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Building the Financial Aspects of a Divorce Case: Discovery and Analysis of Hidden Income and Assets

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Attorneys representing parties in divorce frequently are faced with the difficult challenge of discovering and proving the existence of hidden income or assets. Although most prevalent in the context of private business owners, spouses from all career paths are capable of engaging in divorce planning designed to minimize their income and avoid parting with their assets in divorce.

In fact, there are a host of Web sites and other resources primarily designed to counsel divorcing men on how to conceal their assets and minimize their income in divorce. One such site counsels divorcing men, among other things, to “save money [on alimony and child support] by temporarily reducing income,” to “increase marital debt” to reduce marital assets subject to division in divorce, and to defer income in the final years of the marriage to avoid parting with the funds in the divorce. Another site warns “good Husbands” of the “unfair demands” that they will receive if they are honest and touts its ability to help avoid the pending “attack” on the husband’s “assets and income.” The site warns that, “for the man who has not prepared, there is almost no defense” but that with proper planning men can save “thousands on... legal fees, property division, and alimony and child support.”¹ As detailed in this article, in addition to these somewhat rudimentary tactics,

divorcing spouses can use a variety of sophisticated techniques in an effort to conceal assets/income in divorce.

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This article is designed to provide an overview of the process of representing a client who believes that his or her spouse has concealed assets/income and will address the following topics:

1. Using your client as an invaluable source of information
2. Assembling your team of necessary experts
3. Conducting discovery with an eye toward identifying hidden assets/income
4. Understanding common methods used by divorcing spouses to conceal assets/income
5. Reviewing documents for affirmative evidence of concealed funds
6. Understanding and using techniques available in the absence of affirmative evidence of concealed funds, and
7. Capitalizing on a spouse's failure to make adequate financial disclosures.

START WITH YOUR CLIENT

Many parties begin the process of divorce believing that their spouse has "hidden" assets and/or underreported income. Although your client's belief ultimately may prove to be unjustified, your client is in the best position to provide you with invaluable information to assess the situation and begin your investigation.

Both clients may face criminal or civil exposure for tax evasion.

Accordingly, upon the commencement of your representation, it is essential that you extensively interview your client to obtain an understanding of his or her spouse's business, their assets, liabilities, and lifestyle to assess whether your client's expressed concern of undisclosed assets/income seems justifiable. For example, it is significantly more likely for the owner of a privately held corporation to have undisclosed assets/income than a W-2 employee. You must pay particular attention to any business with a high volume of cash receipts (e.g., a bar, restaurant, liquor store, or hair salon), as such businesses frequently conceal the full extent of their cash receipts.

Clients that were involved in the operation of their spouse's business can be particularly helpful in identifying unreported assets/income. For example, a spouse that served as the bookkeeper for the family owned business may be aware of the specific procedures in place designed to conceal cash receipts. It is essential that your client share with you his or her understanding of any such mechanisms used during the marriage so that you can appreciate (1) the scope of the undisclosed assets/income during the marriage and (2) the role that your client may have played in the asset concealment. I add that your client may face serious criminal or civil exposure for tax evasion, regardless of whether he or she was actively involved in the concealment of income during the marriage. Although technically there are protections afforded to an "innocent spouse," see I.R.C. § 6013(e), the protection is rather limited and may not protect spouses that knew that they were receiving the benefits of undisclosed income. Moreover, some states *require* that judges refer any evidence of tax fraud to the Internal Revenue Service.² It is thus essential that you educate your client of the potential exposure for both parties and, if necessary, have a criminal attorney assist in the client's representation. You should also discuss the potential benefit to both parties of agreeing to resolve all of the financial disputes by way of binding arbitration.

Whether proceeding in court or arbitration, it is crucial that you obtain from your client an understanding of the parties' lifestyle, the manner in which they paid for their expenses, and whether the assets that they have acquired make sense in light of their reported income. You should pay particular attention to whether the parties made any large cash expenditures. For example, I recently met with a woman whose husband owned a landscaping business and reported income of only \$70,000 per year. The parties, however, had recently renovated their home at a cost of approximately \$200,000, all of which had been paid in cash. The husband also had purchased a yacht in cash for approximately \$250,000. Fortunately, the wife had receipts for both the home renovation and the yacht, which clearly debunked the husband's claimed \$70,000 annual income.

Undisclosed assets and income, however, do not simply arise in the context of cash businesses, and the client interview should not be focused exclusively on cash expenditures. To the contrary, part of your interview should focus on your client's knowledge of the extent to which the parties'

personal expenses were paid through his or her spouse's business. For example, I recently represented a woman that was able to detail all of the family's expenses paid through her husband's business, including an apartment in New York City, several cars for the family, cell phones, a personal chauffeur, and extravagant vacations.

Discuss the significant costs of litigating over concealed funds.

A spouse with the ability to control a closely held business not only has the ability to pay for his or her family's expenses but also has an almost inexhaustible supply of techniques available to reduce their reported income, some legitimate and some not. It is thus essential to obtain from your client at the commencement of your representation an understanding of the scope of his or her spouse's control over the business. Is the business a family owned operation rife with the possibility of manipulation? Is the spouse a minority owner with little or no control over the company? Is the spouse, although technically only a minority owner, in complete control of the corporate affairs? Does the business operate in a heavily regulated industry that would reduce the spouse's ability to manipulate his or her income? The more control exerted by the spouse, the more likely that he or she will be able to manipulate the corporate affairs in an effort to shield assets/income in the divorce.

Disgruntled Former Employees and Former Partners

You should also discuss with your client whether he or she is aware of any disgruntled former employees or scorned business partners, both of whom can be an invaluable source of information. For example, the disgruntled employee or former business partner may be aware, *inter alia*, of personal expenses run through the business, undocumented cash, steps taken to defer the realization of a significant financial event until after the divorce, and marital funds spent on boyfriends or girlfriends. Best of all, disgruntled employees and former partners are frequently all too happy to share whatever dirt they have (or believe that they have) on your client's spouse. If your client is able to identify any such individuals, it is important to interview them as soon as possible. In doing so,

you must maintain some level of skepticism (keeping in mind that they are disgruntled for a reason), request copies of any documents that they have to corroborate their allegations, and ask them if they believe that there are others with whom you would benefit from speaking.

Finally, you must discuss with your client the serious potential obstacles to discovering and proving hidden assets/income. You must advise your client of the painful reality that it will be his or her burden to prove the existence of such concealed funds and that in many circumstances, no matter how strongly held their belief, he or she may not be able to satisfy the burden. You also must discuss with the client the significant costs associated with litigating over concealed funds, including the costs associated with forensic accountants and other necessary experts. At the end of the day, your client (with your counsel) must perform a cost-benefit analysis to determine whether the potential benefits of proving the existence of hidden funds outweigh the costs of the litigation.

ASSEMBLE YOUR TEAM

The task of uncovering hidden assets/income can be one of the more difficult ones confronted by a matrimonial attorney. Even the most experienced practitioner should not attempt to undertake this responsibility without, at a bare minimum, retaining a forensic accountant. When hiring a forensic accountant, it is crucial that you retain someone not only with significant accounting experience but also with experience working as part of a team in the context of matrimonial litigation. Experts with experience in the divorce context will be cognizant of the unique issues and problems that arise in the matrimonial context and will be well known to the judges and lawyers in your area. Hiring an expert that is well respected in the matrimonial field in your jurisdiction can help facilitate a settlement (because your adversary will have a greater comfort level relying upon your expert's representations) and will serve you well at trial (as your expert will be well known to the local bench).

In addition to a forensic accountant, you should consider retaining a private investigator with experience investigating and tracing undisclosed income/assets.

Finally, electronic discovery may prove to be a key component in building your case. Given

the complexities involved in electronic discovery, you may benefit significantly from the retention of a computer expert or consultant, particularly if the destruction of electronic evidence becomes an issue. Your team should be assembled immediately and relied upon at every stage of the litigation. For example, it is essential that your experts provide support throughout the discovery process, both in identifying documents to request and reviewing documents received.

CONDUCT DISCOVERY WITH AN EYE TOWARD HIDDEN INCOME/ASSETS

As previously stated, the burden will be on your client to prove the existence of undisclosed assets/income. Thus, his or her case will rise or fall based upon the information that you and your experts are able to obtain during the discovery process. You and your expert will need to (1) identify existing assets, when they were acquired, and the source of the funds used to acquire the assets, (2) identify existing liabilities, when they were incurred, how the proceeds were used, and what was used for security, (3) identify income from all sources, and (4) identify all expenses incurred by the family. You will then need to put the puzzle together and look for missing pieces.

In reviewing the information obtained, focus on any questions for which you and your expert have not been able to obtain an answer and any inconsistencies that you have identified. For example, have assets been acquired without corresponding net income being earned or an increase in liabilities? Are there any proceeds from loans or sales of assets for which you are unable to account? Was there any income earned that you are unable to locate? In the event that your client's spouse has hidden assets/income, working with your forensic accountant to gather the documents necessary to identify and answer these types of questions will serve as the foundation for your case.

UNDERSTAND COMMON METHODS OF CONCEALING ASSETS/INCOME

In conducting your discovery (and working with your experts), it is crucial that you have an understanding of certain common methods used to conceal assets/income. Although far from exhaustive, understanding the following commonly used

methods will make you more sensitive to the types of financial chicanery used by spouses to conceal assets/income:

Receiving Substantial Perquisites from the Business

An owner of a privately held corporation may be able to have his company pay for significant personal expenses. This can decrease personal income that would otherwise be reported and increase the purported business expenses. It is essential that the business records are reviewed to identify such personal expenses. Otherwise, the owner spouse may seek to establish an artificially low personal income on which his support obligation will be based. Additionally, failing to identify and segregate the personal payments from the business will increase the purported business' expenses, which can negatively impact the valuation of the business in the divorce.

For example, I represented a wife whose husband was the owner of a closely held corporation who claimed to be unable to support his wife and children because of a recent business downturn. A review of the business credit card statements, however, revealed that during this time of purported financial crisis, the following payments had been made by the business on the husband's behalf (in just two months):

- Thousands of dollars *per night* at hotels in New York, totaling more than \$30,000;
- More than \$53,000 on new electronics for his new apartment and home;
- \$35,000 on a necklace for his girlfriend;
- \$36,000 on a vacation with his girlfriend to Nevis; and
- \$22,000 for plastic surgery for himself and his girlfriend.

A review of the credit card statements for the following month revealed an additional \$30,000 charged by the husband, his girlfriend, and his chauffeur for the husband's personal expenses. Thus, the husband had charged approximately \$206,000 of personal expenses to the company during the three months in which he claimed that his income had disappeared. He had also purchased a \$200,000 car and rented a vacation home at a cost of approximately \$30,000 per month. In fact,

several of these payments were made in the days immediately preceding and following a court appearance in which the husband claimed to be unable to pay the parties' mortgage (the house had gone into foreclosure) because of a purported "cash crunch." The husband ultimately was jailed for failing to meet his *pendente lite* support obligation when evidence of the company's spending on his behalf was discovered. After claiming to have no available funds for his family, after just one night in jail, the husband was indeed able to obtain the necessary funds to satisfy his arrears (and get out of jail).

Courts frequently look to the value of perquisites received from the business when determining a spouse's actual income. For example, in *Re Marriage of Jacobson*,³ the husband was employed by a closely held corporate ranch owned by his family. Although he reported minimal monthly income, the company provided him with use of a home, gasoline, vehicles, and ranch food and products. The court relied on expert testimony regarding value of perquisites received and concluded that his actual income was 450 percent higher than his reported income.⁴

Manipulation of Income

It is a common occurrence that a self-employed spouse will report a substantial decrease in income around the time of the divorce. If your client's spouse makes such a claim, you must fully explore whether there is a legitimate basis for the income reduction or whether his or her spouse has simply become "divorce poor." As one court explained, "self-employed spouses, in contrast to salaried employees, have the ability to control and regulate their income. Their testimony, tax returns and business records accordingly may not reflect their true earnings, earning capability and net worth."⁵

Was there a bona fide basis for retained earnings?

A spouse's ability to manipulate his or her income was evident in *Kelley v. Kelley*,⁶ in which the wife was president and chief operating officer of a closely held family business. The court found that she was intentionally under-compensated and therefore rejected her artificially low reported income. The court focused on the fact that she

was the lowest paid of all corporate officers and received less compensation than two vice presidents. Similarly, in *In re Marriage of Elies*,⁷ the court likewise disregarded the husband's reported drop in income, finding that that he and his father had manipulated his income to drastically reduce it to avoid his support obligation. The court "disbelieved [the husband and the father's] testimony regarding why, suddenly in 1991 [the husband] was not paid a bonus" and noted that the husband's reported expenses for the year exceeded his reported income. In *Brisrian v. Brisrian*,⁸ the court likewise focused on the husband's failure to receive his annual raise and cash bonus. Because the husband worked in the family business (and had failed to demonstrate a legitimate basis for his lack of raise and bonus), the court calculated his support obligation *as if* his raise and bonus had been received.⁹

Illegitimate Transfers/Payments to Relatives and or New Spouses

In addition to manipulating their own income, spouses in control of a business can make illegitimate payments to relatives and their new spouses in an effort to reduce their own reported income. In *In re Marriage of Aranow*,¹⁰ the husband owner of a medical practice claimed to have reduced income, but was paying his new spouse \$77,500 per year plus pension contributions for working part time. In finding that he was intentionally overpaying his new wife to reduce his income, the court explained:

[W]e will look to the salary paid to his or her spouse to determine whether the allocation is fair or if it results in a salary to the spouse that is larger than average salaries for comparable employment. If the salary is in excess of salaries for comparable employment, then we will assume the portion of the salary that is in excess of comparable salaries is being paid in an attempt to show a reduced level of income...Absent evidence showing a valid basis for the excess salary, we will attribute that portion of the salary that is excessive to the obligor spouse.¹¹

In *Pearson v. Pearson*,¹² the husband paid thousands to his parents as purported repayment of a loan made for the purchase of a liquor license.

Even accepting as true his contention that such a loan had been made to the company, the court rejected the notion that the *voluntary* prepayment of the company's obligation to the husband's parents should be allowed to reduce his income. The court focused on the fact that money paid to the husband's parents would have been attributable to the husband as gross income absent his voluntary purported loan prepayment.

You may place the bad actor in a Catch 22.

Finally, in *Richard v. Richard*,¹³ the husband claimed to be earning no income after the purported transfer of his family trash removal business. The court disregarded the purported transfer to his family and found that the husband continued to operate the business on a "cash basis." The court also held that the husband had "hidden his assets by transferring their ownership to his relatives."

Sham Loans from Company

Additionally, spouses may seek to disguise income by characterizing distributions received (or payments made on their behalf) as "loans" received from the corporation. For example in *Pearson*, the husband claimed that the company's purchase of a motorcycle on his behalf was a loan that should not be considered as part of his gross income. This is the same husband that had claimed that his income should not reflect the monies voluntarily prepaid by his business to his parents. *Pearson* rejected the husband's contention that the "loan" should not be considered his income, focusing on the fact that he had failed to produce any notes payable, tax returns, or other documents to substantiate his claim that money paid for the motorcycle was a loan.

Use of Corporations and Trusts to Shield Assets/Income

Spouses familiar with more sophisticated financial planning may seek to use corporate structures and trusts to deplete the marital estate and/or disguise their income. In such instances, it is crucial for you to work with your forensic accountant, and trust experts if necessary, to unravel the various corporate structures and trusts created during the marriage.

For example, in *In re Marriage Dick*,¹⁴ the trial court concluded that the husband had organized "a labyrinth" of trusts and corporations, including various offshore trusts, designed to improperly shield his assets from his wife. The court therefore disregarded the fact that "the evidence fails to disclose any assets actually standing in the name of [husband]" and concluded that he nevertheless had "access to and control of extensive assets" valued at more than \$20 million. An appellate court affirmed, rejecting the husband's argument that the trial court had erred by failing to recognize the legitimacy of the various corporations and trusts created during the marriage. Specifically, the appellate court concluded:

It is well-settled that a trust created for the purpose of defrauding creditors or other persons is illegal and may be disregarded. This rule has been applied to the creation of trust where the grantor's intention was to prevent his Wife from reaching the property. The rule regarding fraudulent corporations is equally well settled: When a corporation is used by an individual or individuals, or by another corporation, to perpetrate a fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose, a Court may disregard the corporate entity and treat the acts as if they were done by the individuals themselves. Thus, the Court below was entitled to look past the apparent form of ownership in which Husband's assets were held to determine the extent of Husband's true interest in them and the availability of those assets in assessing Husband's ability to pay.¹⁵

When representing a client whose husband has sought to conceal assets through the use of trusts and corporations, you should also review the Connecticut case *Labow v. Labow*.¹⁶

Labow found that the husband had "intentionally and willfully created sham trusts and employed a large variety of ever changing corporate entities and other devices to obscure his assets in order to shield them from the [wife]."

Failing to Take Distributions from the Corporation

Whether a spouse's retained earnings in a corporation should be considered available personal

income is a topic of frequent debate. Your client's spouse will argue that the retained earnings are appropriate and necessary for the operation and financial viability of the corporation. Your client will argue that earnings are being retained to improperly minimize income and/or reduce marital assets. As one court explained, the key for your representation will be to demonstrate the spouse's improper intent:

It does not matter what guise the obligor uses; whether the corporate income is labeled "retained earnings," "earned surplus," or "salary," a family Court is authorized to pierce the corporate shield if it is convinced that the obligor's intent is to avoid financial obligations arising from the dissolution of the marital relationship. Depending upon the case, it is the obligation of the family Court to determine if corporate income or profits are a necessary part of a well-managed corporation or an excuse for the sole shareholder to keep income or profits from being considered when the family Court is setting financial obligations.¹⁷

In *Zold v. Zold*,¹⁸ the Florida Supreme Court analyzed whether retained "pass through" income from an S corporation—that is, undistributed net profits from the corporation that are reported as personal income to a spouse but not actually distributed—should be considered income for the purposes of support. The Florida court concluded that such a determination turned on a fact-based analysis of whether there existed a *bona fide* basis for retaining the earnings in the corporation. The court set forth various factors to examine when determining whether undistributed "pass-through" income was retained for a legitimate corporate purpose, including the extent of the spouse's access to or control over the retained income, any statutory restrictions or limitations governing corporate distributions to shareholders, and the stated purpose for which the "pass-through" income has been retained.

Zold stressed that a legitimate corporate purpose may be established, even when the owner-spouse has complete control over whether the monies were distributed. However, the court held that the burden should be placed on the owner-spouse to prove a legitimate corporate purpose—not on the non-owner-spouse—because the

"shareholder-spouse...has the ability to obtain information to establish the propriety of the corporation's actions."¹⁹

Regardless of whether the burden is placed on your client or the shareholder spouse, you should be prepared to address the legitimacy (or lack thereof) of the retained earnings. To support your position, you should examine both the relevant industry standards and the company's prior practice. If the business traditionally had little retained earnings, this will significantly aid your argument that the recent retained earnings are designed to avoid obligations to your client. Likewise, your client will be well served by the presentation of evidence demonstrating that the retained earnings of the company substantially exceed the industry's standard.

Reduction of Business Income to Decrease Value of Business

Business owners may seek to decrease their income to reduce the value of the business in the divorce proceeding. In order to assess the legitimacy of the spouse's reported business income, it is therefore essential to obtain an understanding of the industry in which the business is operating and its historic expenses and profits. Two methods that a spouse seeking to minimize their business income may use are to (1) increase the cost of sales and (2) carry excessive inventory.²⁰

Increase Cost of Sales. Owners may seek to increase their expenses by inflating their costs of sale. For example, if a normal restaurant has food expenditures of approximately 27 percent to 30 percent of gross revenues, serious questions should be raised if the owner-spouse in your case operates a restaurant with costs of sale of 45 percent. In such an instance, it is likely that the spouse is receiving cash and hiding it by inflating his costs of sale. By identifying the significant deviation from the industry standard, you will be able to put the burden onto the restaurant owner to justify his inflated expenses.²¹

Excessive Inventory. A business can similarly reduce revenue (and hide cash) by maintaining an unreasonably high level of inventory. Once again, it is important to determine whether the amount of inventory comports with industry standards and the prior practice of the business. Excess inventory may represent potential revenue that should be included in determining the value of the business. Also, it is possible that the owner of the business has manufactured the inventory as a means of hiding unreported cash.²²

REVIEW DOCUMENTS FOR AFFIRMATIVE EVIDENCE OF HIDDEN INCOME/ASSETS

Your first goal will be to establish affirmative evidence of unreported income/assets through documents obtained during discovery. In seeking to accomplish this task, keep in mind that there are both legitimate and illegitimate reasons for the failure to disclose income/assets.

Readily Discoverable Undisclosed Assets/Income

A spouse may have significant retained earnings in a corporation that diminish his or her income. As previously detailed, these retained earnings reduce the spouse's income and can be retained for either legitimate or illegitimate purposes. Similarly, a spouse may have received a substantial distribution from a company that is legitimately not detailed on his or her individual tax return, because net profits from S corporations are income in the year earned not necessarily when they are distributed. Spouses also may have depreciated business assets, legitimately or illegitimately, to significantly reduce their business profits and correspondingly their reported income.²³

Your first goal will be to establish affirmative evidence of unreported income/assets through documents obtained during discovery.

Although the court's treatment of non-taxable distributions, retained earnings, and depreciation will vary depending on the facts and circumstances of each case, they are three areas that should be readily ascertainable in discovery. Accordingly, they are good starting points for your analysis of undisclosed assets/income. For example, it is essential to promptly review business records and K-1s to determine when distributions were made to your client's spouse. You will then be in a position to ascertain whether there are any recent distributions of funds for which the spouse has failed to account.

Individual tax returns may also prove to be fertile ground for readily discovering the existence of undisclosed assets/income. Accordingly, the returns (and all accompanying schedules) must be closely scrutinized to ascertain, *inter alia*, potential undisclosed sources of wages, undisclosed accounts generating taxable interest, and mortgage deductions taken on undisclosed real estate.²⁴

Detailed Review of Cash Receipts from Business Accounts/Unexplained Cash Deposits in Personal Accounts

Once you have obtained discovery of the personal and corporate bank accounts, it is essential to closely review the accounts for unexplained cash deposits into personal accounts and/or unexplained withdrawals of cash from business accounts.

For example, in a matter in which my client's husband claimed a drastic reduction in income, the cash log from his privately held corporation showed the following unexplained payments made to "cash," "funds transfer," or "advance to [husband]":

- 1/14/06: \$150,000
- 1/17/06: \$50,000
- 1/21/06: \$50,000
- 1/29/06: \$150,000
- 2/14/06: \$100,000
- 3/9/06: \$100,000
- 3/13/06: \$99,840
- 3/28/06: \$160,000
- 4/14/06: \$75,000
- 4/16/06: \$75,000
- 5/28/06: \$50,000

Total: \$1,009,840

Thus, the review of the cash log demonstrated that the company's purported decline in profits was simply a reflection of the husband's having failed to disclose his raiding of the company's cash to a tune of more than \$1 million.

This husband was hardly unique, and courts across the country have confronted similar spouses whose claimed reduction in income was contradicted by unexplained cash receipts from their business.²⁵

Similarly, courts frequently are confronted with proof of substantial unexplained cash deposits into a spouse's personal bank account. For example, in *Palazzo v. Palazzo*,²⁶ the husband owned a landscaping business whose income he claimed had substantially declined. He contended that his personal income had declined as a result of his

| Date | Beginning Balance | Deposits | Withdrawal | End Balance |
|----------------------------|-------------------|------------------|--------------------|-----------------|
| 1/12/07 | 23,000 | 65,000 | (38,000) | \$50,000 |
| 2/10/07 | 50,000 | 50,000 | (53,000) | 47,000 |
| 3/10/07 | 47,000 | 47,000 | (49,000) | 45,000 |
| 4/12/2004 | 45,000 | 35,000 | (28,000) | 52,000 |
| 5/10/2007 | 52,000 | 43,000 | (46,000) | 49,000 |
| 6/12/2007 | 49,000 | 149,000 | (138,000) | 60,000 |
| 7/13/2007 | 60,000 | 52,000 | (48,000) | 64,000 |
| 8/10/2007 | 64,000 | 43,000 | (44,000) | 63,000 |
| 9/13/2007 | 63,000 | 38,000 | (50,000) | 51,000 |
| 10/12/2007 | 51,000 | 47,000 | (42,000) | 56,000 |
| 11/10/2007 | 56,000 | 45,000 | (46,000) | 55,000 |
| 12/12/2007 | 55,000 | 25,000 | (63,000) | 17,000 |
| TOTAL | \$23,000 | \$639,000 | (\$645,000) | \$17,000 |
| Sales Per F/S | | | | \$498,000 |
| Loan Proceeds | | | | \$100,000 |
| Total Reported | | | | \$598,000 |
| Under Reported Sales | | | | \$41,000 |
| Operating Expenses Per F/S | | | | \$685,000 |
| Plus Purchase of Equipment | | | | \$100,000 |
| Less Depreciation Exp. | | | | (\$25,000) |
| Less 179 Depreciation Exp. | | | | (\$28,000) |
| Total Cash Expenses | | | | (\$732,000) |

business' downturn and supported this argument with the fact that he had been forced to secure loans to pay for certain expenses. Despite his contentions, however, the court focused on the fact that large unexplained cash deposits had been made into his personal bank account. It found that these unexplained cash accounts were inconsistent with the husband's contention that his income had declined.²⁷

Accounting Technique for Affirmatively Proving Hidden Assets/Income

One commonly used accounting method for affirmatively demonstrating the existence of hidden assets/income in a business is the "Four Column Proof of Cash."²⁸ This approach examines a company's cash account and compares the beginning balance, deposits made, withdrawals, and ending balance with the sales and expenses reported on the company's financial statements. This methodology can identify both under-reported sales

over-reported expenses, the combination of which equals the business' total unreported income.²⁹ Although the actual accounting will be performed by your forensic accountant, it is important that you understand the mechanics of the procedure and the significance of its results.

Four Column Proof of Cash: How It Works

A review of the following company's³⁰ cash account and financial statements reveals under-reported sales of \$41,000 and over-reported expenses of \$87,000. The two combined equal \$128,000, which represents the total under reported income for the year.

UNDERSTAND AND USE TECHNIQUES AVAILABLE ABSENT AFFIRMATIVE EVIDENCE

Unfortunately, it will not always be possible to affirmatively prove the existence of hidden assets/income, because they simply will not be reflected

in any of the business accounts. For example, if the cash simply never hits the books, there may be no records available to demonstrate under reported sales. In such instances, you must seek to rely upon the following techniques to support your client's position.

Proof That Lifestyle Is Inconsistent with Reported Income

One of the most commonly used techniques is to focus on the parties' lifestyle and demonstrate that known expenses exceed reported income. This method has been accepted by courts across the country as evidence of undisclosed assets/income.

For example, in *McCormick v. McCormick*,³¹ the husband's expenses during the period in question exceeded his reported income by approximately \$420,000. Focusing on the extent of this discrepancy, the court imputed income to the husband commensurate with the level of his expenses. The court held that, when conventional methods for determining income prove to be inadequate, it is appropriate to impute income based upon lifestyle and personal expenses.

Similarly, in *Nadrich v. Nadrich*,³² the court found that the husband's lifestyle demonstrated that he had significant unreported income. In reaching its decision, the court examined the husband's credit card debt and found that his debt did not increase commensurate with the difference between his reported income and the expense of his lifestyle. In *Saporta v. Saporta*,³³ the appellate court found that the trial court had abused its discretion by failing to impute income to the husband based upon the difference between the parties' lifestyle and reported income.

Specifically, the Court in *Saporta* concluded as follows:

The record demonstrates that the Husband's reported income is dwarfed by the household's lifestyle. The Husband's testimony that his business has been doing poorly for years is belied by the family's lifestyle, and the former Husband provided no credible reason for maintaining a business that operates at such alleged severe losses. Here... where the head of the family has established and maintained a standard of living on a certain financial level the Court can impute income or financial status sufficient to maintain that standard.³⁴

Contradictory Representations on Credit Applications

Another potential avenue to demonstrate concealed assets/income is to produce recent credit applications inconsistent with the financial representations being made by your client's spouse in the divorce. For example, *Palazzo* noted that the husband's claim of diminished income was contradicted by his claim of very high monthly income on a recent application for a mortgage on a 10 bedroom, 6 bathroom house that he had built for his family. Similarly, in *Franke v. Franke*,³⁵ the court relied upon conflicting statements made by the husband in a recent loan application (with respect to both his income and assets) in support of its decision to disregard the husband's purported decreased income.

Prior Voluntary Support Payments Inconsistent with Reported Income

To the extent that your client previously received support from his or her spouse that exceeds their reported income, the amount of the voluntary support can be used as evidence of unreported income/assets. For example, in *Mann v. Mann*,³⁶ the court rejected the husband's claim of diminished income when he had been making voluntary monthly payments to his wife far in excess of his claimed monthly income. Accordingly, the court ordered that he continue to pay support equal to the amount he had previously been paying.

Accounting Method Available Absent Affirmative Evidence of Unreported Income/Assets

Although the Four Column Proof of Cash method can be extremely effective when cash accounts do not comport with financial statements, what happens when neither the company's cash accounts nor the financial statements are accurately maintained? In other words, what happens if the business has substantial unrecorded cash sales that never appear in any of the corporate records? As previously detailed, the Four Column Proof of Cash method can be used only when the business records affirmatively evidence under reported sales and over reported expenses.

Net Worth Method: An Overview

The most common method used when business records do not affirmatively demonstrate concealed income is the Net Worth Method, which relies exclusively on circumstantial evidence focusing on changes in a spouse’s net worth during an identifiable period. This methodology, which is frequently used by the IRS, was first approved by the US Supreme Court in *United States v. Holland*.³⁷

At its most basic, the Net Worth Method requires establishing the taxpayer’s opening net worth and then comparing that amount with the taxpayer’s net worth at the end of the period in question. The taxpayer’s expenses during the relevant period are then taken into account to determine whether the spouse’s increase in net worth exceeds his or her reported income during the period in question. In the event that the change in net worth exceeds the income reported minus the expenses, the difference is presumed to represent unreported income.

In *Holland*, the government successfully used the Net Worth Method to convict the parties of tax fraud. The government established that the Hollands had an opening net worth of approximately \$31,000, a closing net worth (after three years) of approximately \$113,000, and reported income during the same period of only \$32,000. The Hollands claimed that the apparent increase in their net worth was based upon approximately \$113,000 of cash that they had earned in prior years and kept in their home in \$100 bills. The government successfully refuted this allegation by demonstrating that the husband’s tax records from prior years did not support the claim of such prior savings. Significantly, the Supreme Court rejected the Hollands’ argument that their conviction should be overturned because the government had failed to identify any improper entries in the corporate books. The court aptly concluded that the Net Worth Method demonstrated that the “books were more consistent than truthful, and that many items of income had disappeared before they had even reached the recording stage.”³⁸

Net Worth Method: How It Works

As demonstrated by the following examples, the Net Worth Method can be used to prove the existence of both undisclosed income and assets. Undisclosed income is demonstrated by showing

that the parties’ net worth has increased in excess of reported income minus known expenses. The existence of undisclosed assets, on the other hand, is demonstrated by establishing that the reported increase in net worth does not fully reflect the known sources of income. Again, although the analysis will likely be performed by your forensic accountant, it is necessary that you understand both the methodology used and the attendant results.

Net Worth Method: Proof of Undisclosed Income

| | |
|--|------------------|
| Assets at end of period (at cost) | \$875,000 |
| Liabilities at end of period | (225,000) |
| = Net worth at end of period under investigation | 650,000 |
| Prior period’s net worth (beginning of period) | (350,000) |
| = Net worth increase during the period | 300,000 |
| + Living expenses during period | 175,000 |
| = Expected income | 475,000 |
| Known sources of income | (260,000) |

Net Worth Method: Proof of Undisclosed Assets

| | |
|---|------------------|
| Assets at beginning of period | \$585,000 |
| Liabilities at beginning of period | (235,000) |
| = Net worth at beginning of period | 350,000 |
| + Known sources of income during period | 260,000 |
| - Living expenses during period | 175,000 |
| = Expected net worth increase | 435,000 |
| - Disclosed net assets at end of period | (275,000) |
| = Indicated Hidden Assets | \$160,000 |

CAPITALIZE ON A SPOUSE’S FAILURE TO MAKE ADEQUATE FINANCIAL DISCLOSURE

When litigating the existence of hidden assets/income, you can expect that the bad actor spouse

will do everything in his or her power to conceal wrongdoing. Although you must zealously pursue the financial discovery, you should also capitalize on the bad actor's failure to comply with discovery demands or otherwise make adequate and necessary financial disclosures. Indeed, several courts around the country have relied upon the spouse's conduct that wrongly limited the financial information as grounds for finding the existence of hidden assets/income.

For example, *Palazzo*, recognized that, "[w]here a party through his own wrongful conduct limits the financial evidence available to the Court, that party cannot complain about the resulting calculation of a monetary award." Similarly, in *Blaise v. Blaise*,³⁹ the New York Court of Appeals recognized that trial courts have broad "discretion to attribute or impute an annual income to a parent based upon his or her ability to earn sufficient means to pay child support, particularly where the inability to establish that parent's income is directly attributable to inaccurate financial records for which he was responsible."⁴⁰

By focusing on the spouse's failure to maintain and/or produce accurate financial information, you effectively place the bad actor in a Catch 22. If he or she produces the necessary financial information, they risk revealing undisclosed assets/income. If he or she fails to make the necessary production, however, he or she risks having the court exercise its broad discretion to impute additional assets/income based, *inter alia*, on the parties' lifestyle during the marriage.

NOTES

1. Interestingly, there seem to be an equivalent number of Web sites and divorce planning resources counseling women how to "Avoid the Mistakes That Could Cost You Thousands And Hurt Your Kids!"
2. See, e.g., *Sheridan v. Sheridan*, 247 N.J. Super. 552, 589 A.2d 1067 (N.J. Super. Ch. 1990).
3. *Re Marriage of Jacobson*, 251 Mont. 394, 825 P.2d 561 (1992).
4. See also *Marriage of Schultze*, 60 Cal. App. 4th 519, 70 Cal. Rptr. 2d 488 (1997) (holding appropriate to include value of company car and apartment as income); and *Askew v. Askew*, 268 A.D.2d 635, 700 N.Y.S.2d 594 (2000) (more than doubling husband's reported income based upon evidence that he used his business accounts to pay for personal expenses). For a comprehensive state survey of imputation of undisclosed income, see Alan Stephens, "Divorce and Separation: Attributing Undisclosed Income to a Parent or Spouse for Purposes of Making Child or Spousal Support Award," 70 A.L.R.4th 173 (1989).
5. *Ugarte v. Ugarte*, 608 So. 2d 838 (Fla. Ct. App. 1992).
6. *Kelley v. Kelley*, 656 So. 2d 1343 (Fla. Ct. App. 1995).
7. *In re Marriage of Elies*, 248 Ill. App. 3d 1052, 618 NE2d 934 (1993).
8. *Brisrian v. Brisrian*, 176 Misc. 2d 556, 672 N.Y.S.2d 976 (Sup. Ct. 1998).
9. See also *Jensen v. Jensen*, 877 S.W. 2d 131 (Mo. Ct. App. 1994), *reh'g denied*, (June 6, 1994); *R.D. v. Elisabeth R.D.*, 197 A.D.2d 457, 603 N.Y.S.2d 37 (1993); *Matter of Marriage of Christensen*, 123 Or. App. 412, 859 P.2d 1192 (1993); *Lendman v. Lendman*, 157 Wis.2d 606, 460 N.W.2d 781 (1990).
10. *In re Marriage of Aranow*, 480 N.W.2d 87 (Iowa 1991).
11. See also *In re Marriage of Colby*, 569 N.W.2d 157 (Iowa App. 1997) (holding husband, who was owner of closely held corporation, had intentionally reduced his income and arranged to have his new Wife paid instead); *McClelland ex rel. Winters v. Broussard*, 736 So. 2d 878 (La. Ct. App. 1999) (mother and new husband refused to take salary, but paid for all of their expenses from business); *Evjen v. Evjen*, 171 Wis. 2d 677, 492 N.W.2d 361 (1992) (imputing new wife's income to husband in a closely held family business when husband had complete control over new wife's income); *Pratt v. Pratt*, 645 So. 2d 510 (Fla. Ct. App. 1994) (same).
12. *Pearson v. Pearson*, 190 Ariz. 231, 946 P.2d 1291 (1997).
13. *Richard v. Richard*, 930 So. 2d 156 (La. Ct. App. 2006).
14. *In re Marriage Dick*, 15 Cal. App. 4th 144, 8 Cal. Rptr. 2d 743 (1993).
15. *Id.* at 161-162 (internal citations and quotations omitted).
16. *LaBow v. Labow*, 537 A.2d 157 (Conn. App. 1988).
17. *Evjen v. Evjen*, 171 Wis. 2d 677, 492 N.W.2d 361 (1992).
18. *Zold v. Zold*, 911 So. 2d 1222 (Fla. 2005).
19. For an excellent analysis of the treatment of retained earnings, see Laura W. Morgan, "Corporate or Partner-

- ship 'Retained Earnings' As Income Under Child Support Guidelines," 14 No. 11 *Div. Lit.* 205 (Nov. 2002).
20. See Simborg and Wilkolaski, "Scrutinize The Business Books," 26 *Fam. Advoc.* 20 (Fall 2003).
21. *Id.*
22. *Id.*
23. Like retained earnings, the issue with depreciation will be whether it is appropriate to add the depreciation back into the spouse's income. The party taking advantage of the depreciation will argue that the depreciation reflects the loss of value of equipment, and the necessary savings for replacement equipment. Representing the non-owner spouses, you must determine whether the depreciation is indeed an accurate reflection of loss of value.
24. For a detailed analysis of reviewing tax returns and business records to discover hidden assets and income, see Zuckerman and Reich, *The 1040 Handbook: A Guide to Income and Asset Discovery* (A.B.A. Family Law Section 4th Ed. 2003); Hofstein and Weiner, "Show Me The Money," 26 *Fall Fam. Advoc.* 17 (Fall 2003); Stephen M. Reiss, "Tips for Uncovering Hidden Assets In Tax Returns," 16 *Matrim. Strategist* 1 (May 1998).
25. See, e.g., Stallworth v. Stallworth, 275 Mich. App. 282, 738 N.W.2d 264 (2007) (evidence revealed that reported income was contradicted, *inter alia*, by husband's receipt of cash from his business).
26. Palazzo v. Palazzo, 9 Conn. App. 486, 519 A.2d 1230 (Conn. 1987).
27. See also Posson v. Posson, 645 N.Y.S.2d 155 (App. Div. 1996) (declining to use reported income for purpose of determining support based husband's total control over closely held corporation and, *inter alia*, large unexplained cash deposits into his personal accounts); Julian v. Julian, 868 SW2d 182 (Mo. App. 1994) (rejecting claim of reduced income based upon substantial deposits of unexplained cash during period of purported financial decline).
28. See Richard F. Koc, *Forensic Accounting and Valuation In Divorce*, 36428 NBI-CLE 13 (National Business Institute 2007).
29. *Id.*
30. *Id.*
31. McCormick v. McCormick, 621 A.2d 238 (Vt. 1993).
32. Nadrich v. Nadrich, 936 So. 2d 15 (Fla. Ct. App. 2006).
33. Saporta v. Saporta, 766 So. 2d 379 (Fla. Ct. App. 2000).
34. *Id.* at 382 (internal citations and quotations omitted) (emphasis supplied). See also Turner v. Turner, 745 So.2d 880 (Ala. Civ. App. 1999), *cert. denied* (Oct. 15, 1999) (holding husband's reported income was contradicted by the lifestyle maintained by the parties); Johnson v. Fritz, 406 N.W.2d 614 (Minn. Ct. App. 1987) ("The Court can take into account the lifestyle of a sole business owner if the figures offered do not comport with the evidence of that person's lifestyle ...").
35. Franke v. Franke, 913 S.W.2d 846 (Mo. Ct. App. 1995).
36. Mann v. Mann, 507 N.Y.S.2d 710 (App. Div. 1986).
37. United States v. Holland, 348 U.S. 121 (1954).
38. *Id.* See also Tucker v. Office of Child Support, 368 Ark. 481, 247 S.W.3d 385 (2007) (upholding use of Net Worth Method for determining actual income for support purposes); Schoenbachler v. Minyard, 110 S.W.3d 776 (Ky. 2003) (recognizing propriety of using Net Worth Method for determining actual income for support purposes but finding that no evidence of additional income was presented at trial).
39. Blaise v. Blaise, 241 A.D. 2d 680, 659 N.Y.S.2d 926, 929 (1997).
40. *Id.* (citations omitted) (emphasis added). See also Buley v. Buley, 142 A.D. 2d 814, 530 N.Y.S.2d 697, 698 (1988) (since husband's failure to produce his current tax records obscured his true economic status, "a Court is entitled to make an award based upon the Wife's proof of her needs"); Franke v. Franke, 913 S.W.2d 846, 850-51 (Mo. Ct. App. 1995) (wife relied on loan documents to prove income and husband had failed to produce sufficient evidence to sustain his claimed monthly income, providing substantial evidence for the trial court's imputation of income).