Finding Hidden Treasures in Tax Returns and How It Affects the Divorce Process

I often tell of my first experience as an expert witness in a matrimonial matter. At that time there was not a plethora of literature that addressed the search for omitted income or hidden assets. Much of what we now call forensic accounting was performed intuitively by those of us with strong auditing backgrounds.

The “money spouse” was in a family business. Income, sales, and payroll tax returns were all filed on time and appeared to be complete and accurate. The problem appeared when the reported income (net of income taxes) was compared to the ordinary living expenses on the “non-money spouse’s” Certified Net Worth Statement.

As you probably guessed, the expenses greatly exceeded the funds earned and available to pay these expenses. Now that the red flag has been raised, two obvious questions emerged; (1) Were the expenses listed on the net worth statement actually paid or merely the non-money spouse’s wish list?; and (2) Were there other sources of funds such as an increase in loans and/or credit card debt, distributions from other entities, receipt of gifts, etc. to account for this difference?

Truth be told, you don’t necessarily need to be an auditor or a forensic accountant to smell a thief. However, to catch the culprit red-handed you need the skills of a gumshoe. This article is designed to provide attorneys with a road map to identify those possible treasures found within tax returns.

Business tax returns report the assets, liabilities, equity, revenues, and expenses of an entity. The balance sheet primarily lists the historical cost of what the entity owns (assets) and its obligations (liabilities). Assets are those items that have economic value or which are used in the ordinary course of business. These are also commonly referred to as the business’s resources. Examples of assets are cash, inventory, fixed assets, and real estate. Liabilities represent amounts owed. Examples of liabilities are amounts due to vendors and suppliers, mortgage/loan obligations and other debts.

When analyzing the balance sheet of a business one should verify that these assets and liabilities are truly business related and not personal. Examples of personal assets hidden within the confines of a business commonly include automobiles, real estate, investments and other tangible assets. A good start in this analysis is to request a detailed fixed asset schedule and then identify what assets are actually being used in the normal course of business. Don’t forget to look for other assets identified within the balance sheet. Potentially, any excess assets identified may be personal.

Liabilities should also be considered. Recorded and paid debts should be verified to insure that they relate to the business. The payment of obligations can be easily traced to its source. If payments are being made, then an asset or benefit should exist. You may even identify debt payments where an asset is not apparent or recorded.

The income and expense sections of tax returns are also rich sources of information. However, the devil is in the detail. There are two common ways to identify personal expenses. First, compare expense categories year by year. Spikes and valleys within the same category commonly detect personal spending. Second, obtain grouping schedules and transaction listings for deductions taken. Identifying vendors, suppliers, and other payees often highlights those that may not be business related. The Treasury calls these *non-deductible expenses*; the forensic accounting community frequently refers to them as *discretionary items*. Expense categories that commonly contain such items are travel, meals, entertainment, automobile, and miscellaneous.

Further analysis can also identify hidden assets, such as real property. A review of the utility and real estate tax payments may uncover property not otherwise known. But these items may not necessarily be found only within the expense detail of tax returns. Amounts paid on behalf of the business owner may be recorded as a dividend distribution, loan payment or even salary. In these instances, the true nature of the disbursement can be easily disguised.

Personal income tax returns can also serve as an investigative tool. A review of itemized deductions can be very informative. For instance, a deduction for investment management fees can lead to the discovery of an undisclosed investment portfolio. Since such fees are commonly based upon the principal value of the portfolio, this amount may be reasonably estimated. And don't forget about the miscellaneous deduction for the safe deposit box rental. Unfortunately, you won't know what assets are kept there until you open the box.

A review of the pass-through entities on Schedule E, Supplemental Income and Loss, can also be informative. Schedule E lists the income and losses attributed to ownership interests from business entities. Bank and brokerage accounts appear on Schedule B, Interest and Dividend Income. What may be the most important observation in analyzing Schedules E and B are the change in their components from year to year. The change in bank, brokerage, and investment accounts may be an indication of money being moved.

Another item to note is the change in interest and dividend income. This may reflect a change in returns on investment or the alteration of principal investment. You may also want to trace the proceeds for the sale of stocks and investments. These transactions are itemized on Schedule D, Capital Gains and Losses on Form 1040.

The paths on which business and individual income tax returns take you may be limitless. Although this process may be an expensive task, more times than not it provides an insight to a couple's finances that may otherwise go undetected. Hopefully, this article will make the attorney aware of the potential issues you may encounter, and how you may want to address these matters with your client.

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