Family Law – Shareholder Income from an S Corporation

by Chris Hamilton, CPA, CFE, CVA, DABFA

Type of Matter: Family Law.
Ex-husband petitioned court for termination of spousal support. Arxis Financial, Inc. was retained by spouse to establish husband's income.

Husband claimed negative income (loss) of over $15,000 per month. Wife claimed (based on our work) that husband's income was over $11,000 per month. Difference of over $26,000 per month ($192,000 per year)

Summary of Issue:
Husband is a shareholder and works for a business organized as an S corporation. Arxis Financial, Inc. showed total income that included salary plus cash distributions from the S corporation. The opposing expert showed total income (loss in this case) that included salary minus losses reported on the K-1. The only difference between the expert's opinion was how the cash distributions from the S corporation should be handled.

Husband's expert position:
Cash distributions from the S corporation were previously taxed and, therefore, to include them in the shareholder's income when actually distributed would represent a double-dip. The fact that the business did not distribute all profits in the form of cash does not mean that the cash distributed in subsequent years is new income – it is simply distributing prior year income. This is especially true when the business is currently losing money and the K-1 issued to the shareholder shows substantial losses.

Arxis Financial, Inc's position:
The difficulty in this case came from the fact that we were dealing with an S corporation. The opposing expert was a tax expert. In fact, our expert said on the stand that he agreed with absolutely everything he said in the context of recognition of income for tax purposes. If we were presenting tax definitions of income, our expert could not disagree with him at any point. However, for purposes of determining the economic income of the shareholder there was a sharp disagreement.

S corporations were designed to allow small business owners to avoid the double taxation of dividends. C corporations, like S corporations, distribute dividends from after-tax income. In other words, income minus expenses equals taxable income. After tax is paid, the remaining cash is either retained by the business, distributed to owners via dividends, or both. However, for C corporation shareholders, dividends are taxed on their personal income tax returns – even though the income was already taxed on the corporate tax return.

In our testimony, our expert used the example of an employee of Apple computer who also owns stock. The economic income to that hypothetical person would include two elements:

- Compensation for service to the business – salary
- Compensation for the risk of investing capital in Apple - dividends

It would not matter that Apple might have actually generated a loss in the year it distributed dividends. And, in fact, that happens a lot. Businesses retain profits so that dividends can be paid consistently regardless of temporary volatility in the earnings of the corporation.

Our expert drew parallels to the case at hand. Husband was being compensated for service to the business through his salary and he was also being compensated for his investment through the payment

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of dividends. The fact that he was not required to pay tax on those distributions did not change the fact that it was compensation. I also made the point that many S corporation shareholders shift compensation for service from salary to dividend to save social security taxes.

The cross-examination was vigorous. It allowed our expert to say that his position in this case not necessarily applicable to every S corporation. Analysis of income from an S corporation is a facts-and-circumstances analysis. The following were elements that distinguished this case from others:

- The subject company had a history of maintaining a separate identity from the shareholders. All shareholder transactions were accounted for appropriately. In other words, personal expenses of the shareholders and paid by the corporation were not deducted as business expenses – they were called dividends. This is not the practice of some, or many, S corporations.
- The corporation had a history of retaining profits as evidenced by several hundred thousand dollars in bank accounts. Dividends were paid in measured amounts with the goal being the survival and health of the company – not the cash flow of the shareholders. Again, this is not the practice of very many S corporations.

Result:
The court rejected Husband's request to eliminate or reduce monthly spousal support. The court also indicated that, had the request been made, the evidence supported an increase in monthly support.

About the author:

Chris Hamilton is a partner with the CPA firm of Arxis Financial, Inc., in Simi Valley. He is a member of the California Society of Certified Public Accountants (Litigation Services Committee), and the American Institute of Certified Public Accountants. Mr. Hamilton is a Certified Public Accountant, a Certified Fraud Examiner, a Certified Valuation Analyst, and a Diplomate of the American Board of Forensic Accounting. He can be reached at ph. 805-306-7890 or chamilton@arxisgroup.com.