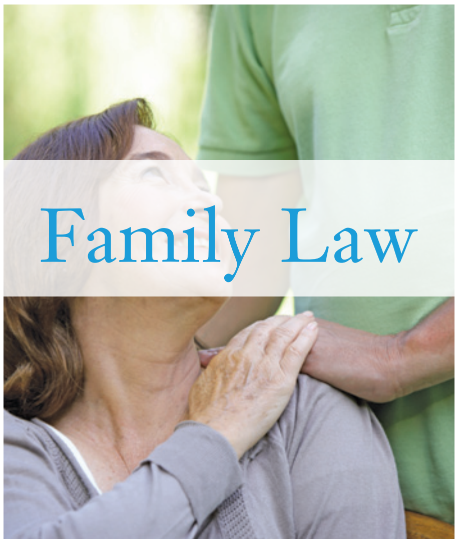
The Legal Intelligencer

THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2011

PHILADELPHIA, THURSDAY, JULY 2012

An ALM Publication



Litigation in Divorce Requires Lawyer-Accountant Interplay

BY MATTHEW PODOLNICK AND MICHAEL A. SACCOMANNO

Special to the Legal

In divorce litigation, there are the kids and the house, and while these issues are challenging, in many cases the greatest difficulty is routinely about the money — especially if the litigants have an ownership interest in a business. A successful handling of a domestic matter requires informed interplay between the lawyer and the accountant — a blending of the legal and the financial. It is essential in every case to determine what documents are needed to complete a proper marital cash-flow analysis and business valuation. Cash flow and identifying the sources of income vis-a-vis equitable distribution of a business and support calculations, however, may be the most challenging of all.

Whether the family business has multiple owners or is solely titled in one spouse's name, a forensic analysis may be necessary to "follow the cash." Remember, you cannot accurately value a business if you cannot determine the actual income available to the owner. It is critical that the family lawyer and accountant identify the issues particular to the matter at hand and then zero in to efficiently and effectively uncover the true cash flow and the underlying value of the business. To accomplish this, a family law attorney needs to team with a CPA experienced in matrimonial work to do the research,

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identify and find the proper documentation and assist both parties in coming to a fair and equitable resolution.

Routinely, there is an undetachable symbiosis between the cash flow of a business and the lifestyle of the parties. Invariably, judges are left at the end of a trial without certain essential questions having been asked or answered, such as how the parties lived on the cash flow of the business or how the income differs from that shown from the business. These and other issues must be scrutinized by a tenacious attorney and accountant to uncover the unreported income, value the business and identify the lifestyle of the parties.

The analysis of cash flow necessarily makes a distinction between unreported (or underreported) cash flow from a business and unreported cash and income to the individual. In order to discern both, the attorney and accountant first concentrate on unreported cash to the business. Unreported cash for a business is cash received as payment to a business that is not recorded as sales and is pocketed and used for nonbusiness purposes. Conversely, unreported cash/income to the individual equates to the personal expenses paid by the business (perquisites) and unreported cash for a business that ends up in the hands of the individual. These items can be difficult to compute and identify.

The circumstances ripe to identify unreported cash necessitate cash changing hands. Examples include, but are not limited to:

- Restaurants/food establishments.
- Landscaping.
- Boutique clothing.
- Auto repair shops.
- Cleaning services.
- Convenience stores.

More subtle examples of unreported cash (imposters), and which blur the lines between reported income and cash flow, are K-1 distributions, shareholder loans through the business and marital balance-sheet changes.

One mechanism to measure unreported cash is identifying excess spending. This may be revealed in spending habits that exceed reported income, yet are not evidenced by credit card debt or personal loans. Another mechanism to measure unreported income is to spotlight a buildup of assets without identifiable sources of income.

Most likely falling under the exclusive province of the accountant is the mechanism of looking at industry averages. This approach looks at margins and other key statistics of the subject company compared to industry norms and averages. Uncovering bags of cash is certainly a strong indicator of unreported income, but a less common means. Furthermore, look for undisclosed bank accounts that can be investigated with an individual's social security number or corporate identification number. Finally, the elusive second set of books not only reveals unreported cash, but also can foster an expedited resolution to the divorce litigation.

After the unreported income is identified, the next step is to determine how to treat these assets. The business valuation should include an analysis of the revenue increased by the amount of unreported cash. The attorney and accountant need to make sure that all expenses have also been recorded — otherwise, the margins will be unrealistic. It is important to note that unreported cash does not necessarily translate to income for the business owner. In cases where we see underreported revenue, business owners also underreport expenses. An additional issue is whether the unreported income should be tax-affected; these issues should be discussed between the attorney and accountant. Unreported income to the individual, or perquisites, mean the business expenses as reported are not ordinary and necessary business expenses and should be removed (normalized). The result is increased margins and, potentially, a higher value of the business.

With respect to the individual and concomitant support calculations, extra cash enhances the lifestyle during marriage and must be included in both cash flow available for support for its entirety, and as part of the lifestyle expenses to the extent it was spent. Similar to the analyses conducted in the business valuations, the attorney and accountant must ask and answer the question of whether the found income should be taxed.

The perplexing issue for the parties to negotiate or the court to resolve is how to calculate the proper level of alimony that is greater than reported income. It is essential to avoid double-dipping, which would occur by increasing alimony and the business value as a result of the identification of the unreported income. Adding these items back to the business income increases the value of the business, thus increasing the pot available for equitable distribution. If the unreported funds are also included as part of income, thus increasing alimony, a double dip (included twice) would result from an accounting perspective. The bottom line when analyzing these two issues is: When enhancing the cash flow, which increases the business value, does the result pass the reasonableness test?

The parties and the court are left with the legal treatment of the nontitled spouse relative to the unreported income. Legal culpability as seen through the eyes of the IRS may not be so clear to the taxing authority. To untangle this problem, look at the IRS rules concerning culpability. There are degrees of culpability and innocence. The nontitled spouse may have to launch an innocent-spouse defense. As part of that investigation, the IRS will consider, among other factors, the extent of involvement or knowledge of the nontitled spouse.

Moreover, valuing a business is one thing, but determining what portion of the business is subject to equitable distribution or what part of the cash flow should be considered to calculate support is another. Whether by trial or through negotiations, equitable distribution and alimony cannot be resolved independent of one another. In today's economic times, more often a business owner is required to pay the spouse an equitable distribution payout (monthly payments) and then pay alimony and/or child support on top, and the business owner only has one source of cash flow for payment: the business. The attorney and accountant must work together to ensure the financial plan meets the financial ability of the parties.

Equitable distribution is the process by which the marital portion of the titled spouse's interest in the business will be distributed. The court will look at several factors in reaching a decision about how to divide the assets and calculate support. Ultimately, application of the various factors and how the value of the business is divided are within the sound discretion of the court. Furthermore, many of the factors considered by the court relative to equitable distribution cross over to those relative to a determination of alimony.

Only the marital portion of the business and income are considered for equitable distribution. Pinpointing what comprises the marital portion of the value and income affords its own unique challenges. For example, the titled spouse may increase his or her ownership interest in the business by way of inheritance, stock purchase or gift during the marriage. While the value of that portion of the business bequeathed may be excluded from equitable distribution, arguably the increase in value of that newly acquired interest as a direct result of the efforts of the owner spouse is subject to equitable distribution. Moreover, the income generated by acquisition may be considered when figuring out the appropriate amount of support. When faced with these issues, determining historical value at various periods of time adds a level of complication and cost to a business valuation. •