The Search for Undisclosed Assets:  
Using Tax Returns When Investigating Divorce Settlements

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An important element of representing a dependent spouse during divorce negotiations is the identification and verification of the couple's assets. Because most individuals will not risk filing a fraudulent tax return simply to hide assets from their spouse,\(^1\) previously filed tax returns can provide a wealth of financial information. The purpose of this article is to provide a systematic approach to reviewing previously filed tax returns in an attempt to verify the completeness and accuracy of the taxpayer's financial statement. Although an examination of tax returns may not identify all of a couple's assets, such an examination can often uncover assets that were not initially disclosed by the client's spouse. The approach suggested in this article is a tool to help measure the marital assets available for distribution and can be used to help determine the veracity of the spouses' self-disclosed financial positions.

The number of returns required for review is dependent on the sources of the taxpayer's income. For example, if the individual is a significant shareholder in a corporation, member of an LLC, or partner in a partnership, then copies of the corporate and partnership tax returns should be examined in conjunction with the individual tax return. At a minimum, the tax returns for the prior two taxable years should be obtained. Even though the examination of a single return can provide important information about the taxpayer's wealth, multiple returns are necessary to analyze variances in specific items from one year to the next. Because blank tax forms are readily available, there is no way of determining the authenticity of tax returns presented by your client's spouse. If

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\(^1\) Unfortunately there is a segment of the population in the “underground tax economy” who deal in unreported cash. For those clients the tax return will prove less useful.
there is any doubt as to the accuracy of the returns presented, your client can request copies of previously filed returns directly from the Internal Revenue Service (IRS) by completing and filing Form 4506 with the IRS.²

Individual and business returns that you examine will either support or call into question the completeness and accuracy of the asset schedule presented by your client's spouse. If income sources are found without an associated disclosed asset, this should be viewed as red flag indicating that there may be hidden assets which can be recovered and brought in to the property settlement agreement. This article provides a systematic approach for conducting your examination. The first section examines various line items on the Individual return (Form 1040), including accompanying Schedules A, B, C, D and E. The second section considers various line items on the Partnership return (Form 1065). Corporate tax returns (Forms 1120S and 1120) are discussed in the third and fourth sections, respectively. When appropriate, references to corresponding line numbers on the 2009 tax return have been included.

THE INDIVIDUAL INCOME TAX RETURN - FORM 1040

Items of Income: Lines 7 through 22

Wages and Salaries (Line 7). A W-2 is generally issued to support the amount entered on this line. In addition to verifying that the amount on the W-2 equals the amount reported on the return, you may also wish to verify the accuracy of the W-2. As with tax return forms, blank W-2

² Copies of previously filed individual income tax returns can be obtained without the permission of the estranged spouse as long as your client signed the return. Copies of the spouse's returns filed separately will not be released to your client without the authorization of the spouse. Copies of partnership returns are released to any partner who was a partner in the partnership for the time period covered by the return. Copies of corporate tax returns (Forms 1120 and 1120S) will be issued to (1) an officer having legal authority to bind the corporation, (2) any person designated by the board of directors or other governing body, or (3) any officer or employee on written request by any principal officer and attested to by the secretary or other officer.
forms are easily obtained and may be falsified to lower reported income. The amount reported on the W-2 may be verified by either contacting the employer who issued the W-2 or obtaining a copy of the return that was filed with the IRS. When the spouse is both an employee and owner of the business, verification may be accomplished by comparing the amount deducted on the business return with the amount reported on line 7. If the spouse is an officer of a corporation, then the W-2 may be compared to the amount reported as officer's compensation on Schedule E of the corporation's tax return (Form 1120).

An examination of the W-2 also will indicate whether the taxpayer participates in a Section 401(k) plan. Many states do not recognize 401(k) plans and, as a result, State wages (box 16) will be higher than Federal wages (box 1). If this difference is observed, the balance in the plan should be investigated and verified to the list of assets.

A reference to code "C" in Box 12 of the W-2 indicates that the taxpayer is provided with group term life insurance coverage in excess of $50,000. For each $1,000 of excess coverage, an amount is added to the taxpayer's wages on the W-2. Using a table provided in the regulations, the amount of total group term life insurance coverage can be ascertained. For example, for a taxpayer who is 42 years old, the regulations state that for each $1,000 of coverage in excess of $50,000, $.10 will be added to his or her wages each month ($1.20 annually). Therefore, if the amount in Box 12 of the W-2 reports $60 from premiums on excess insurance, then the taxpayer's total group term life insurance coverage is $100,000, i.e., [$50,000 + (($60 ÷ $1.20) x $1,000)]. This amount can be compared to the spouse's asset list.

Interest (Line 8). The existence of interest income generally indicates the presence of liquid investments. When taxable interest income (line 8a) exceeds $1,500, Schedule B must be

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3 26 CFR §1.79-3(d)(2) provides a table which shows the amount included in the taxpayer's wages each month based on $1,000 of excess coverage. The monthly amounts vary based upon the taxpayer's age.
completed and attached to the return. Schedule B identifies the payor of the interest and can be used to verify the account balances provided by your client's spouse. When an insurance company is listed as the payor, this often means that the taxpayer owns a life insurance policy. The cash surrender value of the policy should be determined and compared to the list of assets presented by your client's spouse. If a brokerage house is listed as the payor, then either bonds or money market accounts should be identified on the asset schedule. The market value of the bonds, money market accounts, and other interest bearing investments may be roughly approximated by dividing the interest income reported by an estimated market interest rate (e.g., two to four percent). For example, if the current interest rate is three percent and $1,000 of interest income is reported, then the investment should be worth approximately $33,333. This figure should be compared to the value reported on the asset schedule. Large differences between imputed values and reported values should be investigated.4

Compare the previous year's interest income to the interest income reported in the current year. A sharp decrease in the current year's taxable interest may suggest that the taxpayer has shifted his or her investments from taxable interest bearing to tax-exempt interest bearing investments. Although line 8b requires taxpayers to disclose the amount of non-taxable interest received during the year, many taxpayers do not comply with this requirement. For these taxpayers, identifying the location of their tax-exempt investments requires further investigation. In many instances, copies of state income tax returns will provide a more accurate account of these assets as states frequently deny tax-exempt status to debt securities by other states. Additionally, some state

4 Differences between the rate of interest being earned on the investment and the market rate used to impute the value of the investment may result in significant disparities. Also, if the balance in the account dramatically increased during the last months of the year, then using this approach will underestimate the value of the asset. Similarly, if large withdrawals were made towards the end of the year, this approach would overestimate the value of the investment.
and local governments require taxpayers to file personal property tax returns. These returns may also disclose the taxpayer's tax-exempt investments. Once the amount of tax-exempt interest income has been verified, an approximate value of these assets may be determined by dividing the income reported by an appropriate interest rate.

**Dividends (Line 9).** The presence of dividend income indicates investments in marketable equity securities. When ordinary dividend income exceeds $1,500, Schedule B must be completed and attached to the tax return. As with interest income, Schedule B identifies the payor of the dividend. However, unlike interest which accrues throughout the year, not all companies pay dividends annually. In these situations, an examination of dividends listed on Schedule B in prior years can provide information about the taxpayer's current investments. Once an asset has been identified on a prior year's Schedule B, you can determine whether the asset was later sold by checking Schedule D (Capital Gains and Losses) for that year and all subsequent years.

Using the payors listed on Schedule B, information about the corporation's dividends per share can be obtained from *Standard and Poor's Stock Guide* or *Moody's Dividend Record*. If the taxpayer owned the same number of shares throughout the year, dividing the dividend income reported on Schedule B by the dividends per share reported in either *Standard and Poor's* or *Moody's* will provide you with the number of shares of stock owned by the taxpayer. The current market value of the shares can then be determined using stock quotes from *The Wall Street Journal* or a variety of on-line services. Finally, when analyzing dividend income, it is important to remember that some stocks (e.g., growth stocks) do not pay dividends and that these investments would not be disclosed on the return. In these cases, a review of state and local property tax returns may be necessary.

**Taxable Refunds of State and Local Taxes (Line 10).** State and local tax refunds are taxable to the extent that the amount was deducted on Schedule A as an itemized deduction in a
prior year. Copies of the previous year's state returns should be requested and examined. Comparing the amount reported on line 10 to the prior year's state tax returns may help in detecting whether the returns provided by the client's spouse have been "doctored."

**Business Income (Line 12).** An amount entered on line 12 should be accompanied by a Schedule C, which is used to report profit or loss from a sole proprietorship. It is advisable to compare the current year's Schedule C to prior years and to investigate large fluctuations in income. A decrease in the current year's Schedule C income may reflect lower sales; but, assuming the business uses the cash basis of accounting, it could also suggest that the taxpayer has intentionally increased accounts receivable or has not reflected all cash receipts.

Many costs are directly proportional to the level of sales activity. If sales are lower, but proportional costs (e.g., cost of goods sold, commissions and shipping) have not declined, then further investigation is warranted. On the other hand, sales could be consistent, but Cost of Goods Sold could have significantly increased (correspondingly reducing profit). This may indicate an agreement where the vendor has agreed to re-purchase inventory after the start of the year.

Fluctuations in expenditures for travel, entertainment, automobile, home office, or salaries should also be investigated, as these are areas where an individual can easily bury personal expenses in an attempt to decrease net income from the business. Examining the documentation underlying these expenditures will disclose this situation if it exists. When valuing the business, it is important to remember that depreciation is not a cash expense. Therefore, amounts deducted as depreciation may or may not have economic substance. For example, while automobiles and computers clearly decline in value with time and use, buildings generally do not. Independent appraisals should be obtained to value all significant assets including the value of the business as a going concern.

**Capital Gains or Losses (Line 13).** Gains and losses from the sale of capital assets that are
reported on line 13 require that Schedule D be completed and attached. In recent years the I.R.S. has required that the gross proceeds from security and real estate transactions be reported on Form 1099 in a manner similar to the reporting required for dividends and interest. Taxpayers must now make certain that all of these proceeds are accounted for on Schedule D. This has made it easier to verify an individual's investment activity. The location of the proceeds from these sales should be traced to ensure that these amounts have been properly disclosed. An examination of brokerage statements is also useful in tracing these proceeds.

If, overall, the taxpayer sold the assets at a large loss, then a capital loss carryover will appear on line 14 of Schedule D. Capital loss carryovers provide future tax benefits as they can be used to offset future capital gains and up to $3,000 per year of earned income. If Schedule D shows a capital loss carryover, the future tax benefit of such carryovers should be taken into consideration during negotiations.

Amounts reported on line 13 frequently represent capital gains distributions from mutual funds. This type of distribution suggests the existence of stock that is held by the taxpayer that may not be shown on Schedule B. The source of any capital gains distribution should be identified and reconciled to the asset disclosure statement.

**Other Gains or Losses (Line 14).** Form 4797 is used to report gains and losses on the sale of Section 1231 assets (i.e., assets used in a trade or business). If a gain or loss is reported on line 14, then the location of the proceeds, or their use, should be verified.

**IRA, Pension, and Annuity Distributions (Lines 15 and 16).** The presence of distributions should alert you to the existence of retirement or deferred savings accounts. Note that the Minimum Required Distribution (RMD) requirements were suspended for the 2009 tax year; therefore it is important that the 2007 and 2008 returns also be reviewed. Non-taxable rollovers are shown on lines 15a and 16a, whereas taxable distributions are shown on lines 15b and 16b. In
either case, further investigation is warranted to identify and verify the account balances.

Rental Real Estate, Royalties, Partnerships, S Corporations, Trusts, etc. (Line 17). Detail for the amount shown on line 17 is provided on Schedule E. Part I of Schedule E summarizes the income or loss from rental and royalty properties. If Part I is completed, it indicates the existence of rental property or an investment in natural resources (typically oil and gas). Since the value of these investments is not required to be disclosed on the tax return, an independent appraisal of the property should be obtained and compared to the spouse's list of assets.

Although rental properties often report an operating loss, depreciation is not a cash expense. In general, buildings appreciate in value, so depreciation expenses will understate both real rental income as well as the value of the building. An independent appraisal of the property is essential.

If rental income has dropped dramatically, then it is necessary to verify that there is a bona fide reason for the decline. Check with the tenants to see if the rent paid to the taxpayer is the same as the amount that is reported on Schedule E. Also, a review of the leases will help detect whether there is a bargain rental to a new "friendly" tenant.

Part II of Schedule E summarizes the income or loss from partnerships and S corporations in which the taxpayer has an interest. Income and loss from partnerships and S corporations flow through to the owners. A Schedule K-1 should be available for each entity listed on Schedule E. The partnership and corporate tax returns for each entity should also be obtained to verify the amounts presented on the K-1s. If the activity of the entity involves rental property, then the buildings should be valued by an independent appraiser. This will provide a better measure of the value of the entity than capitalizing the income stream. If a K-1 reflects a loss, then an examination of the entity's return is warranted, as losses often result from accelerated depreciation deductions or other tax conventions. Furthermore, losses reported by flow-through entities may be mitigated by interest or dividend income earned by the entity, which flows through separately to the
partner/shareholder and is reported on the individual's Schedule B. Finally, large income amounts generally indicate that a cash distribution may be forthcoming, an important consideration during divorce negotiations.

Rental activities and other business activities in which a taxpayer does not materially participate are defined as “passive activities”. The losses from these activities are subject to a complex set of rules limiting the allowable deduction in a given year. Unused losses can be carried over to future years. The existence of passive loss carryovers, which will be detailed on Form 8582, indicates that taxes will be reduced in future years when either passive income is received or the underlying activity is terminated or sold.

Part III of Schedule E reports the income or loss from estates and trusts. Since income or loss from a fiduciary can flow through to the beneficiary, it is important to obtain copies of the Schedule K-1 and the Form 1041 for each fiduciary entity. The existence of any reported income from a fiduciary entity should be thoroughly investigated. As a beneficiary, the taxpayer may be expecting a distribution of trust corpus or a liquidating distribution from an estate once the divorce is finalized.

Farm Income (Line 18). If income or loss is reported on line 18, then the taxpayer is likely to own a significant amount of real estate. Unless farming is the taxpayer's primary trade or business, the value of the real estate on which the farm is located probably will exceed the value of the farm as a going concern. A real estate appraisal should be obtained.

Social Security Benefits (Line 20). If your client's spouse is receiving social security payments, then your client may be entitled to a portion of the wage earner's benefits. The Social Security Administration should be contacted with respect to your client's rights.

Other Income (Line 21). Any amounts reported on this line should be investigated. For example, the taxpayer may have had significant gambling winnings during the marriage of which
your client may be entitled to a portion. Additionally, prizes, awards, director’s fees and any other item of taxable income not reflected elsewhere would be reported on this line.

As mentioned at the outset, each of the above income items should be examined for the current year and for several prior years. Personal tax returns are filed using the cash basis method of accounting. Over a period of years, the distortions possible from cash basis accounting should level out. Therefore, when an impending divorce has prompted an individual to hide assets, a comparison of several years’ returns may help to identify the situation.

**Adjustments to Income: Lines 23 through 30**

**IRA and Keogh (H.R. 10) Plans (Lines 32 and 28).** Amounts shown on these lines indicate that the taxpayer has some form of tax deferred retirement savings. It is important to compare the current year's contributions to retirement plans to contributions made in previous years. Large increases in recent years may indicate that the spouse has been overfunding his or her plan in an attempt to reduce both reported income and the amount of cash available to the former spouse. Employee contributions to qualified pension and profit sharing plans, however, will not be reflected on the Form 1040. Therefore, the taxpayer's Form W-2 should also be examined. If coverage exists, an “X” will be entered in the block labeled "Retirement Plan." The balance in all retirement accounts should be verified, as this can represent a substantial asset.

While the existence of qualified plans can be determined by examining Form W-2 and line 28 of the individual tax return, other types of deferred compensation arrangements are not so easily found. In order to attract and retain valued executives, many corporations, large and small, have instituted non-qualified deferred compensation arrangements to benefit a select group of employees. The benefits which accrue to the employee are generally not taxable until received and may be subject to forfeiture if the employee leaves the company before a stated time ("golden handcuffs"). However, these non-qualified arrangements are frequently funded through a trust or life insurance
policy and are the result of a contractual arrangement with the employee. A representation as to the existence or lack of such a plan should be requested from the client's spouse. If the stock of the employer is publicly traded, then a review of the corporation's annual report will often reveal if deferred non-qualified arrangements exist. These arrangements are typically disclosed in the notes to the corporation's financial statements. The accrued liability for future payments should also appear on the entity's balance sheet.

An additional item which the examination of personal or business tax returns may not uncover, but one that may be identified by reviewing the audited financial statements of the employer, is the existence of an incentive stock option plan (see AMT discussion below). Such plans entitle participants to acquire shares of the employer's stock at favorable prices. The difference between the current fair market value of the stock and the exercise price represents a potential gain to the employee. The notes to the financial statement will indicate if any stock option plans exist. If your client's spouse participates in such an arrangement, then a specific document establishes his or her rights and obligations. This document should be reviewed for the existence of currently exercisable and future options granted, and appropriate adjustments made for the additional value.

**Penalty on Early Withdrawal of Savings (Line 30)**. A penalty assessed on the early withdrawal of savings can indicate that the taxpayer has prematurely withdrawn funds from a Certificate of Deposit. The new location of these funds should be identified and verified to the list of assets provided by your client's spouse.

**Credits (Lines 47 through 53)**

**Foreign Tax Credit (Line 47)**. The presence of this credit indicates that a portion of the taxpayer's income is derived from sources outside the U.S. and that foreign taxes have been paid on the income. The amount of the credit is calculated on Form 1116. This form also provides
information about the source of the foreign income. It is necessary to determine whether the
investments giving rise to this income were accurately valued on the spouse's list of assets.

**Other Credits (Line 53).** The presence of Investment Tax Credits, Historic Rehabilitation
Credits, or Energy Credits indicates that the taxpayer has investments in these specific types of
activities. Be certain to identify and ascertain the value of each investment from which the credit
arose.

**Alternative Minimum Tax (Line 45)**

If an amount appears on line 45, Form 6251 should be examined for the presence of
deferred compensation. An amount reported on line 15 of Form 6251 indicates that an incentive
stock option may have been exercised in the current year. The amount shown on line 15 equals the
excess of the fair market value of the option over the option price on the exercise date. The value
of these shares should be disclosed on the spouse's list of assets.

**Payments (Lines 61 through 71)**

Check to see if estimated tax payments (line 62) have significantly increased in recent
periods or if the taxpayer has overpaid taxes on an extension request (line 68 and Form 4868). A
similar check should be performed on the taxpayer's year-to-date pay stub. It is possible that he or
she has either over-paid or over-withheld and is anticipating a large refund after the divorce.

**Schedule A - Itemized Deductions**

**Medical and Dental Expenses (Lines 1 through 4).** Because medical and dental expenses
are deductible to the extent that they exceed 7.5 percent of adjusted gross income, the existence of a
medical expense deduction on line 4 results from sizable medical expenses incurred by the
taxpayer. When this occurs, it is necessary to determine whether the taxpayer carries medical
insurance. If so, then the taxpayer may be anticipating a large insurance reimbursement in the
subsequent year.
Taxes You Paid (Lines 5 through 9). Attempt to verify the amount deducted on line 6 as real estate taxes by examining the underlying tax bills. If the tax bills are not available, verify that the expense appears reasonable with respect to the property listed on the asset disclosure schedule. If the real estate tax deduction seems unreasonably high, it is possible that the spouse has acquired additional properties of which your client has no knowledge. A recent increase in real estate taxes coupled with a decrease in investment income often suggests that liquid assets are being reinvested into real estate. Large fluctuations in real estate tax liabilities should always be investigated.

Any amounts deducted on line 7 as personal property taxes should be investigated, as a very small personal property tax liability may indicate significant holdings. For example, if the tax rate is .004% (4 mills), a $500 personal property tax deduction translates into $125,000 of taxable assets. Furthermore, if foreign income taxes have been deducted on line 7, this means that the taxpayer earned income from non-U.S. sources. If so, it is important to check the spouse's list of assets for the existence of foreign assets and investigate any inconsistencies.

Interest You Paid (Lines 10 through 15). A sudden increase in home mortgage interest on lines 10 and 11 or the presence of deductible points on line 12 are indicators that the taxpayer may have purchased a new residence. In these instances, it is important to determine the amount and the source of funds used for the down payment. Alternatively, an increase in mortgage interest could result from the refinancing of a separately held mortgage. If the mortgage balance has been increased, determine where the cash withdrawn was invested.

The presence of investment interest on line 14 indicates that money was paid to carry investment properties. Be certain that these properties have been reported on the spouse's list of assets. If investment interest increases from year to year, this may suggest that the taxpayer is investing in additional properties.

Gifts to Charity (Lines 16 through 19). Large increases in contributions should always be
investigated. If contributions have increased significantly in recent years, it is possible that the taxpayer has been funding a private non-operating foundation which has tax-exempt status. If so, the taxpayer may be indirectly accruing benefits to himself or to designated parties. Another possibility is that the taxpayer may be pre-funding several years contributions in an attempt to lower reported income.

**Casualty and Theft Losses (Line 20)** Any large casualty or theft losses on the most recent return should be investigated. In a situation where the taxpayer has insurance, they may be understating the expected recovery. Verification of insurance proceeds (or lack thereof) is required.

**Miscellaneous Itemized Deductions (Lines 21 though 23).** Increased unreimbursed employee expenses in recent years could result from the taxpayer spending substantial sums for travel and entertainment on which personal enjoyment is derived. Any deduction for dues and subscriptions should be of a business nature; however, the taxpayer may be attempting to lower his or her reported income by deducting country club dues or personal subscriptions. The documentation supporting unusually large amounts deducted as miscellaneous deductions should be examined. Finally, the presence of a deduction for safe deposit box rental may indicate that the taxpayer has valuable possessions worth protecting in this fashion. An inventory of the safety deposit box should be requested.

**THE PARTNERSHIP TAX RETURN - FORM 1065**

Partnerships are unincorporated businesses with multiple owners that do not pay tax at the entity level. The partnership tax return simply summarizes and reports the results of partnership operations for the year. Each partner receives a Schedule K-1 which indicates the amount of income that partner must report on their individual tax return. Line H of Form 1065 identifies the method of accounting the partnership uses. If the partnership uses the accrual basis method of
accounting, the return for any given year is more likely to reflect the real economic results of operations than if the cash method of accounting has been used. The use of the cash method may sometimes result in a temporary distortion of income through an inappropriate matching of income and expense. When an individual owns only a small interest in a partnership, it is unlikely that he or she would be able to manipulate the information reflected on the partnership return. However, when the individual owns a large percentage of the partnership, a careful inspection of the partnership return over a multiple year period is warranted.

**Income (Lines 1 through 8)**

The techniques used to analyze income for a partnership are the same as those discussed earlier for a sole proprietorship. Specifically, careful attention should be paid to fluctuations in the ratios of gross profit to sales and net profit to sales.

**Deductions (Lines 9 through 21)**

Dramatic increases in salaries and wages (line 9) might result from the taxpayer putting "friendly parties" on the partnership payroll. Unusual or abnormally high payments warrant further investigation. Along similar lines, a dramatic increase in guaranteed payments (line 10) to partners other than your client's spouse could suggest that the partners have entered into an agreement where the other partners are currently pulling money out of the partnership as guaranteed payments with the understanding that your client's spouse will pull money out of the partnership as a guaranteed payment once the divorce is finalized. Compare the guaranteed payments allocated among the partners from the most recent returns to prior returns to determine whether such an arrangement may exist.

Substantial increases in rent expense (line 13) should always be investigated. It is possible that additional or above market rent is being paid to a party related to your client's spouse. Finally, it is advisable to investigate the partnership's retirement arrangement. An overfunded plan could
increase the value of the partnership interest.

**Partners' Distributive Share Items - Schedule K**

If the partnership has rental real estate, the net income or loss from this activity will appear on line 2. (Each partner’s share will also appear on his or her individual Schedule K-1.) Losses from rental activities can be deceptive. Activities that generate negative taxable income may still have significant economic value. Because depreciation is not a cash expense, adding back depreciation should give a rough estimate of the activity's cash flow. As always, the underlying fair market value of the property should be determined by appraisal.

**Balance Sheets per Books - Schedule L**

**Assets (Lines 1 through 14).** If the business is being valued by capitalizing cash flows, any unusual increase in accounts receivable should be taken into account. A large increase in accounts receivable (line 2a), especially from one or two major clients, may suggest that the taxpayer is delaying collections and attempting to lower the partnership's value by lowering current income. A significant increase in the allowance for bad debts (line 2b) should be investigated, as this may signal an attempt to induce you into undervaluing the business.

While the balance sheet can prove very helpful in the valuation process, it also can be very deceiving. Assets on the balance sheet are recorded at historical cost, rather than market value. Thus, unrealized appreciation of assets is not reflected on the balance sheet. All assets and investments reported on lines 3 (inventory), 4 (U.S. government obligations), 5 (tax-exempt securities), 6 (other current assets), 8 (other investments), 9 (buildings and other depreciable assets), 11 (land), and 12 (intangible assets) should be identified and valued at their current market value. This is especially important for real estate holdings. Amounts entered on line 12 represent the partnership's intangible assets. Generally this amount represents start-up costs, organizational expenses, and/or goodwill. However, intangible assets also include patents, copyrights, and
trademarks which can have significant value.

**Liabilities and Capital (Lines 15 through 22).** Identify the creditors of the partnership (lines 15 and 16). If the taxpayer is one of the creditors, then his or her net worth may be substantially higher than reported. Additionally liabilities may be accrued to “friends” in an attempt to reduce the value of the business. Review the reasonableness of the other liabilities reported by the partnership (lines 17 and 20), as accrued liabilities for unrealistic contingencies can artificially depress the value of a partner's ownership interest. Finally, certain nonrecourse loans (i.e., loans for which the partners are not personally liable) included on line 18 should be investigated to determine whether the loans legitimately reduce the value of the business.

**Reconciliation of Income per Books With Income per Return - Schedule M-1**

Schedule M-1 reconciles reported net income on the financial statements with taxable income. This schedule will be useful primarily if the partnership has financial statements prepared on a non-tax basis. Schedule M-1 is also an excellent place to look for non-taxable income such as tax-exempt interest income.

**Analysis of Partners' Capital Accounts - Schedule M-2**

Schedule M-2 reconciles the beginning and ending balances in the partner's capital accounts. Line 6 summarizes all distributions to partners made by the partnership during the year. Comparing the prior years' ratios of the spouse's distribution (Item L on the spouse's K-1) to the total distributions (line 6 of Schedule M-2) often reveals whether any disproportionate distributions have been made in recent years. Substantially disproportionate distributions to other partners in prior years might suggest that your client's spouse is waiting until after the divorce is finalized to withdraw his or her share of the partnership funds.

**Partner's Share of Income, Credits, Deductions, Etc. - Schedule K-1**

In addition to detailing the individual partner's share of each element of partnership income
or deduction, Schedule K-1 identifies whether the spouse is a general or limited partner (Item G). General partners are more likely to have a greater degree of control over partnership operations than limited partners who are typically minority investors. The individual's ownership percentage may also be determined from Item J on the schedule. This will provide an additional measure of the amount of control the individual has over partnership operations. Finally, Item L provides a reconciliation of the partner's capital account. This includes the partner's withdrawals and distributions from the partnership during the year, and the balance in the partner's capital account at the end of the year. Since the capital account does not reflect any unrealized appreciation of the property owned by the partnership, it is not usually a good indication of the value of the partner's partnership interest. However, assuming that the partnership has a positive net worth, the balance in the capital account should provide a minimum value for the taxpayer's partnership interest.

**U.S. INCOME TAX RETURN FOR AN S CORPORATION - FORM 1120S**

In many ways, S corporations are similar to partnerships. Like partnerships, S corporations function as reporting entities that issue K-1s to shareholders who then report the contents of the K-1 on their individual Form 1040s. In addition, several line items on Form 1120S are similar to those on Form 1065. For example, Compensation of Officers (line 7) for an S corporation is roughly equivalent to guaranteed payments for a partnership. Accordingly, the steps outlined for partnerships in the previous section would apply to S corporations as well. The remainder of this section will focus on the areas of Form 1120S that differ from Form 1065.

**Other Information - Schedule B**

Line 1 addresses the accounting method used by the corporation. Recall that the cash method of accounting can produce an unreliable picture of the corporation's activity. Line 3, if answered in the affirmative, indicates that the corporation owns a substantial interest in another
corporation. This should be considered when valuing the taxpayer's interest in the corporation.

**The Balance Sheet - Schedule L**

Loans to shareholders are identified on line 7. If the taxpayer owes a significant amount of money to the corporation, this will reduce his or her net worth. Alternatively, the corporation may be making investments on the taxpayer's behalf. Loans from shareholders are identified on line 19. If the corporation owes a significant sum to the taxpayer, then the taxpayer's net worth may be significantly more than it originally appeared.

**Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed - Schedule M-2**

Similar to the rules regarding partners and partnerships, once the owners of S corporations have reported the income earned by the business, the entity can distribute that amount without causing any additional taxation at the shareholder level. Schedule M-2 provides the amount available for distribution tax-free as well as indicating the amount distributed in the current year. Unlike partnerships where distributions may be made in unequal amounts, the provisions governing S corporations require that distributions be made pro-rata in accordance with stock ownership percentages. As a result you need not be concerned with unequal distributions of net profits, but should focus on fluctuations in shareholders' salaries.

**U.S. CORPORATION INCOME TAX RETURN - FORM 1120**

Corporations subject to tax under Subchapter C of the Internal Revenue Code are known as regular or "C" corporations. C corporations have separate legal existence and, like individuals, are tax paying entities. The analyses of the accounts presented on Form 1120 are virtually identical to the analysis that would be performed on the accounts of a partnership or an S corporation.
Accordingly, there are only a few differences to be discussed.

Because a C corporation is a tax paying entity, it makes estimated tax payments on a quarterly basis. As was the case with an individual, look to see if the corporation is overpaying its estimated tax liability with the expectation of receiving a refund after the divorce has been finalized.

A significant difference between C corporations and S corporations is the treatment of distributions from the corporation to the shareholder. While distributions out of a partnership or an S corporation are generally not taxable to the recipient, distributions from a regular corporation will be taxed as dividend income. Therefore, a distribution of an equivalent amount out of a C corporation will have significantly less value than the same distribution coming from an S corporation or a partnership.

**Dividends, Interest, Capital Gains, etc. - Lines 4 through 10**

Another difference between C corporations and S corporations or partnerships is in the reporting of investment income. Investment income is combined with operating income when computing the net income of a C corporation. The reviewer must carefully inspect each item of gross income to determine and value its source.

**Compensation of Officers - Schedule E**

When a C Corporation’s total receipts (line 1a plus lines 4 through 10 on page 1) are $500,000 or more, the corporation is required to complete Schedule E which discloses the compensation paid to each of its officers. This disclosure includes the percentage of stock in the corporation owned by each officer. This may be useful when attempting to value the taxpayer's investment in the corporation. As previously discussed, a substantial decrease in the taxpayer's compensation relative to total officers' compensation should be investigated.

**Other Information - Schedule K**
Line 5 will tell you whether the corporation owns 50 percent or more of the voting stock in another foreign or domestic corporation. Question 9 provides the corporation's tax-exempt interest income for the year. The answers to each of these questions could be important when valuing the taxpayer's investment in the corporation.

**Reconciliation of Income (Loss) per Books With Income per Return - Schedule M-1**

As discussed in the Partnership section above, Schedule M-1 will detail items of income and expense which are treated differently for financial statement purposes than for tax purposes. Common differences reflected on Schedule M-1 include: differences caused by using the cash receipts and disbursement method for tax purposes and accrual basis reporting for financial statements; depreciation adjustments caused by using different depreciation methods for book and tax purposes; the cost of life insurance premiums paid on the lives of key employees and shareholders; the current financial statement expense for non-qualified deferred compensation arrangements; and non-taxable interest income. Additionally, unlike S corporations and partnerships which flow through charitable contributions and capital losses to their shareholders/partners, C corporations deduct these amounts (subject to certain limitations) in arriving at taxable income. In instances when the charitable contribution deduction is limited, the carryover appears on line 5b on Schedule M-1. If the corporation incurred capital losses in excess of capital gains, this amount will appear on both Schedule D and line 3 of Schedule M-1. Both capital loss and charitable contribution carryovers expire after five years. However, provided that the corporation has sufficient income/capital gains, these carryovers represent future tax benefits that may affect the value of the shareholder's stock.

An analysis of this section of the tax return can, therefore, identify the existence of additional assets, as well as the potential for future income from life insurance policies and deferred compensation arrangements. Also, since financial statement net income is usually more indicative
of the true economic income of the corporation, it is typically a better starting point for valuation than taxable income.

**Analysis of Unappropriated Retained Earnings per Books - Schedule M-2**

Schedule M-2 reconciles beginning and ending retained earnings of the corporation. This schedule will indicate whether or not distributions of cash or property have been made to the shareholders (line 5), providing another way to identify distributions made to the taxpayer.

**CONCLUSION**

Frequently, a taxpayer being sued for support is reluctant to cooperate during divorce negotiations. As a representative of the plaintiff spouse, it is necessary to validate the information presented and ensure that your client receives a favorable settlement. The approach presented in this article provides a tool to help measure the amount of marital property available for distribution on the dissolution of the marriage.

If a taxpayer is determined to conceal assets from your client, he or she will attempt to do so without being detected. Although it is impractical to suggest that an analysis of previously filed tax returns will uncover every undisclosed asset, tax returns are a valuable source of information and should be used as a tool to uncover inconsistencies in the information presented by your client's spouse. Once an inconsistency is detected, additional records can be obtained that may identify previously undisclosed assets.