SELF-EMPLOYMENT INCOME

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BACKGROUND AND INTRODUCTION

The topic of this presentation is Self-Employment Income, and my hope is to communicate to you, as best I can in the limited time available, both the calculation of that income, under existing law, as well as what information courts need to perform that calculation.

SELF-EMPLOYMENT INCOME

Minnesota Statutes Section 518A.30 governs the determination of self-employment income, and provides, in relevant part, as follows:

> (Income) from self-employment or operation of a business, including joint ownership of a partnership or closely held corporation, is defined as *gross receipts minus cost of goods sold minus ordinary and necessary expenses required for self-employment or business operation*. Specifically excluded from ordinary and necessary business expenses are amounts allowable by the Internal Revenue Service for the accelerated component of depreciation expenses, investment tax credits, or any other business expenses determined by the court to be inappropriate or excessive for determining gross income for

> purposes of calculating child support. *The person seeking to deduct an expense, including depreciation, has the burden of proving, if challenged, that the expense is ordinary and necessary*.

Id. (Emphasis added).

This provision makes clear, consequently, the following:

(1) "Income" for child support is not necessarily the same as "income" for tax purposes. Many perfectly legitimate deductions allowed in order to calculate income for tax purposes are completely inappropriate when calculating income for child support.

(2) Deductions *must*, however, be allowed for "ordinary and necessary" business expenses.

(3) The burden of proving a deduction is "ordinary and necessary" falls on the person seeking to deduct that expense, *if challenged.* In other words, prior to disallowing a deduction, the party seeking to deduct that expense must understand that the expense is challenged, and be given an opportunity to prove the expense is "ordinary and necessary".

(4) When challenged, consequently, the person seeking to deduct the expense has the burden of proving that expense is "ordinary and necessary". The other party and the County do not have to prove that expense is not ordinary and necessary; the party seeking to deduct the expense has the burden of proving that expense is ordinary and necessary.

(5) Although the statute specifically provides that certain specified deductions are not allowed for child support purposes, it also makes clear that other deductions may also be inappropriate.

A. Determination of gross income.

The determination of gross income is an often overlooked first step in the process of determining self-employment income. Although gross income, as reported on the party's individual federal and state tax returns, is certainly a good *starting point*, it is not the end-point of this analysis. Moreover, the nature of that party's business should also be considered.

This begs the question, however, of how, and where do we start this inquiry?

The best *starting point* for determining any self-employed party's income are complete and legible copies, together with all attachments and schedules, of the self-employed party's federal and state income tax returns for the previous three years. It must be emphasized, however, that this is, in a substantial number of cases, simply a starting, and not the end point of this analysis.

There are many different methods of reporting self-employment income for tax purposes, many of which are dependent on the business entity utilized. Sole proprietors, for example, report their self-employment income on Schedule C to their individual federal income tax return. Partnerships and Subchapter S corporations generally file informational returns, but declare income (or losses) to their individual partners or shareholders on Form K-1 (Form 1065), which should be reported on Schedule E to their individual tax return. Rental income is also generally reported on Schedule E to the recipient's individual tax return.

There are, however, many different variations to this same theme, most of which are, quite frankly, too complicated to address here. A party may, for example, be both an employee of and shareholder in a Subchapter C corporation and, consequently, receive income from that corporation both in the form of wages, reported on Form W-2, as well as profits generated by that business, which may or may not be reported as dividends.

That party may, in addition to receiving both wages and dividend income from the corporation, own personally, or through yet another, separate entity, real estate that is, in turn leased to the corporation, resulting in rental income in addition to the wages and dividends reported on their income tax return.

It is essential, consequently, that you obtain complete and legible copies of the self-employed party's most recently filed federal and state income tax returns, together with all attachments and schedules, *and closely scrutinize each line item on and schedule to those returns in order to locate and determine every possible source of business income received.*

It is not at all uncommon, after a review of that party's individual income tax return, to discover it is necessary to request additional information. If, for example, business income is reported on Schedule E, you will generally want to determine the source of that income. If it is from either a partnership or Subchapter S corporation, you will need to obtain and review copies of the K-1 forms declaring that income.

Moreover, certain businesses, such as bars, restaurants, coin laundries and the like are inherently cash businesses and, therefore, invite closer scrutiny. In such cases, a review of the party's bank deposits may be warranted to ensure that all of the cash received by the business finds its way onto the party's tax returns.

B. Cost of goods sold.

Section 518A.30 defines gross income, in part, as gross sales or receipts less cost of goods sold and other “ordinary and necessary” expenses. Cost of goods sold is generally the direct cost attributable to production of the goods a business sells such as, for example, material, supply and labor costs, exclusive of indirect costs of production.

Cost of goods sold, for a sole proprietor, is reported on page 2 of Schedule C to their individual income tax return.

This area is, quite frankly, not usually scrutinized to the degree it should, primarily because there is no good rule of thumb for determining an appropriate amount or percentage of cost of goods sold as compared to gross sales or receipts. It is, however, an area that deserves far greater scrutiny than it usually receives.

In determining cost of goods sold, for example, the taxpayer is required to report purchases *less items withdrawn for personal use*. This is intended, in short, to ensure business owners do not purchase items for personal use (food, clothing, etc.) through their business and deduct the cost of their doing so from their taxable income. The problem, of course, is that this occurs quite regularly and, short of scrutinizing each and every purchase (a practical impossibility) the accuracy of this deduction depends almost entirely on the honesty and integrity of the individual taxpayer.

There are, however, other things to look for. Substantial increases or decreases in inventory from one year to the next should be scrutinized. Is, for example, the taxpayer, for lack of a better term, “loading up” on inventory one year, in order to reduce their income for tax (and/or child support) purposes?

Substantial, unexplained increases or decreases in cost of goods sold, over time, might also be evidence of underreporting of gross income for either, or both, tax or child support purposes. Hence the importance of obtaining and examining copies of the taxpayer’s last three years’ individual income tax returns.

The nature of the business is also something that should be considered. Businesses, for example, that involve primarily, if not exclusively, personal services (childcare centers, law firms, etc.) that report substantial inventory costs should be required to provide verification of those costs. Most law firms, after all, do not sell groceries, in addition to their services, to their clientele.

Care should also be taken to ensure the taxpayer is not “doubling up” on their deductions by reporting them both as cost of goods sold and as other “ordinary and necessary” business expenses. This magistrate has, for example, seen a number of cases over the years where contract labor costs were deducted both as “cost of labor” on line 39 to Schedule C *and* as part of “other expenses” reported on lines 27 or 48 to that same schedule.

Simply obtaining copies of a party’s tax return is not, consequently, the solution to this problem. Close scrutiny and, if necessary, requesting verification of questionable expenses is also necessary.

C. Ordinary and necessary business expenses.

A self-employed party is entitled to deduct certain business-related expenses related to the production of income. The court should, however, consider the possibility of overlap between reported "business expenses' and that party's basic living expenses and, further, whether those expenses are, in fact, "ordinary and necessary".

Certain types of business expenses are inherently subject to challenge. Those are:

- Asset depreciation and/or amortization
- Vehicle expense
- Meals and entertainment
- Professional expense
- Office expense
- Repairs and maintenance
- Supplies
- Utilities
- Consulting and "miscellaneous" expenses
- Deductions for business use of the party's home

This is not to say that deductions for these expenses should never be allowed; the analysis cannot be that inflexible. Rather, these expenses, as well as others that may not have been identified, can, and should be challenged.

1. Depreciation expenses.

Most substantial business assets have usable lives in excess of one year. The allocation of the cost of those assets over their expected usable life is called "depreciation" or, in some cases, depending on the asset type (i.e. "intangible assets"), "amortization".

The most common types of depreciation are "straight line" and "accelerated" depreciation. "Straight line" depreciation simply divides the cost of the asset by its expected usable life, thereby resulting in the same amount of depreciation each year. "Accelerated" depreciation, obviously, accelerates depreciation in some fashion. Additionally, the tax code allows business owners to deduct, as "Section 179" expenses, a portion of fixed asset purchases each year, rather than depreciating them over time. Section 179 deductions are, therefore, another form of "accelerated" depreciation.

In 2008 the Section 179 expense deduction was increased to *$250,000* (or $285,000 some, limited assets). Although some limitations were imposed on the deduction, it remains substantial.

The appellate courts have made clear that the court may ignore a self-employed person's depreciation deductions, and other “paper losses”, and find their income for support purposes is greater than their income for tax purposes. They also make clear, however, that it is improper to completely disregard a party’s depreciation deductions if they will incur costs, from time to time, to replace assets subject to depreciation.

The Minnesota legislature has also severely limited the use of depreciation deductions in support cases. Minnesota Statutes Section 518A.30 prohibits the use of “accelerated” depreciation deductions in support cases. This is not to say, however, that accelerated depreciation deductions, to include Section 179 expense deductions, are to be entirely disregarded. Those deductions should be converted to non-accelerated, or straight-line depreciation, and allowed *if* “ordinary and necessary

It must be emphasized, however, that just because someone takes a substantial depreciation deduction, accelerated or otherwise, does not mean they are trying to avoid their obligations of support. There are significant public policy considerations supporting the depreciation of assets *for tax purposes*, not the least of which is that allowing such deductions encourages business owners to spend capital to replace existing equipment, thereby encouraging economic growth.

It is important, therefore, to accept that these deductions are perfectly legal and legitimate. It is no more inappropriate for a self-employed party to take these deductions than it is for any other taxpayer to claim deductions on their tax return in excess of the standard deduction.

2. Car and truck expenses.

Business owners may deduct expenses related to the “business use” of their vehicles. They may do so by deducting *either*, but not both, mileage, at the current IRS allowable rate of $.55 per mile, *or* actual expenses (gas, oil changes, insurance, *depreciation* and repairs).

Be wary, however, of self-employed persons attempting to write off use of their personal vehicle as business use. Very few people use their vehicles 100-percent of the time for business purposes.

3. Travel and entertainment.

Care should be taken to ensure that the business owner is not attempting to write off personal entertainment expenses as business expenses. The ultimate question to ask is whether the nature of their business requires travel and entertainment expenses.

Expense deductions for meals are particularly problematic. Every person, whether self-employed or not, whether they are or are not child support obligors, must eat.

4. Other expenses.

Home office deductions are also subject to particular scrutiny, both by the courts and the IRS, because of the obvious potential for abuse. Such expenses offer the opportunity to allocate at least a portion of the expense related to the business owner's home, to include mortgage interest, real estate tax, utilities and insurance to the business.

Other, vaguely labeled expenses (i.e. "miscellaneous expenses") should also be closely scrutinized.

5. Self-Employment taxes.

Self-employed business owners must pay *both* the employee and the employer's share of social security and Medicare taxes. Consequently, rather than being liable for 7.65-percent (6.2-percent social security + 1.45-percent Medicare taxes), they are liable for 15.3-percent (7.65-percent x 2) *of 92.35-percent* (100-percent – 7.65-percent) of their gross, after expense business income. (Paying tax on 100-percent of that income would result in paying tax on a tax).

Although *100-percent* of a party's gross, after expense business income is subject to Medicare taxes, social security or FICA taxes are paid, in 2009 only the first $106,800 of that income.

If, for example, a self-employed party receives $110,000 in gross, after expense business income, they would be liable for $15,090 ($106,800 maximum subject to tax x 92.35-percent x 12.4-percent) in social security and $2,946 ($110,000 total wages x 92.35-percent x 2.9-percent) in Medicare taxes. If that same person were not self-employed, they would be subject to only $6,621 ($106,800 maximum subject to tax x 6.2-percent) in social security and $1,595 ($110,000 x 1.45-percent) in Medicare taxes.

Under previous law, guideline child support was based on the obligor's *net* income, which was defined as gross income less certain statutorily allowed deductions, including, but not limited to federal and state income taxes and federal social security and Medicare taxes.

Self-employed parties were previously allowed, consequently, a deduction for social security and Medicare taxes based on *15.3-percent of 92.35-percent of their gross earnings*, and not just 7.65-percent of their gross earnings.

Child support is currently, however, based on *gross*, as opposed to net income which, again, is defined as "gross receipts minus … ordinary and necessary expenses *required for self-employment or business operation".*

The employer's share of both social security and Medicare taxes is, at least in the opinion of this author, an "ordinary and necessary expense required for self-employment or business operation". A deduction should, consequently, be allowed based on 7.65-percent of the party's gross earnings in calculating their gross income for child support.

CONCLUSION

The parties are ultimately responsible for providing verification of their earnings, whether they are, or are not self-employed. They should be reminded of the old adage, often applied to statistical analyses, that: “Garbage in – Garbage out”. Do not allow any party, whether self-employed or not, to make their problem your problem by allowing them to shift responsibility for verifying income from themselves to you.