

A Quick Start Guide to Reading Tax Returns

BY MILES MASON SR.

Mark Twain once said, “Eat a live frog first thing in the morning and nothing worse will happen to you the rest of the day.” Reading tax returns is like eating a live frog. Don’t stare at it. Just take a bite.

Why should a family lawyer love reading tax returns? Because doing so wins divorce cases. (Promise. Cross-examination is the best!) Divorcing spouses expect us to know a fair amount about tax returns.

In homage to Mark Twain’s “Tom Sawyer,” reading tax returns is great fun even for the math averse. Like Sawyer whitewashing the fence, this author asked a few friends for help.

Learn to spot the most obvious ways of hiding assets. Fit the puzzle together by reviewing Form 1040s line-by-line. Spend the time to extract clues to hidden income in every tax form, schedule, and report. The return on this investment can be huge. Not all income is taxable, but all income is needed for child support determinations as well as for spousal support purposes.

Review Multiple Years of Tax Returns

Karolina Calhoun, CPA, ABV, CFF, vice president of Mercer Capital, Memphis, Tennessee, explains: “Reviewing multiple years of tax returns and accompanying supplemental schedules may provide helpful information on trends and/or changes and could indicate the need for potential forensic investigations.”

Use the tax returns to gain insight into the couple’s married lifestyle. Taxpayer patterns may have a self-serving function, but deviations from those patterns can be equally useful to the family lawyer. Changes over time tell a more detailed story than any single year snapshot. Is there a change of pattern with income and deductions in the period leading up to the divorce? Did a spouse’s income decrease while expenses increased? A spouse’s divorce preparation could begin years before a petition is filed, possibly long before the other spouse becomes aware of an imminent breakup.

IRS Form 1040. Start with the filed Form 1040 income tax returns. Note the tax status (single, married filing jointly, married filing separately, head of household, qualified widower with dependent children).

Calhoun adds:

Form 1040 provides a general understanding of a taxpayer’s financial status and can be a guide to finding additional information about one’s finances. It can serve as a starting point to get a picture of an individual’s (or couple’s) income(s), assets and liabilities, and lifestyle. Form 1040 is supplemented with additional schedules and documentation which lend detail and insight into one’s lifestyle and financial matters.

Along with 1040s are additional forms, schedules, worksheets, records, and notes. Look for hidden income-generating assets, undisclosed transactions, unreported and underreported income, deflated asset valuation, and all sorts of shenanigans, especially in anticipation of divorce.

Conflicts Between Loan Applications and Tax Returns

People sometimes make honest mistakes on their taxes and with recordkeeping. Other times, people embellish and manipulate to hide income. Some taxpayers utilize every possible way to transfer income back and forth between their individual 1040s and their business returns. Some manipulations are lawful, others are illegal.

Here’s the best-case scenario. The opposing party’s 1040 notably conflicts with the personal financial statement she provided to a bank or mortgage company as part of a loan application. The motives are opposing. The taxpayer’s motive is to pay no more tax than legally required, which means recording as little income as possible and deducting as much as possible. On a financial statement’s income and net worth disclosures, the debtor’s motive is to list every last dime of income to show as high net worth as possible and obtain the desired loan or mortgage at the best interest rate.

There is always a reason for why those differ. With conflicting disclosures hanging over the spouse’s head, this is a great place to start. Lying on a tax return invites criminal penalty. Loan applications are submitted under oath subject to criminal penalty of perjury. Finding the discrepancy has a special effect of getting cases settled favorably. A loan

applicant's overstatement of income or net worth can be potentially devastating in the courtroom.

PRO TIP: For real property ownership and debt documentation, locate the creditor or bank (find recorded trust deeds) and issue subpoenas demanding copies of the spouse's personal financial statements submitted with loan applications.

Examine All 1040 Schedules

Form 1040 tax schedules are a gold mine of information. Cross-reference the descriptions and amounts on each schedule with what was reported on the 1040. Hunt for clues to tax-free investments that will not show on a Form 1040, such as Tax-Exempt Exchange-Traded Funds (ETFs), municipal bonds, and Health Savings Accounts (HSAs). Spot anomalies for further investigation.

Look at Schedule A—Itemized Deductions

Schedule A is filed when qualified itemized deductions are greater than the taxpayer's standard deduction. Review taxpayer elections—standard deduction or Schedule A—over several years for a financial picture of the marital estate and lifestyle changes over time.

Schedule A is also where the taxpayer reports medical and dental expenses, state and local income taxes paid (or general sales taxes paid), and state and local personal property taxes paid based on asset value.

Was property tax paid? Identify the property and where it is situated. Typically, the higher the real estate tax, the greater the property value—location, location, location. Does the reported property tax match the property assessment? Were property taxes paid a year or two in advance?

High personal property tax indicates high-value assets, such as a yacht or luxury vehicle.

Did the spouse pay home mortgage interest and points? When interest paid exceeds the annual amount due, mortgage prepayments are indicated. When less interest was paid than the annual amount, look for refinancing documents or a substantial payment on the principal owed.

Look for investment interest paid, charitable gifts, federal disaster casualty and theft losses, and "Other Itemized Deductions" on Form 1040. By inflating these figures, the taxpayer conceals more cash. "Other" includes gambling losses, a possible dissipation of marital assets.

Look at Schedule B—Interest and Ordinary Dividends

Schedule B offers clues to every asset that generated income. Every taxable income-generating asset listed on Schedule B should be on the parties' marital balance sheet. For every interest or dividend paid, there is an asset producing that interest or dividend. Examine each 1099-INT and 1099-DIV form. Is there a claimed dividend exemption? See 1099-DIV box 12: exempt-interest dividends.

With many mutual funds, interest and dividends can generate income that is reinvested and not distributed to the

taxpayer but still results in taxable income. Also reported on Schedule B is any income related to foreign trusts and accounts.

Look at Schedule C—Profit or Loss from Business

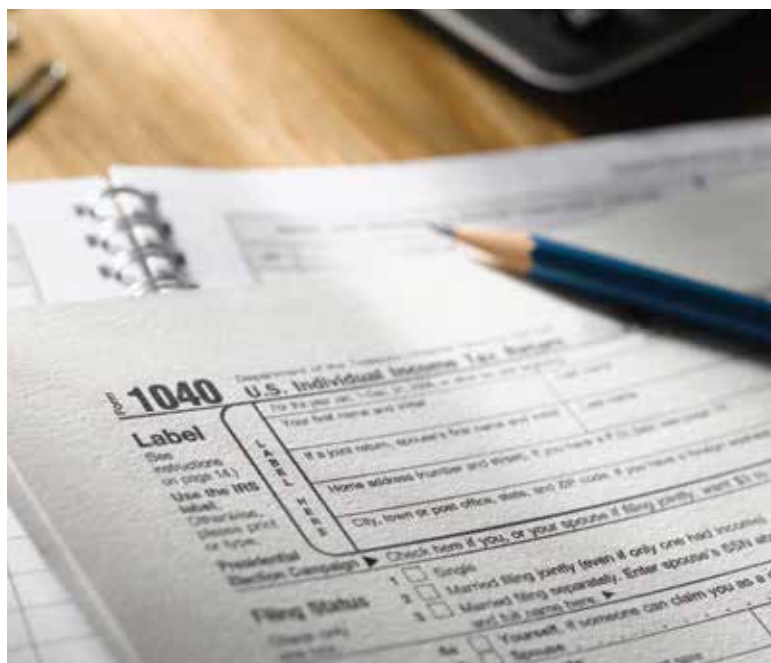
This is the taxpayer's business income. Schedule C reports income from certain types of businesses, often sole proprietorships. If the business reports annual income on a cash basis, then accounts receivable will not be reported.

Robert Vance, CPA, ABV, CFF, CVA, CFP, of Forensic & Valuation Services PLC, Memphis, Tennessee, suggests looking at the balance sheet for helpful information that may not appear on tax returns. Vance warns, "Beware the 'Loan to Shareholder/Member/Owner' account on the ledger wherein personal expenses paid by the company or lump sum payments to the owner are accumulated as if a legitimate loan to that subject."

Whenever the spouse is a business owner, at a minimum review the business balance sheets. Sole proprietors are not required to keep a balanced double-entry accounting system. A lot of manipulation can go on behind the scenes that is not reflected on the sole proprietor's 1040 return.

Joshua Shilts, CPA, ASA, ABV/CFF/CGMA, CFE, of Shilts CPA, Jacksonville, Florida, expands on how easy it is for family lawyers to miss important information:

Recognize that a business reporting a Schedule C doesn't include a balance sheet. A balance sheet is a crucial piece of information for understanding a business and its' assets, liabilities and 'net position' at any given time. A multi-year review of the balance sheets along with income statements can identify other sources of cash inflow and/or outflow.



Sources of Tax Returns Family Lawyers Can Tap



- 1. The client:** Regardless of the number of years of tax returns there may be in existence, make copies of them all. If you don't copy or scan one old tax return, it seems that is always the one that is needed later!
- 2. The parties' home computer:** Even if hard copies of the returns are not available, try to obtain copies of any personal tax return preparation data; all information entered into the program; and all reports, sub schedules, and worksheets generated by the program. When in doubt, ask a forensic accountant or computer consultant to assist.
- 3. Discovery:** Definitely compare what documents have been provided to what was requested. In the comparison, determine whether all of the requested years are included in the production.
- 4. The spouse's CPA:** If the parties' CPA prepared joint returns, either party may request copies be provided by the CPA. One strategic advantage to issuing a subpoena is that, if all financial records are requested in the subpoena, CPAs are very unlikely to shred documents before production. In cases in which the parties' CPA is a close, personal friend of the opposing spouse, consider issuing a subpoena earlier in the case than normal.

- 5. The IRS:** If hiding assets is suspected, definitely request documents directly from the IRS. Obtaining a copy of the return allows for confirmation that the return produced in discovery was, in fact, the return submitted. Often, unsigned tax returns are produced in discovery. There are two options for obtaining information directly from the IRS. First, complete and mail IRS Form 4506, "Request for Copy of Tax Return," available at www.irs.gov and IRS Form 4506-T, "Request for Transcript of Tax Return." Definitely read all IRS forms' instructions to understand exactly what is required and what to expect.

Excerpted from *The Forensic Accounting Deskbook: A Practical Guide to Financial Investigation and Analysis for Family Lawyers, 2nd Ed.*, by Miles Mason Sr. JD, CPA (ABA Family Law Section, 2019).

These businesses are usually on a cash basis, paying taxes through the individual. Existing inventory and existing receivables are not recorded anywhere. Would this type of business typically have inventory or receivables on account? Watch for inflated inventory values and fictitious accounts payable used to reduce income. Is the spouse pocketing unreported income? Unreported cash? A forensic accountant can examine customer invoices, cash register tapes, sales tax returns, and so on.

Work in progress on December 31 may not be reported because the income has not yet been realized (but could be realized on January 1). This is recognized income but not realized.

Sometimes there is pass-through income from an S-Corp or partnership. What about debt forgiveness that is taxable income but not actual cash flow?

Was there a leased asset? This could be a disguised asset purchase. Look for excessive expenses for travel, vehicle use, meals, and miscellaneous items. Follow up by examining receipts and bank statements.

As for the hobby income of a model train enthusiast, look directly at the 1040 and not Schedule C.

Look at the 1040 "Amount You Owe" (total tax minus fed withholding, estimated tax payments made, and credits).

Examine years of filing patterns. Did the spouse over-estimate or under-pay the estimated tax amount? Estimated taxes are based on the prior tax year's realized income, but the current year may fluctuate wildly. Dig deeper to find the reason for over-estimating or underpaying ES quarterly taxes.

Look at Schedule D—Capital Gains and Losses

Look for the sale of business assets. Selling assets prior to a divorcing year can inflate earnings. When the taxpayer transfers an asset (by sale, exchange, involuntary conversion, capital gain distribution, or non-business bad debt), money is either gained or lost on the transaction. Schedule D tells us the taxpayer owned the transferred asset, which is important for tracing assets.

Schedule D gives the asset's date of purchase and cost, transaction date (sale), and what it sold for (gain or loss). This is the beginning of the trail. Trace any sale of stock to the brokerage account.

Find capital gains and losses from activities by partnerships, S-Corps, estates, and other entities on Schedule D. On Form 1040, Karolina Calhoun adds:

Line 7: Capital Gains or Losses - Line 7 indicates capital gains or losses, which means that an asset (or

multiple assets) was sold and some sort of monies were made or lost on the transaction. Not only does this information indicate ownership of assets, it can also be important in tracing analyses as well as other forensic analyses when reviewing several years of tax returns. Details can be found in Schedule D and Form 8949.

Look at Schedule E—Supplemental Income and Loss

The 1040 Schedule E offers clues to income on rental real estate, royalties, partnerships, S-Corps, estates, trusts, real estate mortgage investment conduits (REMICs), and other entities. Does the income or loss amount on Schedule E match the Form 1040?

What to look for? Not uncommonly, the taxpayer owns the building where the small business operates (owns that, too) and collects rent from the business for use of the

building. Again, taxpayer motives conflict. In lieu of a larger draw or bigger salary, the spouse might omit reporting the rents collected, thereby reducing personal income on the 1040. However, the business reports the rent paid on Schedule E to reduce business profit and tax liability.

PRO-TIP: *Check for prepaid expenses for rent and other costs. These tax deductions can take cash out of the marital pool.*

Look for a low income draw (a small salary) while the spouse is pulling a lot of cash from the business. The owner of an S-Corp can make draws (non-reported return of capital) in place of or in addition to wages reported on the W-2. The draw amount should be on Schedule K-1. Not there? Check distributions made on the S-Corp's tax return balance sheet.

In a divorce, the S-Corp owner may attempt to conceal

What Is a Tax Return?

The term "tax return" is vaguely defined. "Schedules" and "Attachments" must be broadly defined because they can be prepared but not included with that which is filed with the IRS. Depending on the user, specific documents called "tax returns" can include:

1. Federal tax returns, also called by their form numbers: the 1040, 1120, and 1165.
2. State tax returns: Although not all states have a tax on earned income, there can be state returns that must be filed to record dividend and interest income.
3. All amended returns: If a taxpayer amended a return, try to obtain both the original and amended versions because the forensic accountant may find something interesting.
4. State excise tax returns, which have a tax on assets, for owners of businesses, such as LLCs and corporations.
5. Copies of tax checks paying estimated payments, associated forms, payment of quarterly and annual tax liability, and tax refund checks from the IRS to the taxpayer.
6. Sales tax and personal property tax returns for businesses.
7. Schedules: The 1040 may also include some of the following most commonly used schedules (which should be attached to the return and cross-referenced) including Schedules A—F.

PRO-TIP: Be on the lookout for depreciation schedules whether or not they are included with the filed return. Assets that are "fully depreciated" still may have significant financial value and should be included in the marital estate.

8. Attachments: Also make sure the federal tax return includes the following attachments:
 - a. W-2s: issued by employers to employees (Practice tip: When copying W-2s, always copy both sides of the form!);
 - b. 1099s: issued by businesses to independent contractors (later cross-reference that all projects and work-in-progress items are disclosed);
 - c. K-1s: issued by partnerships to partners and LLCs to members listing income attributable to individual partners from the partnership;
 - d. W-2Gs: income from gambling; and
 - e. Miscellaneous supporting schedules, sub schedules, reports, and worksheets: Not every piece of paper filed with a return must be on an IRS form. Often, tax professionals and tax return preparation software will create (and preparers will attach) additional schedules, reports, and worksheets. Those not attached to the return are generally kept with the supporting documents maintained by the taxpayer and/or preparer in the event of an audit.



income by leaving compensation off the W-2, or by reporting a draw on the K-1 that is less than what was reported on the S-Corp's tax return balance sheet. Check all three for income – the W-2, the K-1, and the S-Corp's tax return balance sheet.

Is the spouse a partner or LLC member? Partners and LLC members are compensated with capital draws, reported on Form 1065 (partnership income return) and on K-1s along with guaranteed payments as salary. The K-1 must match the owner's individual tax return. If the partner or LLC member's guaranteed payment is not reported on the K-1, then she avoids paying income tax on that amount.

Determine if the spouse has made loans to the business or invested capital in the business recently. Review year-to-year retained earnings or partners' equity. (Formula: Ending balance = prior year's beginning balance + net income earned – draws.)

Owners of businesses often invest money and then legally loan money back and forth between the business and themselves. A red flag goes up if a lot of capital is invested even though business operations do not require it. Dig deeper. The spouse may be hoarding cash in the business to avoid categorizing it as income in the divorce. To identify suspicious transactions, track retained earnings, partner's equity, and loans over multiple years.

Learn to love the W-2. Pick the W-2 clean of information and closely inspect for errors and omissions. That is the form employers use to report annual wages, salaries, and tips paid, but there is a whole lot more there. W-2Gs report gambling winnings. Forensic accountant Robert Vance suggests:

For employees, don't just request the W-2, request the year-end pay stub also. If the employer has a cafeteria plan and the employee participates, the subject could have thousands of dollars of higher income due to the cafeteria payroll deductions 'right off the top' that do not show up anywhere on a W-2 since those are deductible for federal taxes, and Social Security and Medicare taxes.

A Section 125 Cafeteria Plan is an employer-sponsored benefits plan that lets employees pay for certain qualified medical expenses, such as health insurance premiums, on a pre-tax basis. Examine each W-2. Critical information is reported on line 1 (wages, tips, other compensation), line 3 (Social Security wages), and line 5 (Medicare wages). Are wages and Medicare wages the same amount? Look for a 401(k) or pension. When wages differ from Medicare wages, is "retirement plan" checked on line 13? If so, then the employee has a retirement, 401(k), or another important asset. Copy and review the back of the W-2 form for identifying codes and reference information. For more

discussion about reading W-2's, see *The W-2 as Roadmap for Tennessee Child Support Guideline Income*, by Robert Vance, <https://www.forensicval.com/resources/the-w-2-as-roadmap-for-tennessee-child-support-guideline-income>. And, *The Forensic Accounting Deskbook: A Practical Guide to Financial Investigation and Analysis for Family Lawyers*.

If federal withholding (line 2) as a percentage is above the tax bracket this employee-spouse is likely in, then she could file for a large refund after the divorce. Keep in mind, the pre-divorce tax return could be amended after the divorce, claiming the correct amount of pre-paid tax liability, resulting in a meaningfully large refund post-divorce.

Line 12 offers 29 possible deferral items, from uncollected taxes to retirement plan contributions. As for line 15, did the state lack the authority to withhold income? Was too much withheld when the person neither worked nor lived in the withholding state? This could mean a large refund to the taxpayer after the divorce.

Of course, not everyone has W-2s. Independent contractors receive 1099-NECs. Income from extraordinary sources may appear on 1099-MISCs, such as royalties, rents, and non-qualified deferred compensation. Because 1099-MISCs are frequently one-offs, a taxpayer might omit reporting it on the 1040 return. Forensic analysis may be needed.

Social Security is not divisible in divorce, but it is an important income source in the gross income calculation of child support and is relevant to spousal support. Look at the SSA-1099.

Clues to Hidden IRAs, SEPs, SIMPLEs, and Qualified Plans

Is an amount listed on Form 1040 for an IRA deduction? If yes, then the taxpayer contributed to an IRA for that tax year and claimed the amount as a deduction from income. To hide an IRA, a spouse could choose not to contribute to an existing IRA in the tax year prior to the divorce. Or the spouse could contribute after the year of the tax return. Check prior years' tax returns. Confirm the balance of the IRA by reviewing the most recent monthly statement.

Look for IRA distributions. Examine 1099-Rs and asset documentation. Any withdrawal from an IRA may be dissipation of an income-producing marital asset.

Check the 1040 for Self-employed SEP, SIMPLE, and qualified plans. Investigate any amounts included on the 1040 as a "Penalty on early withdrawal of savings."

Look at Schedule K-1 – Partner's Share of Income, Deductions, Credits, etc.

Schedule K-1 (Form 1065) is packed with information. The K-1 has details about the business, percentage of ownership, whether the spouse is a limited or general partner, the entity's profit and loss, capital and liabilities, the spouse's proportionate share of taxable income or loss, and whether a decrease is due to a sale or exchange of partnership interest. If

the spouse's percentage of ownership is smaller, then investigate the transaction that reduced it.

What assets are being depreciated and amortized?

Compare Form 4562 (Depreciation and Amortization) with the business balance sheet and profit and loss statement (under expense items). Did the business claim IRC Section 179 expense deduction to write off the full value of equipment put into service during that tax year? Note depreciation of "listed Property" (Part V) is described as a "qualified business use" of property.

Was there a distribution to the partner? Was there a capital call with investment in the business? Use the K-1 to do a Partner's Capital Account Analysis.

Compare and contrast the internal financial records of the business with what was reported on Schedule L (Transactions with Interested Persons), Schedule M (Noncash Contributions), Schedule M-1 and M-2 (Reconciliation of Income (Loss) and Analysis of Unappropriated Retained Earnings per Books).

Vance suggests family lawyers should know or learn the relationship and tax return requirements for each category of business ownership. "If the subject owns the company where they are employed and it is an S-Corp. or LLC, get the K-1s and observe the S-Corp Distributions or LLC Draws/ Distributions to record the true income of the subject."

Forensic Accountants Interpret Tax Returns

Forensic accountants, and CPAs in general, can be your best friend. Ask for help. Forensic accountants will have favorite starting points. Some will create a spreadsheet for all data appearing, line by line. They know how to keep an eye on cash flow. The author prefers to assemble all the pages of multiple years' tax returns into a notebook, flip back and forth, identify what changes over time, and make notes. CPAs can also smell problems. A career's worth of staring at these documents means CPAs know what makes sense and what doesn't. The 1040, W-2s, and other income reported therein become the beginning of the inquiry, not the end. When you know what to look for, you can confidently determine whether to hire a forensic accountant to analyze the paper trail.

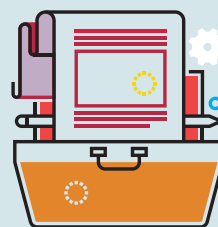
Go the extra mile to get it right the first time. Trying to fix problems later means additional lawyer fees, court costs, delay, and stress for the client and possibly for the attorney, too. **FA**

Additional Resources

The 1040 Handbook: A Guide to Income and Asset Discovery, Eighth Edition, by Jack Zuckerman and Ron E. Thompson (ABA Family Law Section, 2021).

Navigating Tax Returns Booklet (free digital publication from Mercer Capital).

The Forensic Accounting Deskbook: A Practical Guide to Financial Investigation and Analysis for Family Lawyers, Second Edition, by Miles Mason Sr., JD, CPA (ABA Family Law Section, 2019).



MILES MASON SR., JD, CPA (memphisdivorce.com) is a divorce lawyer in Memphis, Tennessee, and founder of the Miles Mason Family Law Group, PLC. A nationally recognized speaker on divorce trial practice, forensic accounting, and business valuation, he has authored four books on divorce, including *The Forensic Accounting Deskbook, 2nd Ed.* (ABA Family Law Section, 2019) and *The Tennessee Divorce Client's Handbook*. Mason previously served on the *Tennessee Bar Journal's* editorial board and as the chair of the Tennessee Bar Association Family Law Section.