TAX TRENDS AND DEVELOPMENTS

Michigan Court of Appeals Rules on Availability for Support of (1) Undistributed S Corporation Earnings and (2) S Corp Distributions to Cover Taxes on Undistributed "Pass Through" Income

Diez v. Davey, Mich App No. 318910 (10/23/14)

By Joseph W. Cunningham, JD, CPA

Facts

- The case, involving unmarried parents (Dad and Mom) of three children, was focused on child support, custody, and parenting time.
- Dad is the sole owner of SGC, a manufacturer of equipment used in the aerospace industry.
- SGC is operated as an S Corporation for federal tax purposes – that is, its income is "passed through" and taxed to Dad individually, whether actually distributed to him or not.
- The Friend of the Court (FOC) conducted an evidentiary hearing and made a recommendation based on testimony of Mom's CPA expert regarding Dad's "money … available for support."
- Included in the FOC's determination of Dad's funds available for support were:
  - His W-2 income;
  - Various perks paid by SGC on his behalf;
  - All distributions he received from SGC, some of which were, evidently, made to provide Dad funds to pay the tax on undistributed SGC income; and
  - SGC's "excess working capital" – that is, funds retained by SGC in excess of what the company needed to operate the business. The excess working capital was determined by application of (1) a formula used in some federal tax cases and (2) the CPA's judgment.
- The trial court adopted the FOC's recommendation.
- Dad appealed objecting, in pertinent part, to the inclusion of funds he allegedly had available for support as (1) excess working capital and (2) SGC distributions to pay tax on undistributed income, for the following reasons:

1. **Excess Working Capital** – SGC was "capital intensive" and had to regularly purchase new equipment to remain competitive. Historically, such purchases were made with cash retained by the company. The amount of cash maintained by SGC was approximately the same year to year. Thus, the so-called excess working capital in fact consisted of funds that would similarly be used to acquire new equipment, continuing a long established SGC operating practice.
2. **Distributions to Pay Tax on "Pass-Through," Undistributed Income—**Distributions to pay tax on SGC income taxable to— but not received by—Dad were simply not funds available to him for support. Since the money was paid to federal and state tax authorities, it clearly was not "available" to him.

Court of Appeals Decision

In a published split opinion, the Court of Appeals (Court) agreed with Dad on the two issues noted above.

Excess Working Capital

The Court referenced the Michigan Child Support Formula Manual (MCSFM) in which it is stated that "income (or losses) from a corporation should be carefully examined to determine the extent to which they were **historically** passed on to the parent." (Emphasis added.)

One reason for the historical analysis is to determine if there has been a deviation from past practice of "passing" income to a parent to shield money from consideration for child support purposes.

But, the Court indicated, if there has been no change in a corporation's established practice in retaining vs. distributing cash reserves for reasonable business purposes, the MCSFM does not mandate imposition of "one reasonable business model over another, and it does not necessitate the revamping of a parent's reasonable and historical business practices in favor of alternative methods in which a corporation *could* theoretically be run in order to make additional funds available."

Thus, the Court ruled that it was error for the trial court to rely on the expert's opinion, which was not based on how SGC was historically operated but, essentially, on an alternative business model posited by the expert.

Distributions to Pay Tax on "Pass-Through," Undistributed Income

The Court reversed the lower court on this issue as well, ruling – " [i]t is clear that funds distributed for payment of taxes on earnings retained by the corporation are not an indication of what the parent has, or should have, available for child support."

Judge Hood's Dissent

Judge Hood disagreed with the majority opinion.

Excess Working Capital

Judge Hood stated that the majority too narrowly interprets MCSFM by ruling that undistributed S Corporation income cannot be included in a parent's income for support unless there has been a reduction in distributions to the parent relative to past practice.

By doing so, Judge Hood stated, "the majority overlooks other relevant factors that should be considered when considering undistributed income in an S Corporation and limits the purpose of the MCSFM, which is not to protect business owners, but to determine the amount of income *available for child support."*

Judge Hood went on to state, "I would adopt a case-by-case, fact-specific inquiry that is not limited to situations where there is evidence of reduction in distributions compared to historical practices."

Distributions to Pay Tax on "Pass-Through," Undistributed Income

Judge Hood noted that Dad had stipulated to inclusion in his income of "funds distributed to plaintiff for payment of taxes arising from SGC's corporate earnings." Thus, she believes Dad is precluded from raising this issue on appeal.

But, it is not clear that Dad's stipulation related to *undistributed* corporate earnings. There is no question that distributions for tax on distributed corporate earnings are includable in income for support.

Comments on the Case

General

Whenever a parent with child support obligations owns a controlling interest in a business, determining the parent's income *available* for support should be done, as Judge Hood's dissent indicates, on a "case-by-case, fact-specific" basis.

This applies whether the business is operated as a sole proprietorship, partnership, LLC, S Corporation, or a regular corporation. One obvious reason for this is that an owner in control can manipulate amounts and/or timing of salary payments and distributions of business earnings.

In this regard, MCSFM 2.01(E)(2) provides that "it may be necessary to examine business tax returns, balance sheets, accounting or banking records, and other business documents to identify any additional monies a parent has available for support that were not included as personal income."

In *Diez v Davey,* Mom's expert did just that. He examined SGC's balance sheet and determined, based in part on his judgment, that the company could afford to distribute more of its earnings to Dad.

However, it can also cut the other way – that is, "money available" may be less than "personal income." A business may have to make payments on debts (e.g., an equipment loan) that are not deductible in determining income, but which require cash that is, consequently, not available to the owner-parent.

Perhaps the most salient statement in MCSFM is 2.01(B) – "All relevant aspects of a parent's financial status are open for consideration when determining support." In other words, as with so many determinations in divorce, determining a business owner's money available for support should be case specific, based on the particular facts and circumstances of the parent, including the money available from, or needed by, the parent's business.

Deviation from Past Practice Re Distributing vs. Retaining Corporate Earnings

In her dissent, Judge Hood stated that the majority placed too much emphasis on SGC's historical distributions to Dad and, hence, gave too little regard to the other considerations relevant to determining money available for support.

The lack of deviation from past practice does, generally, indicate the owner-parent is not manipulating salary or distributions to reduce income available for support. But, as Judge Hood maintained, that does not necessarily mean that, based on "all relevant aspects of a parent's financial status" in relation to his/her child support obligation, that past practice of

retaining earnings should arbitrarily limit the owner-parent's money available for support from the business.

"Arbitrary" application of rules is often out of step with the case-specific nature of divorce.

Correspondingly, arbitrary imposition of a business model on an owner-parent presently using another acceptable business model is similarly inappropriate. This is what the majority objected to in *Diez v Davey.* The Court found that SGC had sound business reasons for retaining earnings in excess of amounts indicated as reasonable under the alternative business model Mom's expert presented.

So, while past practices regarding salary and distributions are certainly relevant, they should not, on a "bright line" basis, give rise to:

- An automatic assumption that departure from past practice is not justified under the circumstances – Judge Hood's point.
- Or, dismissal or disregard of the past practices simply because they differ from another business model – the majority's point.

Rather, all relevant factors concerning the owner-parent's money available for support from a business should be considered, taking both past practices and other considerations germane to determining money available into account.

S Corporation Distributions to Pay tax on Undistributed Income

As has been previously indicated in this column, many S Corporations limit distributions to shareholders to amounts needed to cover tax on undistributed pass-through income. This is frequently done because the businesses need to retain funds for operations.

In such instances, the distribution is not money available for support since it is used to pay federal and state income taxes.

An illustration of various scenarios concerning this issue will be presented in a forthcoming column.

About the Author

Joe Cunningham *has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy though his practice is statewide.*