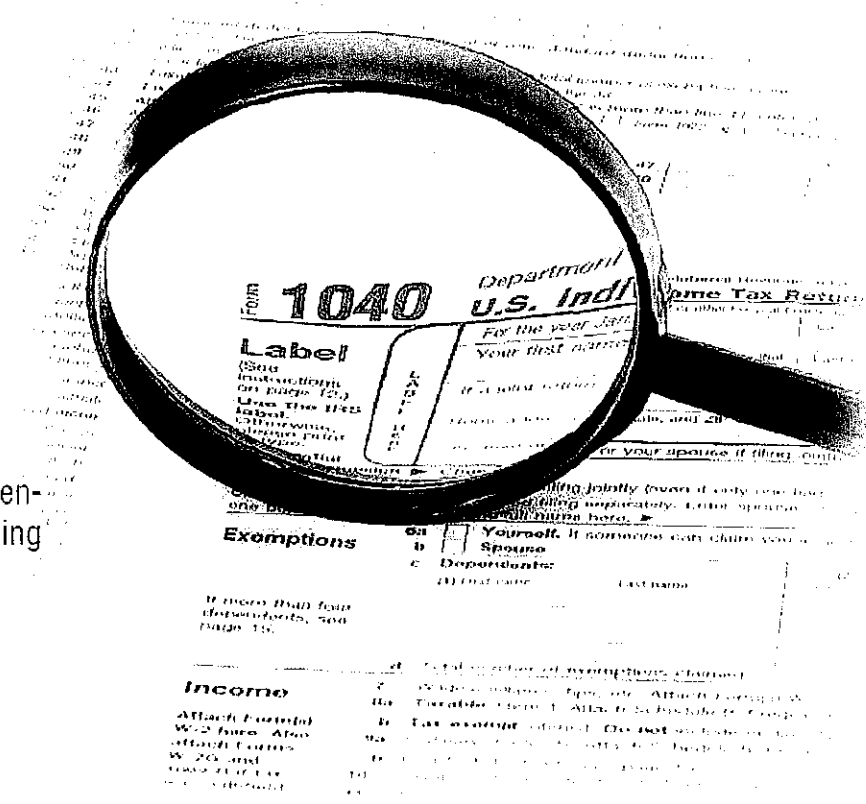


Discovering "Hidden" Income Using Individual Tax Returns



A review of personal tax returns can enable attorneys to gain an understanding of the possibility of hidden income.

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Clients often allege hidden income, but are not necessarily accurate in their allegations. It is invaluable for a lawyer to quickly assess these claims. The lawyer can then moderate the expectations of the client or call in a forensic accountant for further expert-investigation.

In general, the ability to "hide income" is primarily available to owners of closely held businesses. However, do not begin this analysis with the corporate or partnership tax returns; begin with the individual tax returns. Our caveat is that there are many ways to obscure and underreport income to the taxing authorities, some sophisticated and many not so sophisticated, our method is designed to establish the fact that further investigation is necessary. In other words, it serves as one of your tools to assess the cost/benefit analysis of bringing on a forensic accounting expert to your client's team. Our method will not uncover every instance of underreported income.

A quick review of selected elements of the last three years of personal tax returns can give you an idea of the truth of hidden income allegations. You are looking at three years, or longer, to give you a large enough cross section to eliminate one-time tax event variables and/or to compare current tax return information to prior years, ideally to recognize a time when a spouse had not planned to divorce, if possible.

While tax returns appear formidable and unintelligible, you just need to know some basics. The first two pages of the tax return are all you need to do this analysis. These pages are labeled "Form 1040, Personal Tax Return". These two pages are the summary of all the data found in all the pages, forms and schedules following.

Our analysis is a simple question: does this tax return show enough income to pay for the expenses of the family unit?

The interviews you have had with the client will assist you in honing your analysis. These questions are the same you analyze in attempting to understand the marital standard of living. Remember to quantify amounts, asking follow-up questions to establish reasonable cost estimates. These costs of living are not deductible, with some exceptions, and therefore are not listed on tax returns. Gain an understanding of how much money the family spends, saves, or reduces debts on an annual basis.

1. Do the kids go to private schools?
2. Are the kids involved in expensive sports or hobbies?
3. Does the family travel frequently?

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4. What are the other living expenses?
5. Are there increasing savings in bank or investment accounts?
6. Are their debts increasing or decreasing?

Business-owner taxpayers have an obvious financial incentive to under-report income to the government and our government lacks the resources to vet business income reported. A taxpayer's financial transgressions, fortunately, are aggregated and pop out as one number on a personal tax return as "Taxable Income".

Taxable income is found on "Form 1040, Personal Tax Return", page 2, line 43. Observe this number and compare it to the family unit's living expenses estimated during your interview. Does taxable income exceed the estimated living expenses of the family unit, excluding mortgage interest paid and property taxes (common housing costs that are deducted on the tax returns to arrive at taxable income)? If you suspect it does not, you might have a hidden income issue.

Example:

Take the "Taxable Income" figure and subtract estimated expenses (not including the above-mentioned housing costs). Estimated expenses were determined in your interview and/or an examination of bank statements and credit cards. If it is a negative number, it makes sense to hire a forensic accounting expert as unreported income may exist.

Taxable Income	\$100,000
Known living expenses	
Auto expenses	\$20,000
Private school tuition	\$40,000
Spending on credit cards	<u>\$70,000</u>
	(\$130,000)
Increase in savings (non-pension)	
Investment accounts	\$25,000
Loan payoffs	<u>\$30,000</u>
	(\$55,000)
	<u>(\$85,000)</u>

Further inquiries are necessary. How is the family unit funding \$85,000, almost double their reported income? Savings increased, debts decreased, and there is no one else providing funds, such as relatives. Hence, this analysis supports an instance of "hidden" income. In many cases, forensic accountants examining the business books and records will uncover these personal costs, which is a common form of underreporting income. ■



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