

Income tax returns of the self-employed

Minnesota Family Support & Recovery Council (MFSRC)
Amy A. Anderson, Assistant Ramsey County Attorney
September 21, 2010

1040 Income Tax Form

- Current income of parents
- Clues to assets held
- Income trend (if several years of returns)
- Self employed status of parent
 - Entries on lines 12, 17, 18, and 21 on page 1 of 1040 (Schedule C, S Corporation, Rental income, Farm income)

Child Support - Gross Income for the self-employed

- Self-employed tax returns may need adjustments
 - Some deductions allowed by IRS should not be allowed for child support
 - Expenses are exaggerated or include personal expenses
 - The opportunity for a self-employed person to support himself and yet report negligible income is too well know to require exposition.

Ferguson v. Ferguson 357 N.W.2d 104, 108 (Minn. App. 1984)



518A.30, Minnesota Statutes 2006

Copyright © 2006 by the Office of Revisor of Statutes, State of Minnesota.

518A.30 INCOME FROM SELF-EMPLOYMENT OR OPERATION OF A BUSINESS.

For purposes of section 518A.29, 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 costs of goods sold minus ordinary and necessary expenses required for self-employment or business operation. Specifically excluded from ordinary and necessary 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.

History: 2005 c 164 s 15,29; 1Sp2005 c 7 s 28; 2006 c 280 s 26



518A.30, Minnesota Statutes 2006

Copyright © 2006 by the Office of Revisor of Statutes, State of Minnesota.

518A.30 INCOME FROM SELF-EMPLOYMENT OR OPERATION OF A BUSINESS.

For purposes of section 518A.29, 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 costs of goods sold minus ordinary and necessary expenses required for self-employment or business operation. Specifically excluded from ordinary and necessary 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.

History: 2005 c 164 s 15,29; 1Sp2005 c 7 s 28; 2006 c 280 s 26

Deductions Allowed by IRS but Not Allowed for Child Support*

- Depreciation
 - Cannot take Section 179 depreciation in MN - In re the Marriage of Ruehle v. Schmitz A03-1834
 - Cannot take accelerated depreciation in MN - Minn. Stat. Sec. 518A.30
 - If depreciation is allowed, it can only be straight line
- Business use of home
- Meals and entertainment expenses
- Half of vehicle expense

*Per Ramsey County's Interpretation of Minnesota Statutes and Case Law

Other Deductions to Disallow

Deductions that are

- not substantiated or
- not ordinary and necessary in light of obligation to pay child support or
- are inappropriate or excessive
 - Some categories are ripe for overstatement

How to Identify which Expenses to Disallow

- Categories change from year to year
- Amounts are large compared to gross receipts
- Request documentation for expenses, checkbook register
- Numbers are repeated or round

RAMSEY COUNTY ATTORNEY'S OFFICE Child Support Enforcement Division Income Calculation Self-Employed Child Schedule C			
DEBTOR_Example 1	PRISM		
YEAR		2005	2006
Net income Schedule C		26,748.00	50,815.00
ADDOCKS:			
Deduction for business use of home - Line 30		6,296.00	0.00
Meals and Entertainment - Line 24d		0.00	628.00
Depreciation - Line 13		5,310.00	6,969.00
Vehicle expense - 1/2 of Line 9			
SUBTOTAL:		38,353.00	58,412.00
OTHER ADDDOCKS:			
Advertising			
Supplies			
Professional Expenses			1,257.00
Utilities			1,118.00
Mortgage interest			
ANNUAL BUSINESS INCOME BEFORE TAXES		38,353.00	60,787.00
OTHER ADDITIONS:			
W-2 income from other jobs - Line 7 104d			
Interest			
Other			
TOTAL INCOME		38,353.00	60,787.00
DEDUCTION - 1/2 Self-employment taxes - Line 5b:		-1,890.00	-3,586.00
ANNUAL GROSS INCOME		36,463.00	57,191.00
MONTHLY GROSS INCOME		3,038.58	4,765.92

Tax Returns Are Not Accurate Reflection of Income When:

- There are cash earnings.
- Income is reported under someone else's name.
- Tax returns should be disregarded entirely.

Tax Returns are Not Accurate When All Income is not Included in Gross Receipts

- Deductions on Schedule C are large compared to income
- Get information from CP
 - How unreported cash was handled in past
 - How living expenses were met when income reported was very low
- Businesses operated as a cash business
- Itemized deductions too large related to income

Income Attributed to Someone Else

- The best way to get some idea this is going on is from the other parent
- Parent may send in Married Filing Separate returns or claim he doesn't need to file
- Lifestyle is not supported by the income reported

When Tax Returns Should Be Disregarded

- Too much information provided but not in any organized format
- Information may appear credible, but there is a disconnect between reported income and itemized deductions and/or lifestyle
- Information totally lacks credibility

Clues to Assets

- Entries on other lines of Page 1 of 1040
- Look at itemized deductions
 - Mortgage expense
 - Real estate taxes

What to Use When Disregarding Tax Returns

- Minn. Stat. 518 A.28(c) and 518A.32 regarding potential income
- Salary survey
- Total household expenses
- Mortgage applications

S-Corporation (Form 1120 S)

- Compensation of officers (Line 7, Pg. 1)
- Pension, employee benefit programs (Lines 17 and 18, Pg. 1)
- Relate book income to taxable income (Pg. 3, Schedule K)
- Balance sheet (Pg. 4)
 - Shareholder loans
 - Capital stock
 - Change in categorization
 - Continuity between years

S-Corporation Continued (Form 1120 S)

- Distributions (Schedule M-2 Line 7, Pg. 4)
- Ownership Percentage (Schedule K-1)
- Method of Accounting (Schedule B, Line 1, Pg. 2)
- Inventory (Pgs. 2 and 4)

C-Corporation (Form 1120)

- Issues similar to Form 1120 S
- Income from company not reported on individual's 1040

Partnerships (Form 1065)

- If provided a K-1 showing more than 1/3 interest, request entire return
- If family partnership, request return when ownership is less than 1/3.

Things to Consider

- Cash vs. Accrual accounting
 - Manipulation
 - Accurate reflection
- Payments on debt
- Non-recurring income

Testimony of Accountant

- Credentials
- Verify foundation
- Examine protocol
 - Standard practices
 - Any verification?
 - How long on account?
 - Has scope of engagement changed?
 - Do they ask about other income?
- 3 levels of financial statements
 - 1) Complied
 - 2) Reviewed
 - 3) Audited
 - If there has not been an audit, the numbers are only as good as what accountant received.

Discovery

- When a person is self-employed and the income is in question, back up documentation can be requested.
 - Checkbook register
 - General ledgers
 - Detailed profit and loss statements and balance sheets
 - Information provided to the accountant to do the returns
 - Reports on Quicken or Quickbooks
 - Mortgage or loan applications

Discovery Continued

- In Minnesota the parties are responsible for providing income verification, and the court can make adverse inferences based upon their failure to provide necessary information.
- The responsibility for income verification, whether it has been requested in discovery or not, is still theirs.

Conclusion

Calculation of income for the self-employed is more of an art than a science; it cannot be accomplished by rigid adherence to a set of rules.

Our goal is to set a child support order that is fair, appropriate and enforceable.

Advanced issue – Depreciation

- Every asset is assigned a useful life, the IRS has specific categories for just about everything.
- The purpose is to allow a business to deduct the cost of assets needed for doing business over the time the asset will be of use to the business.

The major categories of property are:

- 3 year - Tractor units for over the road, race horses
- 5 year - Cars, light purpose trucks, computer or peripheral equipment, and copiers
- 7 year - Office furniture and equipment
- 20 year - Farm buildings
- 27.5 year - Residential rental
- 39 year – Non residential real property

These descriptions are not all inclusive!

Depreciation example

- Options for depreciating a \$25,000 truck (over 6000 pounds) bought in June 2009:

Straight line – 2009 deduction \$2,500, 2010 deduction \$5,000.

Accelerated 200%– 2009 deduction \$5,000, 2010 deduction \$8,000

Section 179 deduction/special bonus – 2009 \$11,060

What to disallow for child support?

- If accelerated depreciation used:
 In 2009 the add back should be 2,500
 In 2010 the add back should be 3,000
- If Section 179 depreciation/special bonus was taken the add back would be \$8,560 in 2009.

Don't try this at home

- SERIOUSLY
- My best recommendation is to tell person trying to deduct depreciation that they need to provide the straight-line calculations.
- Remember you can not completely disregard depreciation if the asset is really going down in value.

Questions?

Amy A. Anderson
Assistant Ramsey County Attorney
Amy.Anderson@Co.Ramsey.MN.US
(651) 266-3069
