WHAT IS INCOME FOR PURPOSES OF SUPPORT

By: Lizanne J. Ceconi, Esq.[1]

Almost 60 years ago, the New Jersey courts determined that we look to a person's income to determine support. See Bonanno v. Bonanno, 4 N.J. 268 (1950). In addition to a person's income, the court guided us to consider the property, capital assets, earning capacity and prospective earnings of the payor. Id. at 275. Potential enhanced earning potential is another factor to be considered in determining support. Mahoney v. Mahoney, 91 N.J. 488, 505 (1982). There is no case law in New Jersey that establishes current earnings as the sole criterion for support. Lynn v. Lynn, 165 N.J. Super. 328, 341 (App. Div. 1979), certif. den. 81 N.J. 52 (1979).

Determining the amount of a person's income is crucial in establishing a fair amount of alimony and/or child support. In most instances, the amount established as income will be used for alimony and child support alike. The exception to this rule is that the income derived from a distributed share of a retirement benefit for purposes of equitable distribution cannot be considered for purposes of alimony. See Innes v. Innes, 117 N.J. 496, 505 (1990) and N.J.S.A. 2A:34-23(b). It can, however, be considered for child support if the income of the parties is insufficient to meet the children's needs. Johns v. Johns, 208 N.J. Super. 733 (Ch. Div. 1985).

Our statute provides that in determining child support, we must consider with each parent all sources of income and assets, earning ability, educational

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background, training, employment skills, work experience, custodial responsibilities and costs of child care, among other factors. N.J.S.A. 2A:32-23 (a)(3)(4). In determining alimony, we must consider the actual need and ability to pay, earning capacities, educational levels, vocational skills, employability, the opportunity for future acquisition of capital assets and income and income available to either party through investment of any assets held by that party, among other factors. N.J.S.A. 2A:34-23(b).

This article sets out to determine what income should be for purposes of support. It will review the definitions of income for support as well as the case law that has developed as a result of these definitions. It will not address the issue of imputation of income since the topic is far too extensive for today's task.[2] Particular focus will be directed to the difference between taxable income and available income or cash flow.

As a result of the case of Crews v. Crews, 164 N.J. 11 (2000), we are instructed to establish each party's income as a baseline in the event of future support modification applications.

Practical Tip #1: Be very thoughtful in the amounts you are looking to ascribe to each party's income. If you successfully argue that the payor's income is higher than reported, you may be hurting your client in subsequent reviews of support because the income may never be duplicated. Likewise, if the economically disadvantaged spouse is imputed with a high income, it may be unlikely that those income levels are ever

[2] Attached is an article first printed in January 2005 for the Family Law Symposium. It has been updated to include published case law since that time regarding imputation of income.

realized warranting a modification. Review the Child Support Guidelines to estimate the difference in support with the higher and lower income numbers. Once a payor's net weekly income exceeds $1,000, the increase in support for one child is approximately $45 for each $500 of increased income.

CHILD SUPPORT GUIDELINES

In 1986, New Jersey adopted Child Support Guidelines. See R. 5:6A. This was in reaction to a federal mandate that conditioned federal funding for families and children on the adoption of guidelines. In 1988, the federal government mandated that all states in this country were required to adopt guidelines for child support no later than 1994. Included within all of the guidelines are definitions of income for purposes of support. While the definitions of income may vary by state, federal regulations require that the child support guidelines take into consideration all earnings and income of the non-custodial parent, be based upon specific descriptive and numeric criteria to allow for a computation, and must provide for children's health care needs.

Practical Tip #2: Read and re-read the Child Support Guidelines frequently. They contain a wealth of information including detailed descriptions of income and how to calculate support.

The definitions regarding income in the New Jersey Child Support Guidelines are attached. They include defining income, gross income, sources of income, income from self-employment, sporadic income, military pay, in-kind income and types of income excluded from gross income. When the Child

Support Guidelines were adopted in New Jersey, many attorneys believed that they would end the ability to advocate for our clients regarding support. A review of all of these definitions makes clear that there is plenty of fodder for effective advocacy.

<u>Net Income</u>

The Court Rules and child support worksheets make clear that child support is based upon *net income*. Net income is defined as gross income less taxes and other expenses. New Jersey Court Rules, Appendix IX-H provides a combined tax withholding table for use with the guidelines. Many of the computer generated support calculations are based upon these tables. The comments to Appendix IX-H make clear that these charts are based on withholding rates and do not consider year-end tax obligations. If either of the parties historically received tax refunds, the amount of withholding on a present paystub may be irrelevant and the refund should be considered as available income. The withholding table is inappropriate for alimony income since neither FICA nor Medicare taxes apply. Care should be given that non-taxable income is not lumped with taxable income. Furthermore, in the case of a self-employed person, the withholdings should be examined in conjunction with prior years' tax returns to establish the effective tax rate of the individual.

Practical Tip #3: Make sure the withholding taxes on the child support guidelines worksheet are consistent with the parties' actual tax liabilities rather than the computer generated chart. The difference in net available income can be significant in determining support.

Gross Income

The definition of gross income includes buzz words like "earned and unearned income", "recurring" and "available." These words carry significance because it makes clear that the income reflected on one's tax return is not the defining amount of income to be considered by the courts for purposes of support. Whether income is recurring or available for support are fact sensitive issues. The definition specifically includes the following language: "the court should consider if it [the funds] would have been available to pay expenses related to the child." New Jersey Court Rules, Appendix IX-B. Availability of funds is often dictated by who has control over the funds. These issues become particularly prevalent when addressing income from self-employment and executive compensation, which will be discussed in more detail below.

Sporadic Income

Appendix IX-B provides a detailed definition of sporadic income. The guidelines also define a sporadic income as one that fluctuates from year-to-year and includes seasonal work, dividends, bonuses, royalties and commissions. We are instructed to average the income over thirty-six (36) months unless its first occurrence is more recent. The court is permitted to ignore sporadic income if the party can prove that it will not be recurring in the future.

In Lanza v. Lanza, 268 N.J. Super. 603 (Ch. Div. 1993), the court instructed that child support be determined by income averaging because of the fluctuation in payor's income. The court opined that averaging of income is particularly significant in circumstances of self-employment where income fluctuates. In the matter of Platt v. Platt, 384 N.J. Super. 418 (App. Div. 2006), the court averaged the payor's income over five (5) years rather than three (3) years based on the circumstances of the case. The court was mindful of the three (3) year period in the guidelines, but determined that the circumstances warranted deviation to create a more expansive and representative time frame. Mr. Lanza reduced his income from self-employment post-divorce complaint, yet there appeared to be an upward trend of the business after suffering from a loss from several years prior. The court relied upon the totality of the circumstances including the recent upward trend of the business to rely upon five (5) years rather than (3).

Practical Tip #4: When looking to the income of a self-employed payor, the issue of income averaging should always be explored. Factors to be considered include the number of years of operation of the business, any economic trends relating to the nature of the business, any reasons for a sudden rise or fall in business revenues, changes in personnel, location, recent capital expenditures, and any other factors that impact the business operations. Successfully arguing how many years should be used for the average income can be significant in the amount of support to be established.

Courts have also pro-rated income when its distribution is periodic. In Cleveland v. Cleveland, 249 N.J. Super. 96 (App. Div. 1991), the former husband received lump sum distributions every five (5) years from a personal injury settlement. The court allocated the sum as if it were received monthly until the next distribution.

In-Kind Income

New Jersey Court Rules, Appendix IX-B defines in-kind income as goods, services or benefits received in lieu of wages if they reduce personal living expenses. Expense reimbursements are not considered income. Examples are cars, car insurance, free housing, meals, benefits selected under a cafeteria plan, memberships and vacations. The amount of the income is to be based upon the fair-market value.

Practical Tip #4: Before embarking on a campaign to include additional income representing in-kind income, calculate the support with and without your highest estimates of these items. Be sure it is cost-effective to make the argument.

EXECUTIVE COMPENSATION

Despite the present economic recession, many highly paid executives receive various forms of income making up their entire compensation package. Some of these items are tax deferred to allow the employee to realize the income upon retirement when taxable income will be lower, resulting in lower tax rates. In some circumstances, employees receive a modest base salary and are paid a bonus annually based upon individual performance, company performance or a combination of both. Employees are granted stock options and restricted stock as a way of retaining employees, tying their income with company and/or individual performance and making their employees feel "invested" in the company.

How these various forms of executive compensation are treated for purposes of equitable distribution or support depends in large part on the purpose of the benefit, the frequency of the benefits, the employee's ability to elect participation and the conditions attributable to the reward of the benefit, among other factors.

Cash Bonuses, Royalties and Commissions

Bonuses, royalties and commissions are all named as sources of income under the Child Support Guidelines. The amount of the cash bonuses and the cash flow of the parties should determine how best to include this income for purposes of support. For an employee who has consistently earned the same bonus from year to year, setting support based on the base and cash bonus on an annual basis may be best for all parties involved. The timing of the bonus also raises issues whether to consider it as an asset or include it in income in order to establish a present support obligation.

Oftentimes, a bonus is paid in January for services performed the previous year. If the complaint for divorce is filed during that previous year, the non-employee spouse may argue that the bonus is an asset acquired during the marriage and may seek a lump sum distribution of the funds when received based on when the complaint for divorce was filed. Obviously, if there is no support obligation in the case, this is the smartest approach for the non-employee spouse. If the non-employee spouse is seeking support from those funds, it needs to be determined whether he or she is in a better position to take a percentage as equitable distribution or have all of it considered for purposes of support. Clearly, it cannot be counted twice.

Practical Tip #5: In cases involving bonuses and other forms of executive compensation, discuss with your client the impact of the timing of a complaint for divorce. Waiting until the end of a calendar year may be the most efficient and beneficial decision for your client.

Given today's economic climate, it is not unreasonable to presume that bonuses in the next few years may vary significantly from previous years. Nowadays, people are happy to have a job rather than expecting substantial bonuses. If there is a basis to believe that the bonuses will drastically change, the best approach may be to agree upon a percentage of a cash bonus upon receipt.[3] This will hopefully save any modification applications over the next few years while volatility in the market is expected. These recommendations require continuing exchange of financial information between parties post resolution. While this may not be preferred by the parties, it certainly is less intrusive than the financial exchange required in a modification application.

Practical Tip #6: If an agreement is reached regarding a percentage of bonus or other income, decide on a number based upon gross income not net income. The calculation is much easier and leaves no questions open about tax deductions, contributions to deferred compensation plans or other deductions elected by the employee.

[3] There are caveats involved in agreeing to a percentage of the supporting spouse's income that will be discussed in more detail below.

Royalties may be considered an asset subject to distribution rather than a component of income. Again, it cannot be counted twice. Commissions are generally income. The frequency and consistency of commissions should determine how support is set and whether it should be based on income averaging.

Deferred Compensation/Retirement Plans

New Jersey Court Rules, Appendix IX-B allows for the exclusion from income mandatory retirement contributions. However, voluntary payments to deferred annuity plans or other forms of deferred compensation plans are to be included in a party's adjusted gross income for purposes of calculating child support. Schwarz v. Schwarz, 328 N.J. Super. 275 (App. Div. 2000). Employer contributions to 401(k) plans, such as the amounts from company matching programs, are not to be considered in gross income in calculating child support. Forrestall v. Forrestall, 389 N.J. Super. 7 (App. Div. 2006). In Forrestall, the court reasoned that these funds were not available to the payor without substantial penalties and taxes. The income produced on this account was not ordinarily accessible and it was not expected that an intact family have utilized these funds.

Stock Options and Restricted Stock

Many highly compensated executives receive stock options and/or restricted stock as part of their compensation package. Stock options grant an employee the right to purchase a specified number of shares of stock at a fixed price, over specified periods of time. The intrinsic value of the option is the increase in the market value of the stock over the strike price or fixed price established at the time of the grant. If the market value is less than the strike price, the options are considered to be "under water" and are incapable of producing earned income for the employee. Vesting of the stock option affords the employee the right to exercise the option. It is not until the exercise of a stock option that the "profit" is treated as earned income for income tax purposes.

A grant of restricted stock to an employee provides a fixed number of shares of stock where ownership in the stock is not complete until the specified vesting period has ended. Upon vesting, the stock automatically grants ownership to the employee. The market value of the stock at the time of vesting is treated as earned income to the employee and will be included in the W-2 wages.

Our New Jersey Supreme Court determined in Pascale v. Pascale, 140 N.J. 583 (1995) that stock options are assets and therefore, eligible for equitable distribution. The stock options in Pascale were granted a few days after the filing of the complaint for divorce and were included as assets for purposes of equitable distribution based on the finding that they were earned during the marriage.

The leading case in New Jersey regarding the treatment of post-divorce stock options for purposes of support is Heller-Loren v. Apuzzio, 371 N.J. Super. 518 (App. Div. 2004).[4] There, the court concluded that the exercise of stock options could not be deemed part of "gross income" for purposes of child support

[4] The author wishes to express gratitude to Jacqueline M. Printz, Esq., the attorney of record for the prevailing party, for sharing her insight and materials related to this case.

based on the specific language defining income contained in the parties' property settlement agreement. Id. at 535. The decision went on to say, however, that "the actual exercise of the options may give rise to income if there is a demonstrated fair market value of the stock above the option price." Id. at 533. The Heller-Loren court concluded that the ability to exercise options (i.e. vesting) does not by itself give rise to "income" for purposes of support. Id.

The trial court in Heller-Loren inquired whether the stock options were "consistent, recurring and a substantial part of defendant's regular income" consistent with the definition of "gross income" contained within Appendix IX-B of the Child Support Guidelines. Id. at 527. The trial court also opined that "[t]he specific phrase 'stock options' did not appear within the definition of income." Id. The appellate court then stated, "our child support guidelines expressly exclude stocks and bonds from income unless the court finds that they were purchased with an intent 'to avoid the payment of child support.'" Id. at 532 (quoting Pressler, Current N.J. Court Rules, App. IX-B at 2434-35 (2004)).

This last reference to the exclusion of stocks and bonds from income gives practitioners an argument to be made against inclusion of income related to stock options. However, this quote is misplaced in the opinion and fails to distinguish between stocks and stock options. Generally, when a person buys stock, the stock is intended for savings and investments. When a person receives stock options, this generally represents a form of compensation for efforts expended in employment.

The better argument to exclude the exercise of options from income is that it may not fall within the definition of "gross income" if the exercise is not recurring or will not necessarily increase the income to the recipient over an extended period of time.

Practical Tip #7: The holding in Heller-Loren is fact sensitive and based upon the specific language in the property settlement agreement. In drafting a property settlement agreement where executive compensation is involved, make sure income is defined to include or exclude stock options, restricted stock or other forms of executive compensation. If the income will be included for purposes of support, make sure it is clear that any of the employee benefits that have been distributed by way of equitable distribution are not to be considered for support so as to avoid the "double dip."

Because the ruling in Heller-Loren is fact sensitive to the property settlement agreement, we look to out of state rulings to provide us with factors to be considered in determining post-divorce inclusion of stock options. In Denley v. Denley, 661 A.2d 628 (Conn. App. Ct. 1995), the husband was awarded his stock options as marital property at the time of the divorce. The trial court improperly considered the profit on the exercise of the options for purposes of support. The appellate court held, "the mere exchange of an asset awarded as property in a dissolution decree, for cash, the liquid form of the asset, does not transform the property into income." Id. at 631 (citing Simms v. Simms, 593 A.2d 161, certif. denied, 597 A.2d 335 (Conn. 1991)).

In Seither v. Seither, 779 So. 2d 331 (Fla. Dist. Ct. App. 2000), the court affirmed the trial court's decision that considered vested options as income for support. The court noted, however, that if a trial court determines the stock option to be an asset, then it cannot consider the same options as income for the purpose of calculating alimony. Id. at 334 (referring to Diffenderfer v. Diffenderfer, 491 So. 2d 265 (Fla. 1986)). Interestingly, the court specifically left open the issue whether the income from a distributed stock option could be considered for calculating child support. The Seither court recognized that stock options have the characteristics of both income and assets. The opinion also acknowledged that stock options are further complicated by whether they are granted based on past, present or future services. The court stated:

> [T]he cases discussing stock options universally recognize that the circumstances under which options are granted and the nature of the options themselves can vary so greatly that no single formula or set of factors can effectively deal with them. See, DeJesus v. DeJesus, 665 N.Y.S.2d 36 (N.Y. App. Div. 1997); In re Marriage of Hug, 154 Cal. App. 3d 780 (Cal. Ct. App. 1984). Id.

Kenton v. Kenton, 571 A.2d 778 (Del. 1990) recognized that profits realized from the exercise of stock options can be income in calculating support. The court analogized it to a bonus and therefore, found it fit within the definition of income under Delaware law. However, in Kenton the obligor exercised his stock options by purchasing the stock rather than liquidating the stock with the exercise of the option, as in a same day sale. The court, therefore, did not consider the income in calculating support because the stock provided the obligor with no additional monies. "In those cases where a support obligor is employed and earning ample wages from which adequate child support can be paid, this court customarily does not require that the obligor liquidate his or her assets for the purpose of paying even more support." Id. at 783.

In the case of Murray v. Murray, 716 N.E.2d 288 (Ohio Ct. App. 1999), the court ruled that stock options were included within the definition of gross income[5] for purposes of support, regardless of whether they were exercised. Essentially, the court imputed income as a result of the annual grant of stock options to determine gross income. In Murray, the obligor was a Proctor and Gamble employee who received options annually. Testimony from the Director of Global Compensation established that stock options were an integral part of the obligor's annual compensation. The court concluded that stock options in this matter fell within the definition of "gross income" because they were recurring and a sustainable source of income. The obligor tried to argue that the options should not be considered since they were not income until exercised. The court rejected this argument because the employee makes an investment choice. The investment choice allows for the value of the options to be imputed as part of the gross income. The court stated that if income only included the exercise of options,

> an employee receiving such options would be able to shield a significant portion of his income from the courts, and deprive his children of the standard of living they would otherwise enjoy. This would be in direct contradiction of the very purpose of the child support statute, the child's best interest.

Id. at 294 (referring to Marker v. Grimm, 601 N.E.2d 496, 497-499 (Ohio 1992)).

[5] The Ohio and New Jersey definitions of "gross income" in their respective child support statutes are nearly identical.

The Murray court also rejected the argument for inclusion of income only upon exercise of the options because it could then constitute "non-recurring income" that would be excluded from the definition of "gross income." In Yost v. Unanue, 671 N.E.2d 1374 (Ohio Ct. App. 1996), the court held that exercised stock options were excluded from "gross income" as "non-recurring income". The Murray court distinguished the two cases because, in Yost, all of the options were exercised in one year and the parties failed to account for the exercise of options in their divorce decree.

In light of Heller-Loren, is there an argument in New Jersey for the imputation of income associated with the vesting of stock options rather than waiting for the exercise of the option? First, all of the discussion in Heller-Loren regarding stock options is essentially dicta since the court made its rulings based on the fact sensitive definition of income in the property settlement agreement. Since the court referenced the child support guidelines' exclusion from income any stocks and bonds unless they were purchased with an intent "to avoid the payment of child support," an argument can be made that an employee's unwillingness to exercise profitable options is being made with the intention of avoid a support obligation. Factors to be considered would include the past history of treatment of options by the parties, the amount of support being paid and whether it is sufficient to meet lifestyle and the all encompassing factor in fixing support is what "the circumstances of the parties and the nature of the case shall render fit, reasonable and just." N.J.S.A. 2A:34-23.

Support Based upon a Percentage Share

Stock options, restricted stock and cash bonuses are expected to vary greatly from year to year as we go through this economic crisis. Stock options and restricted stock values are directly tied to the value of the company's stock. The value of stock options and restricted stock are almost exclusively related to the value of stock in a publicly traded business. They are often granted to employees as a means of retaining them in the business. Given the volatility of the stock market and the dwindling cash reserves of many large companies, there is a tremendous amount of uncertainty regarding the future value of these benefits.

In order to avoid annual modification applications, parties may agree to support based upon a percentage interest in the benefit or bonus received. In a recent New Jersey unpublished appellate decision, Schwartz v. Schwartz, Docket No. A-2560-07T2, decided January 13, 2009,[6] the motion judge accepted the plaintiff's argument that the modified support amount was based on a percentage of earnings and set support based on a percentage of the income established. Defendant disputed that there was an agreement of support based upon a percentage of his income and appealed the trial court's decision. The appellate division held, "the implementation of a formula percentage to determine child support or alimony, although attractive in its simplicity of application, ignores the clear requirements of the law and shirks the responsibilities of the court." Id. at 6. The opinion did not address whether a negotiated agreement between litigants that provides for a percentage of income for support would be

[6] A copy of the decision is attached.

enforceable. There are no other known cases in New Jersey that specifically address that issue.

In California, the trial court in Kerr v. Kerr, 91 Cal.Rptr.2d 374 (Cal. Ct. App. 1999) awarded the wife additional child support and alimony based in part on a percentage of the post-dissolution stock option income from the husband's employment. The husband appealed. The appellate court ruled that it was proper to award additional support based on the stock option income because it was received annually, produced substantial income, was part of the husband's compensation and the parties utilized the income to enhance their standard of living. It is significant to note that at the time the order was set, the value of the stock was $39 per share. At the time of the appeal, the value of the stock exceeded $780 per share. Relying on those facts, the Kerr court stated:

> Generally, the use of percentages to determine support will beneficially remove the need for further litigation with its attendant costs, and oftentimes, emotional upheaval. (See, e.g., In re Marriage of Ostler & Smith, [272 Cal.Rptr. 560 (Cal. Ct. App. 1990)]). Here, however, the court was not presented with the typical range of stock activity that would generate some additional income. Rather, due to the enormous increase in value of Qualcomm stock and consequently [the husband's] stock options, the court's percentage support order will far exceed the parties' standard of living, even considering their investment and reinvestment history, during or at the end of their marriage.

Id. at 379. The court remanded the matter to determine an amount of additional support that is "just and equitable." This is consistent with New Jersey statute that requires support to be "fit, reasonable and just." The California court concluded that once the marital standard of living was established, a percentage support award would be permissible as long as the court set a maximum amount proportionate to its findings. Id. Since the child's right to a standard of living is measured by the parent's current station in life and not the marital standard, the maximum award would not necessarily be the same for an award of child support. Id. at 380. Nevertheless, the amount cannot exceed the child's needs. Id. at 381.

Since the courts encourage litigants to resolve their disputes outside the courtroom, a negotiated agreement that bases support on a percentage of income would probably be enforceable in New Jersey so long as the court determined it was "fit, reasonable and just." Given the backlog of cases in most family courts in this state combined with the anticipated deluge of modification applications, it may make sense to negotiate support awards based upon a percentage of earnings.

Practical Tip #8: If you are going to negotiate an award of support based upon a percentage of income, make sure there is a floor and ceiling. Support should never be less than a fixed amount or, if it is, then it should trigger a modification application. If there is no cap placed on the amounts to be awarded, then language should be included in the agreement that it was specifically negotiated between the parties taking into consideration all possible scenarios.

It seems likely that courts would be more inclined to enforce these agreements as they relate to alimony than child support. The courts have a *parens patria* obligation to children to ensure the amounts of support are reasonable to meet their needs. If there appears to be amounts that may exceed the children's needs that would be awarded based on a percentage interest, negotiate that the overage be deposited into a college fund or trust fund for the benefit of the child.

Practical Tip #9: **Oftentimes the highly compensated executive has various components of compensation, including base, cash bonus, stock and forms of deferred compensation. Be sure and establish the average breakdown of these components so that in the event the employment changes or the compensation structure is modified, it can serve as a basis to re-visit support. If you negotiate for a percentage of stock options as part of support and the company eliminates this benefit, you want to be able to modify the agreement to restructure the support.**

INCOME FROM SELF-EMPLOYMENT OR OPERATION OF A BUSINESS

Perhaps the most difficult task in establishing income for support is when one or both of the parties are self-employed or operate their own business. Once again, the Child Support Guidelines are instructive on how to determine income in these matters. New Jersey Court Rules, Appendix IX-B specifically states that:

> [G]ross income is gross receipts minus ordinary and necessary expenses required for self-employment or business operation. Personal income from the operation of a business includes all income sources listed above and potential cash flow resulting from loans taken from the business.

Most significant is the language in the Guidelines that declares: "**In most cases, this amount will differ from the determination of business income for tax purposes.**" Id. (emphasis added). Cash flow is defined as the net of cash receipts and cash disbursements relating to a particular business during a specified accounting period. In other words, what kind of funds can the business generate and distribute without financially jeopardizing the business entity?

Practical Tip #10: Whenever you are handling a support matter involving a self-employed person or business owner, make sure you point out to the court the cash flow of the business rather than the tax returns. Cite the guidelines and include the above quote. Create a separate schedule to the Case Information Statement and make sure you add to the income the items specified in the guidelines, such as depreciation expenses, home offices, entertainment, certain travel, car expenses, voluntary contributions to pension plans in excess of 7% of gross income and any other business expenses that appear inappropriate or excessive. Include a list of the personal expenses the business may be paying on behalf of the parties. In cases where cash flow is less than taxable income, demonstrate the draws or distributions made by the business for a fixed period.

Generally, there are four (4) types of closely-held businesses that we encounter in our daily practices. The first is the sole proprietorship. In a sole proprietorship, the business owner files a Schedule C to the tax return. The business owner is taxed on all the income generated from the business after calculating gross receipts less deductible expenses. Some of those expenses may reduce the personal expenses of the family while still being legitimate business expenses.

The second type of closely-held business is a partnership. The partnership can be two or more individuals that share in the net profit of the business based on their respective share of the business. Many limited liability companies elect to file taxes as a partnership. A partnership tax return is filed and the taxable income is allocated based upon the percentage ownership of the business. A partnership return is filed, yet there are no taxes owed by the partnership. A K-1 tax form is issued for each partner setting forth the taxable income attributable to the partner and the distributions made to the partner during the taxable year. In some cases, the balance of the partner's capital account is listed on the K-1. A capital account is established for those funds which have been invested by the partner in the business and/or earned but not distributed. In a partnership return, a partner can be ascribed income that is never realized by that person. Certain expenses of the business may not be tax deductible. In those cases, the partner is paying taxes on income that was never distributed.

The third type of closely-held business is a Subchapter S corporation. All of the net income of the business is passed through to the individual shareholders based on their percentage interest in the business. Generally, the corporation does not pay corporate taxes since the income is all taxed at the individual rates. There is a corporate return filed and the individual shareholders receive a K-1 tax form. There are certain limitations on Subchapter S corporations, including the number of shareholders, so they are generally small business corporations. N.J.S.A. 14A:7-14.1 imposes limitations on distributions to shareholders. The corporation may not make a shareholder distribution if, after giving effect to its distribution, the business would be unable to pay its debts as they become due in the usual course of business or the total assets of the business would be less than its total liabilities. Rarely in a Subchapter S corporation does the shareholder's taxable income equal distributions made by the business. In some situations, the business makes distributions to shareholders to cover the cost of the tax liability created by the ownership interest even though the business has made no distributions of profit to the shareholder. In other situations, the business retains its earnings. The accounting term for this is the accumulated adjustments account ("AAA"). This AAA generally measures the corporation's gross income, less expenses with the undistributed balance.

The fourth type of closely-held business is a C corporation. The C corporation is taxed twice. A corporate income tax is imposed on its net earnings. After the earnings are distributed to shareholders as dividends, each shareholder must pay taxes separately or his or her share of dividends. A corporation can reduce its federal income tax liability by distributing its income as salary to shareholder-employees who actually work in the business. The C corporation files a corporate tax return. The shareholder-employees receive W-2s for their salary and other wages. If shareholders receive dividends from the corporation, they will receive a Form 1099-DIV.

Practical Tip #11: In order to properly determine income from a closely-held business, you will need copies of all of the tax returns that are required to be filed by the type of entity involved. Get at least three (3) years of these tax documents to compare income, distributions and/or shareholder loans.

Shareholder Loans

The Child Support Guidelines specifically define one income source as the cash flow resulting from loans taken from the business. If a shareholder borrows money from his or her business, those funds will not be taxable to the shareholder upon distribution. The question arises whether those loans are actually income to the shareholder. Oftentimes, shareholder loans are really an advance against a bonus or salary. These loans will be reflected on the corporate books as assets of the company. It usually, however, represents past compensation that was not expensed by the business.

The Internal Revenue Service holds that the shareholder has constructive receipt of income unless the shareholder can show proofs that it truly represents a loan.

Practical Tip #12: If an issue arises regarding shareholder loans and whether it actually represents past compensation, discovery should be sought to determine how the distribution should be treated. The discovery inquiries should include, but not be limited to, a written note, a reasonable interest rate on the loan, whether any repayments have been made, the history of shareholder loans, the resources available to the business and whether there was a *bona fide* business purpose for the loan. If the distribution is treated as income, the value of the business will have to reduce its assets by the asset reflected on the corporate books. In addition, if the distribution is acknowledged as income, the parties need to address the tax liability associated with the distribution.

Shareholder loans are easier to examine when the shareholder owns 100% of the business. When a shareholder loan exists for a less than 100% ownership interest in the business, an examination of the corporate records is necessary to see whether all the owners have loans and are the loans proportionate to their respective ownership interests. If they are, the loans are most likely compensation. If not, it may be an asset of the corporation or there may be an improper classification of the ownership interests. See Kalman A. Barson, Investigative Accounting in Divorce 99-103 (John Wiley & Sons, Inc. 1996).

Retained Earnings

Retained earnings are most often seen in a Subchapter S corporation. In the other forms of closely-held businesses, there are instances where funds are maintained by the business even though the owners and/or partners have paid taxes on the profits of the business entity. Retained earnings represent accumulated profits of the business, usually over a period of time. It is not always in the form of cash, but may represent inventory and/or fixed assets that could not be expensed by the business and have not been fully depreciated. There is no case law in New Jersey that addresses whether retained earnings should be included in the "gross income" of a party for purposes of calculating support.

In reviewing the definitions of income in our statute, gross income is all earned and unearned income that is **recurring** or will increase the income over a period of time. A consideration is whether the income source is **available** to pay expenses. Income from self-employment or operation of a business is defined as gross receipts minus **ordinary and necessary expenses required for self-employment or business operation.** Specifically excluded from ordinary and necessary expenses are any **business expenses that the court finds inappropriate.** Also excluded from gross income are non-income producing assets **unless the court finds that the intent of the investment was to avoid payment of child support.** New Jersey Court Rules, Appendix IX-B (emphasis added).

Reading all of these definitions together, is it really the court's function to tell parties how to run their businesses, what expenses should be incurred on behalf of the business and whether the court wants to make findings as the propriety of certain business decisions?

If retained earnings legitimately stay with the business, the value of the business will increase. Obviously, if a person is not seeking equitable distribution, the motivation will be to classify the retained earnings as income available for support.

Other states have tackled the issue of whether undistributed pass-through income retained by a Subchapter S corporation constitutes available income for purposes of determining alimony, child support and attorney's fees. In Zold v. Zold, 911 So. 2d 1222 (Fla. 2005), the Florida Supreme Court held that "undistributed pass-through income that has been retained by a corporation for corporate purposes does not constitute income" within the meaning of the Florida statute defining income for support. Id. at 1231. The Florida statute defining income is comparable to New Jersey's statute regarding sources of income and the definition of self-employed income. The Zold court also examined the statutory limitations on distributions by a corporation, which are almost identical to New Jersey statute, such that financial responsibilities to creditors and employees must be satisfied before distributions to shareholders take place. The Florida Supreme Court refused, however, to establish a bright line rule that pass-through income could never constitute income for purposes of computing support. Mindful of the ability of shareholder's ability to manipulate the income to shield it from the reach of the other spouse, the Zold court stated: "[c]learly, income retained for purposes of avoiding financial obligations related to dissolution proceedings would not be income retained for corporate purposes." Id. at 1232.

Zold specifically placed the burden of proof on the shareholder-obligor to show that the undistributed pass-through income was properly retained for corporate purposes rather than avoid a support obligation. Id. at 1233. In reversing the appellate court on this specific issue, the Zold court reasoned that the burden should be on the person who has the ability to obtain information to establish the propriety of the corporation's actions. Id. This argument is consistent with N.J.R.E. 101(b)(1) "burden of persuasion" and 101(b)(2) "burden of producing evidence" provisions where the burden generally falls on the party best able to satisfy those burdens because of its expertise and access to relevant information. See comments to N.J.R.E. 101(b)(2) (citing J.E. on Behalf of G.E. v. State, 131 N.J. 552, 569-70 (1993)).

In Kansas, the court placed the burden of proof on the non-shareholder to demonstrate that the shareholder manipulated corporate assets, decreased the amount of his salary to increase retained earnings or acted in a way to shield income. See In re Marriage of Brand, 44 P.3d 321 (Kan. 2002). The Maryland courts follow Zold and place the burden of proof on the parent seeking to exclude pass-through income. See Walker v. Grow, 907 A.2d 255 (Md. Ct. Spec. App. 2006).

In Fennell v. Fennell, 753 A. 2d 866 (Pa. Super. Ct. 2000), the Pennsylvania court established a rule regarding the burden of proof:

> If a shareholder does not have control over the distribution of corporate income, the non-shareholder party to the dissolution proceeding bears the burden of proving the corporation is being used to shield income. However, if the shareholder has control over the distribution, the shareholder has the burden of proving the corporation is not being used to shield assets.

Id. at 869. Indiana courts adopted this rule in Tebbe v. Tebbe, 815 N.E.2d 180 (Ind. Ct. App. 2005) and Nowels v. Nowels, 836 N.E.2d 481 (Ind. Ct. App. 2005).

Once the burden of proof was established, the Zold court established the following test:

> In determining whether the shareholder-spouse has met his or her burden of proving that undistributed "pass-through" income was retained for corporate purposes, the trial court should consider (1) the extent to which a shareholder-spouse has access to or control over "pass-through" income retained by the corporation, (2) the limitations set forth in [state statute] governing corporate distributions to shareholders, and (3) the purpose(s) for which the "pass-through" income has been retained by the corporation.

Zold, 911 So. 2d at 1233. The Florida Supreme Court also discussed the impact of the ownership interest of the corporation. The court held that the percentage ownership interest should be considered, but is not dispositive even where there is access and control because of the statutory obligations regarding the limitations on distributions. The Zold court considered the financial responsibility to creditors, employees, working capital, the purchase of fixed assets, maintenance of accounts receivable and maintenance of inventory, all of which can reduce available cash. "[M]ore important than the shareholder-spouse's ownership interest is the purpose for which the undistributed "pass-through" income has been retained by the corporation." Id.

In Kusterer v. Kusterer, 933 So. 2d 542 (Fla. Dist. Ct. App. 2006), the court applied the decision in Zold and listed various factors to be considered by the fact-finder when addressing the issue of retained earnings. The factors to be considered are a) fiduciary duties to the other shareholders, b) statutory restrictions, and c) the availability of, access to, and control over income personally for distribution for non-corporate purposes. Id. at 549.

The Maryland court in Walker, supra, held that "distributions from an S corporation that are used to fund ordinary and necessary business related investments are not required to be included in the computation of the parent's actual income." Id. at 270. The Walker court instructed trial courts to take special care to ensure that the retained earnings were not being manipulated to avoid a support obligation. The court listed as factors for consideration: Retained earnings and distributions are truly ordinary and necessary expenses required to produce income and not income available to the parent; **any amount that is not actually received by the shareholder not used for expenses**

should be included in the calculation; the ownership interest, however, it is not to be the determining factor in and of itself; nature of the business; governing documents; and the business and non-business relationship among shareholders. Id. at 281-82 (emphasis added). This standard is much more open to challenge than the one announced in Zold. The Zold standard implies that a good faith reason for retaining earnings will be sufficient to exclude it for purposes of support. The Walker court suggests that the shareholder must demonstrate there is an expense necessary for the business to require retention of earnings. The aspirations of growth of a business and potential acquisition of future assets would probably be a successful argument in Florida, but not in Maryland.

In Nebraska, the courts provided that "while ... building equity in a corporation in lieu of taking a salary can be a wise business decision, the support of one's children is a fundamental obligation that takes precedence over almost everything else." Gangwish v. Gangwish, 678 N.W.2d 503, 515 (Neb. 2004). In Pickrel v. Pickrel, 717 N.W.2d 479 (Neb. Ct. App. 2006), the court did not include undistributed retained earnings in income because there was no evidence to demonstrate that the retained earnings were excessive or inappropriate. In Pickrel, the definition for income in self-employment is identical to New Jersey's.

Some Subchapter S corporations make distributions to its minority shareholders to off-set pass-through shareholder tax liability. In Tebbe, supra, the court held that pass-through distributions that are disbursed to off-set shareholder tax liability should not be included in gross income for purposes of support. Tebbe, 815 N.E.2d at 184. The Florida courts have also adopted this position. See McHugh v. McHugh, 702 So. 2d 639, 642 (Fla. Ct. App. 1997).

The courts in South Dakota have taken the approach that the money from retained earnings must be received by a minority shareholder in order for it to be considered in the gross income. See Roberts v. Roberts, 666 N.W.2d 477 (S.D. 2003). Even though the minority shareholder in Roberts received distributions solely to cover his shareholder tax liability, the court determined that the income must be included in the gross income of the shareholder. The Roberts court instructed the trial court, on remand, to consider whether the tax distribution would be an allowable deduction under the statute governing income or provide the basis for deviation of the guidelines. In New Jersey, the child support is ultimately based upon the "net income" of the parties, so the shareholder tax liability would reduce the party's gross income. The structure of our New Jersey child support guidelines and the statutory factors for alimony would seem to indicate that the additional tax liability would be considered in setting support if the income were to be included.

The South Dakota cases addressing this issue focus on control and receipt of the corporate distributions. "If a parent can control whether the business income is retained by the business or distributed to the parent, the requirement that the parent receive the income is satisfied for purposes of [South Dakota statute defining income]. If the provisions ... are met, some or all of that retained business income may be considered in calculating the parent's gross income." Id. at 483. Likewise, a minority shareholder who has no control over distributions will only be required to include the income if it is received. Id.

Finally, in Wisconsin, the courts have established a two-prong test to determine the inclusion of retained earnings in income for purposes of establishing support. The first factor the court must consider is whether the support obligor has the ability to individually control or access the undistributed funds. Secondly, the court must determine whether there is a valid business reason for the business' decision to retain the earnings. Weiss v. Weiss, 572 N.W.2d 123, 126 (Wis. Ct. App. 1997). The Weiss court refused to include the retained earnings of the partnership because the partner could not individually access the earnings.

While New Jersey has not yet addressed this issue, a review of the above cases certainly provides guidance. The general rule is that the income is not distributable until it is received, unless the monies are being retained to avoid a support obligation. Since New Jersey clearly endorses income averaging, particularly involving a self-employed party, the history of compensation and the business history of retention of earnings may become significant factors in determining the treatment of retained earnings.

Practical Tip #13: The difference in taxable income versus available income can be significant and have a tremendous impact on amounts designated for alimony and child support. Make sure you have all the financial data to determine the cash flow of the parties before establishing a support award. Review tax returns, personal checking accounts, quicken

records and corporate financial statements before determining income for purposes of support. The greater the amount of control a party has over a business, the more financial detail you will require.

CONCLUSION

From a review of all of our case law, both in and out of New Jersey, it is clear that income for purposes of support involves far more than reviewing tax returns and plugging in numbers. The first place we should all look is to the state's child support guidelines to review the definitions of income available for support. Courts are more inclined to enhance income if it for child support rather than alimony; yet, there is little distinction in the considerations.

Practical Tip #14: **Remember that discovery concerning income and cash flow issues can be very expensive. If the case only involves child support, review the guidelines and see what the maximum impact purported increased income will have on the support. In most cases, a $500 net increase in income under the guidelines, will only result in a minor increase in support. For example, for one child, a payor's obligation in child support will increase by $94 if the income increases from $1500 net weekly income to $2,500. Be smart in your arguments.**