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CALCULATION OF CHILD SUPPORT AMOUNTS IN NORTH DAKOTA WHEN OBLIGORS ARE BUSINESS OWNERS

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I. INTRODUCTION

In 1989, the North Dakota Legislature directed the Department of Human Services (DHS) to create child support guidelines.¹ The guidelines were created "to assist courts in determining the amount that a parent should be expected to contribute toward the support of a child"² DHS issued child support guidelines which became effective on February 1, 1991.³ DHS amended the guidelines once,⁴ and is currently engaged in rulemaking proceedings to amend the guidelines a second time.⁵ This article discusses how existing guidelines determine the amount of child support business owners pay, and how proposed amendments to the guidelines may impact these calculations. In addition, this article suggests how the current North Dakota child support guidelines could be changed to measure more realistically the amount of child support business owners have the ability to pay.

II. PURPOSE OF CHILD SUPPORT GUIDELINES

Congress passed the Child Support Enforcement Amendments of 1984, which required each state to establish guidelines for child support award amounts within the state.⁶ The amendment gave each state discretion to establish its guidelines by law or by judicial or administrative action.⁷ Four years later Congress passed the Family Support Act of

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1. See *Clutter v. McIntosh*, 484 N.W.2d 846, 848 (N.D. 1992).

2. N.D. CENT. CODE § 14-09-09.7(1) (Supp. 1997). See also *Clutter*, 484 N.W.2d at 848.

3. See *Clutter*, 484 N.W.2d at 848. See also N.D. ADMIN. CODE § 75-02-04.1-01 to -13 (1991).

4. The first amendments to the child support guidelines became effective January 1, 1995. See N.D. ADMIN. CODE § 75-02-04.1-01 to -13 (1995).

5. See N.D. CENT. CODE § 14-09-09.7(4) (1997). DHS issued a Notice of Intent to Amend Administrative Rules on July 31, 1998. In addition, DHS has held two public hearings on the proposed amendments to the child support guidelines. One public hearing was conducted in Fargo, N.D. on September 28, 1998 and the other was conducted in Bismarck, N.D. on September 30, 1998.

6. Child Support Enforcement Amendments of 1984, Pub. L. 98-378, 99 Stat. 1305 (codified at 42 U.S.C. § 667(a) (1991)).

7. *Id.*

1988.⁸ The Family Support Act requires states to review their guidelines at least once every four years to ensure that child support award amounts are appropriately determined.⁹ The Family Support Act also provides that the determination of an award under state guidelines in any judicial or administrative child support proceeding is presumptively correct.¹⁰ A written finding or specific finding on the record that the application of the guidelines is unjust or inappropriate based on criteria established by each state is the only way to rebut the presumption of correctness.¹¹

The purpose of the Child Support Enforcement Amendments of 1984 is to assure that all children who need assistance securing financial support from their parents receive the necessary assistance regardless of their circumstances.¹² Prior to 1984, federal law did not address the adequacy or reasonableness of the amount of child ordered by a state court.¹³ The adequacy or reasonableness of the support amount was left entirely to the discretion of each state and its courts.¹⁴ As a result, the amount of support ordered in many cases was unrealistic.¹⁵ Child support awards were frequently much lower than the amount needed to provide reasonable funds for the needs of the child in light of the obligor parent's ability to pay.¹⁶ In other situations, child support awards were unrealistically high in light of the needs of the child and the obligor parent's ability to pay.¹⁷ Congress believed that by requiring states to have guidelines, reasonable consideration would be given both to the needs of the child and the ability of the obligor parent to pay.¹⁸

Congress also recognized that the development of a court order involving child support is a complex determination requiring a court to consider many aspects of the individual circumstances of the parties involved.¹⁹ While courts need some flexibility to exercise discretion, the establishment of guidelines improves the reasonableness and equity of child support orders.²⁰ Congress urged state and local governments to focus on the vital issues of child support, child custody, visitation rights,

8. Family Support Act of 1988, Pub. L. 100-485, 102 Stat. 2343 (codified at 42 U.S.C. § 667(a) & (b) (1991)).

9. See Family Support Act of 1988 § 103, 102 Stat. at 2346 (codified at 42 U.S.C. § 667(a)). See also N.D. CENT. CODE § 14-09-09.7(4) (1997).

10. See Family Support Act of 1988 § 103, 102 Stat. at 2346 (codified at 42 U.S.C. § 667(b)).

11. *Id.*

12. S. REP. NO. 98-387, at 1 (1984), reprinted in 1984 U.S.C.C.A.N. 2397.

13. *Id.* at 40, reprinted in 1984 U.S.C.C.A.N. 2397, 2436.

14. *Id.* at 40, reprinted in 1984 U.S.C.C.A.N. 2397, 2436.

15. *Id.* at 40, reprinted in 1984 U.S.C.C.A.N. 2397, 2436.

16. *Id.* at 40, reprinted in 1984 U.S.C.C.A.N. 2397, 2436.

17. *Id.* at 40, reprinted in 1984 U.S.C.C.A.N. 2397, 2436.

18. *Id.* at 40, reprinted in 1984 U.S.C.C.A.N. 2397, 2436.

19. *Id.* at 40, reprinted in 1984 U.S.C.C.A.N. 2397, 2436.

20. *Id.* at 40, reprinted in 1984 U.S.C.C.A.N. 2397, 2436.

and other related domestic issues, noting that a mutual recognition of the needs of all parties involved in divorce actions will greatly enhance the health and welfare of America's children and families.²¹

It seems clear that what Congress had in mind by requiring each state to establish child support guidelines was improving the reasonableness and equity of child support awards in every state. It intended the guidelines to be uniformly applied so that a child support award amount would balance the needs of the children and the ability of the obligor parent to pay. In other words, a child support award determined under North Dakota's guidelines should treat both children and parents fairly by striking a balance between the children's needs and the obligor parent's ability to pay.²²

III. IMPACT OF CURRENT NORTH DAKOTA CHILD SUPPORT GUIDELINES ON OBLIGORS WHO ARE BUSINESS OWNERS

A. CHILD SUPPORT OBLIGATION FORMULA PRESCRIBED BY CURRENT GUIDELINES

The first step in determining the child support obligation of an obligor who is a business owner is to calculate his or her gross income.²³ Gross income is broadly defined in the guidelines and includes net income from self-employment.²⁴ Net income from self-employment is

21. *Id.* at 42, reprinted in 1984 U.S.C.C.A.N. 2397, 2438.

22. In cases where the child support guidelines do not establish the amount of child support, the North Dakota Supreme Court has held that the trial court should decide the amount of support "by striking a balance between the needs of the children and the ability of the noncustodial parent to pay." *Bergman v. Bergman*, 486 N.W.2d 243, 246 (N.D. 1992). See also *Shaver v. Kopp*, 545 N.W.2d 170, 177 (N.D. 1996).

23. See *Mahoney v. Mahoney*, 567 N.W.2d 206, 209 (N.D. 1997).

24. See *Dalin v. Dalin*, 545 N.W.2d 785, 789 (N.D. 1996). Section 75-02-04.1-01(5) of the North Dakota Administrative Code states that:

'[g]ross income' means income from any source, in any form, but does not mean benefits received from means tested public assistance programs such as aid to families with dependent children, supplemental security income, and food stamps. Gross income includes salaries, wages, overtime wages, commissions, bonuses, deferred income, dividends, severance pay, pensions, interest, trust income, annuities income, capital gains, social security benefits, workers' compensation benefits, veterans' benefits (including gratuitous benefits), gifts and prizes to the extent each exceeds one thousand dollars in value, spousal support payments received, cash value of in-kind income received on a regular basis, children's benefits, income imputed based upon earning capacity, military subsistence payments, and net income from self-employment.

N.D. ADMIN. CODE § 75-02-04.1-01(5) (1995).

The term "gross income" is not defined in chapter 14-09 of the North Dakota Century Code, which deals with relations between a parent and child. However, the term "income" is broadly defined in section 14-09-09.10(8) of the North Dakota Century Code as "any form of payment, regardless of source, owed to an obligor, including any earned, unearned, taxable or nontaxable income, workers' compensation, disability benefits, unemployment compensation benefits, annuity and retirement benefits, but excluding public assistance benefits administered under state law." N.D.

defined in the guidelines as "gross income of any organization or entity which employs the obligor, but which the obligor is to a significant extent able to control, less actual expenditures attributable to the cost of producing income to that organization or entity."²⁵ The guidelines also provide that

[i]ncome must be documented through the use of tax returns, current wage statements, and other information sufficiently to fully apprise the court of all gross income. Where gross income is subject to fluctuation, particularly in instances involving self-employment, information reflecting and covering a period of time sufficient to reveal the likely extent of fluctuations must be provided.²⁶

To arrive at net income from self-employment, actual expenditures attributable to the cost of producing income are subtracted from gross income.²⁷ The determination of net income from self-employment is complicated, so the guidelines describe the calculation in detail.²⁸ The guidelines start by explaining that the expenses attributable to the cost of producing income vary from business to business.²⁹ The guidelines seem to embrace the Internal Revenue Code's definition of "adjusted gross income" by stating that "[d]educting expenses from the gross income of the business determines the adjusted gross income, according to internal revenue service terminology."³⁰ However, the guidelines also require courts to use a profit and loss statement of the business if the latest tax return is unavailable or does not reasonably reflect income.³¹

After the adjusted gross income from self-employment is determined, the guidelines state that "all business expenses allowed for taxation purposes, but which do not require actual expenditures, such as depreciation, must be added to determine net income from self-employment."³² In addition, the guidelines provide that "[b]usiness costs actually incurred and paid, but not expensed for internal revenue service purposes, such as principal payments on business loans (to the extent

CENT. CODE § 14-09-09.10(8) (Supp. 1997). Thus, it appears that the drafters of the guidelines broadly defined "gross income" to be consistent with the broad definition of income in chapter 14-09 of the North Dakota Century Code.

25. N.D. ADMIN. CODE § 75-02-04.1-01(8) (1995).

26. N.D. ADMIN. CODE § 75-02-04.1-02(7) (1995). See also *Dalin v. Dalin*, 545 N.W.2d 785, 788 (N.D. 1996).

27. See N.D. ADMIN. CODE § 75-02-04.1-01(8) (1995).

28. See N.D. ADMIN. CODE § 75-02-04.1-05 (1995).

29. See N.D. ADMIN. CODE § 75-02-04.1-05(1) (1995).

30. *Id.* For federal income tax purposes, adjusted gross income generally means "gross income minus . . . [t]he deductions . . . which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee." I.R.C. § 62(a) (West Supp. 1998).

31. N.D. ADMIN. CODE § 75-02-04.1-05(1) (1995).

32. N.D. ADMIN. CODE § 75-02-04.1-05(2) (1995).

there is a net reduction in total principal obligations incurred in purchasing depreciable assets), may be deducted to determine net income from self-employment.”³³

Once net income from self-employment of a business owner obligor is determined, it becomes one of the income sources included in his or her gross income.³⁴ In other words, gross income is the sum of the obligor’s various income sources, which for a business owner includes net income from self-employment.³⁵

Generally, if an obligor remarries, the income of the new spouse is not considered an income source for the obligor.³⁶ However, if the obligor is a principal owner in a business, and the business employs his or her new spouse, the income of the new spouse may be considered an income source of the obligor.³⁷ The new spouse’s income is included as an income source of the obligor if the obligor significantly controls the income of the new spouse.³⁸

After gross income of the obligor is determined, certain expenses are deducted to arrive at net income of the obligor.³⁹ The obligor’s annual net income is then divided by twelve, resulting in the obligor’s monthly net income.⁴⁰ The amount of child support an obligor is

33. *Id.*

34. *See Dalin v. Dalin*, 545 N.W.2d 785, 789 (N.D. 1996); *Wilhelm v. Wilhelm*, 543 N.W.2d 488, 490 (N.D. 1996).

35. *See* N.D. ADMIN. CODE § 75-02-04.1-01(5) (1995).

36. *See* N.D. ADMIN. CODE § 75-02-04.1-08 (1995).

37. *Id.*

38. *Id.*

39. *See Dalin*, 545 N.W.2d at 789. *See also* N.D. ADMIN. CODE § 75-02-04.1-01(7) (1995). The administrative code states that:

‘[n]et income’ means total gross monthly income less:

- a. Federal income tax obligation based on application of standard deductions and tax tables;
- b. State income tax obligation based on application of standard deductions and tax tables;
- c. Federal Insurance Contributions Act (FICA) and medicare deductions or obligations;
- d. A portion of premium payments, made by the person whose income is being determined, for health insurance policies of health service contracts, intended to afford coverage for the child or children for whom support is being sought, determined by dividing the payment by the total number of persons covered and multiplying the result times the number of such children;
- e. Payments made on actual medical expenses of the child or children for whom support is being sought;
- f. Union dues where required as a condition of employment;
- g. Employee retirement contributions, deducted from the employee’s compensation, other than FICA, where required as a condition of employment; and
- h. Employee expenses for special equipment or clothing required as a condition of employment or for lodging expenses incurred when engaged in travel required as a condition of employment (limited to thirty dollars per night or actual lodging costs, whichever is less), incurred on a regular basis, but not reimbursed by the employer.

Id.

40. N.D. ADMIN CODE § 75-02-04.1-02(6) (1995). *See also Dalin*, 545 N.W.2d at 789.

required to pay is a function of his or her monthly net income and the number of children for whom support is sought.⁴¹

The calculation of the amount of child support under the guidelines is presumed to be correct.⁴² The presumption may only be rebutted by a preponderance of the evidence that establishes the amount calculated under the guidelines is incorrect, based on criteria that take into account the best interests of the child.⁴³ These criteria are set forth in the guidelines.⁴⁴

B. INTERPRETATION OF CURRENT CHILD SUPPORT OBLIGATION FORMULA BY NORTH DAKOTA COURTS

How to apply the child support obligation formula currently set forth in the guidelines to business owners has not been an easy question for North Dakota courts to answer. The North Dakota Supreme Court has pointed out that "[a] finding of net income is essential to a proper determination of the correct amount of child support."⁴⁵ However, because of the difficulty of calculating net income of a business owner, the court has remanded several cases back to trial courts to correctly determine net income.⁴⁶ In remanding one case, the court noted,

41. See N.D. ADMIN. CODE § 75-02-04.1-10 (1995).

42. See *Montgomery v. Montgomery*, 481 N.W.2d 234, 235 (N.D. 1992). In addition, N.D. ADMIN. CODE § 75-02-04.1-09(1) (1995) states, "The child support amount provided for under this chapter . . . is presumed to be the correct amount of child support."

43. See N.D.CENT. CODE § 14-09-09.7(3) (Supp. 1997); *Montgomery*, 481 N.W.2d at 235.

44. Section 75-02-04.1-09(1) of the North Dakota Administrative Code states that the presumption of correctness of the child support amount may be rebutted based upon:

- a. The subsistence needs, work expenses, and daily living expenses of the obligor; or
- b. The income of the obligee, which is reflected in a substantial monetary and nonmonetary contribution to the child's basic care and needs by virtue of being a custodial parent.

N.D. ADMIN. CODE § 75-02-04.1-09(1).

Furthermore, section 75-02-04.1-09(2) of the North Dakota Administrative Code adds that the presumption of correctness of the child support amount is rebutted only if a preponderance of the evidence establishes that a deviation from the guidelines is in the best interests of the supported children and one of the following is true: 1) more than six children are being supported; 2) the obligor has a monthly net income which exceeds \$10,000; 3) an increased need arises from educational costs of children at private schools if the obligor has consented to the private education in writing; 4) an increased need arises from children with disabling conditions or chronic illness; 5) an increased need arises from children age twelve and older; 6) an increased need arises from children who need child care due to the custodial parent's employment, job search, education, or training; 7) an obligor has the increased ability to provide child support because of additional income from assets; 8) an obligor has the increased ability to provide child support because he or she has purchased an asset to reduce his or her income available to make child support payments; 8) an obligor has the reduced ability to provide child support due to travel and expenses incurred to visit the supported child; 9) an obligor has the reduced ability to pay child support due to a situation over which the obligor has no control, which requires the obligor to incur expenses which are not otherwise described; or 10) an obligor has the reduced ability to pay child support due to the obligor's health care needs. *Id.*

45. See *Shaver v. Kopp*, 545 N.W.2d 170, 174 (N.D. 1996).

46. *Mahoney v. Mahoney*, 538 N.W.2d 189, 197 (N.D. 1995). See also *Dalin v. Dalin*, 545 N.W.2d 785, 789 (N.D. 1996); *Quamme v. Bellino*, 540 N.W.2d 142, 148 (N.D. 1995).

[T]he [trial] court did not coherently assemble facts and figures from the evidence to determine [the obligor's] net income but, instead, took at face value a figure from [an expert] Because the expert's calculations and adjustments were not consistent with the guidelines, the trial court should not have adopted the expert's conclusions.⁴⁷

To understand the difficulty of correctly calculating net income for business owners under the current guidelines, it is useful to examine a sample of existing case law.

1. *Quamme v. Bellino*

In *Quamme v. Bellino*,⁴⁸ the obligee moved to amend the child support provisions of the original divorce judgment.⁴⁹ At the time of the divorce, the obligor was a self-employed dentist.⁵⁰ After the divorce, the obligor incorporated his dental practice.⁵¹ By incorporating and paying himself a salary, the obligor was able to reduce his net income for federal income tax purposes from \$71,000 as a sole proprietor to \$46,000 as an employee.⁵² In addition, the corporation hired the obligor's new wife and paid her a salary, which the corporation then deducted.⁵³ The obligee argued that the trial court incorrectly calculated the obligor's income for child support purposes.⁵⁴

The trial court used the average monthly income of the obligor for the three years preceding incorporation and the average net income of the obligor for the two years following incorporation to determine the obligor's income for child support purposes.⁵⁵ The trial court specifically found that the obligor had been able to reduce his net monthly income by incorporating his dental practice.⁵⁶ However, there was no indication that the trial court calculated the obligor's net income after incorporation on anything other than the salary the obligor chose to pay himself.⁵⁷

The North Dakota Supreme Court held that the trial court committed clear error by failing to include the corporation's entire revenues in

47. *Mahoney*, 538 N.W.2d at 194.

48. 540 N.W.2d 142 (N.D. 1995).

49. *Quamme v. Bellino*, 540 N.W.2d 142, 144 (N.D. 1995).

50. *Id.* at 144.

51. *Id.* at 145.

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.* at 145-46.

the child support obligation calculation.⁵⁸ The supreme court stressed that including the entire business revenues of the corporation is necessary under the guidelines when the obligor significantly controls the business.⁵⁹ The court stated that the guidelines require consideration of the gross income of the business, rather than what an individual obligor chooses his personal income to be.⁶⁰ The court also noted that when an obligor is the sole stockholder of several corporations and determines his or her own salary, it is appropriate to pierce the corporate veil and include the income of the related corporations in determining the obligor's earning capacity.⁶¹

The trial court also did not include in the obligor's income the salary the corporation paid to the obligor's new wife.⁶² The supreme court held that the exclusion of the new wife's salary from the obligor's income was also clear error.⁶³

2. *Edwards v. Edwards*

In *Edwards v. Edwards*,⁶⁴ the obligee filed a motion requesting the trial court to amend the original divorce judgment to require the obligor to pay child support for the only child born of the marriage.⁶⁵ The trial court entered an amended judgment requiring the obligor to pay child support.⁶⁶ The obligee appealed the trial court's decision.⁶⁷ On appeal, the obligee asserted the trial court erred in determining the amount of child support.⁶⁸ When the motion was originally filed with the trial court, the obligor was employed by a business and earned \$18,000 annually, or \$1,500 per month.⁶⁹ Shortly thereafter, the obligor purchased the business and began operating it as a sole proprietor.⁷⁰ The obligor had no earnings or profits from the business during the current year and was uncertain when the business would generate a profit.⁷¹

58. *Id.* at 146.

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. 563 N.W.2d 394 (N.D. 1997).

65. *Edwards v. Edwards*, 563 N.W.2d 394, 395 (N.D. 1997).

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.* at 396.

70. *Id.*

71. *Id.*

The trial court did not attribute any income to the obligor from the sole proprietorship and refused to include his prior salary in income.⁷² The trial court stated, "[I]t is neither fair, equitable, or reasonable to take into consideration the monthly income of \$1,500 per month that [the obligor] used to make as an employee . . . , since he no longer receives such a monthly pay check."⁷³

The North Dakota Supreme Court held that the trial court's refusal to impute income to the obligor was clearly erroneous.⁷⁴ The court pointed out that under current guidelines, a party's ability to pay child support is not determined solely by actual income.⁷⁵ Income based on prior earning history may also be imputed in calculating the obligation.⁷⁶ Accordingly, the court in *Edwards* imputed an annual income of \$18,000 to the obligor.⁷⁷

The obligor in *Edwards* also had a farm operation.⁷⁸ At the beginning of the year, he had an existing equipment loan with a balance owing of \$33,234.⁷⁹ During the year, he borrowed an additional \$49,700 for equipment purchases and made payments on the equipment loans totaling \$56,234.⁸⁰ The trial court applied the guidelines and reduced the obligor's farm income by \$26,700 (\$33,234 beginning loan balance + \$49,700 additional loans - \$56,234 loan payments).⁸¹

On appeal, the supreme court held that the trial court misapplied the guidelines.⁸² The court stated that the guidelines do not provide for a deduction of the outstanding loan balance.⁸³ Instead, they allow a deduction of principal payments if the payments result in a net reduction of outstanding principal.⁸⁴ The court concluded that the obligor's net farm income should have been reduced by \$6,534 rather than \$26,700.⁸⁵ The supreme court arrived at \$6,534 by taking the difference between the obligor's additional borrowing of \$49,700 and his total loan repayments for the year of \$56,234.⁸⁶

72. *Id.*

73. *Id.*

74. *Id.* at 397.

75. *Id.* at 396.

76. *Id.*

77. *Id.* at 397.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* at 397-98.

85. *Id.* at 398.

86. *Id.*

3. *Hieb v. Hieb*

In *Hieb v. Hieb*,⁸⁷ the obligor appealed from an amended judgment setting the child support amount.⁸⁸ He claimed the trial court erred in calculating his net income under the guidelines.⁸⁹ The obligor was a self-employed truck driver.⁹⁰ The trial court received three years of the obligor's tax returns into evidence and made a determination of his average monthly income over that period.⁹¹ The trial court added back (or included) in income amounts that the obligor deducted and claimed as business meal expenses for federal income tax purposes.⁹² The trial court reasoned that these expenses were personal living expenses which should not be subtracted in arriving at monthly income.⁹³

On appeal, the obligor argued that he should be entitled to deduct 100% of his meal expenses in calculating his net income for child support purposes.⁹⁴ The North Dakota Supreme Court disagreed with this argument.⁹⁵ First, it noted that the guidelines specifically provide that business expenses should be deducted from gross income "according to internal revenue service terminology" in determining net income from self-employment.⁹⁶ The court also pointed out that it has held that income determinations for taxation purposes are not conclusive for determination of income for child support purposes.⁹⁷ Finally, the supreme court took judicial notice of the fact that the drafters of the guidelines specifically rejected an across-the-board adherence to internal revenue service definitions.⁹⁸

The court's opinion focused on the language used in the guidelines.⁹⁹ Specifically, the guidelines provide that "[b]usiness costs actually incurred and paid, but not expensed for internal revenue service purposes, . . . may be deducted to determine net income from self-employment."¹⁰⁰ The court noted that the word "may" creates a non-mandatory duty or confers a privilege.¹⁰¹ Further, the court stated that it found nothing in the guidelines or their history which indicated

87. 568 N.W.2d 598 (N.D. 1997).

88. *Hieb v. Hieb*, 568 N.W.2d 598, 599 (N.D. 1997).

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at 600. See also N.D. ADMIN. CODE § 75-02-04.1-05(1) (1995).

97. *Hieb*, 568 N.W.2d at 601. See also *Longtine v. Yeado*, 567 N.W.2d 819, 823 (N.D. 1997).

98. *Hieb*, 568 N.W.2d at 601.

99. *Id.*

100. *Id.* See also N.D. ADMIN. CODE § 75-02-04.1-05(2) (1995).

101. *Hieb*, 568 N.W.2d at 602.

DHS intended "may" to be given any interpretation other than permissive.¹⁰² Thus, the supreme court concluded, the guidelines do not require courts to deduct business meal expenses in arriving at net income from self-employment for purposes of child support.¹⁰³

However, the supreme court did not feel compelled to allow the obligor to deduct 100% of his business meal expenses.¹⁰⁴ Nor did the supreme court feel compelled to affirm the trial court, which did not allow any of the obligor's business meal expenses to be deducted.¹⁰⁵ Instead, the supreme court allowed the obligor to deduct 50% of the per diem meal allowance in determining his net income from self-employment.¹⁰⁶

As the cases above demonstrate, there is no doubt that North Dakota trial courts have struggled with the determination of net income for child support purposes when obligors are business owners.¹⁰⁷ The guidelines do assist courts in determining net income from self-employment, but because of the complexity of the formula, confusion still exists. DHS is currently engaged in rulemaking proceedings to amend the guidelines.¹⁰⁸ The impact of these proposed amendments on business owners is discussed next.

IV. IMPACT OF PROPOSED AMENDMENTS TO NORTH DAKOTA CHILD SUPPORT GUIDELINES ON OBLIGORS WHO ARE BUSINESS OWNERS

The proposed amendments to the guidelines slightly modify the definition of net income from self-employment.¹⁰⁹ Under the proposed

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

107. *See Dalin v. Dalin*, 545 N.W.2d 785, 788 (N.D. 1996) (holding that trial court's adoption of self-employed farmer's calculation of net income without question was clearly erroneous); *Smith v. Smith*, 538 N.W.2d 222, 228 (N.D. 1995) (holding obligor could not deduct principal payments for claimed business loans in determining net income absent sufficient documentation, and obligee was entitled to discovery on extent of obligor's interest in corporation owned by obligor's new spouse); *Mahoney v. Mahoney*, 538 N.W.2d 189, 194-95 (N.D. 1995) (holding the findings of the trial court on the calculation of a self-employed physician were clearly erroneous because the court did not coherently assemble facts and figures from the evidence to determine net income, but instead took at face value a figure from an expert); *Heley v. Heley*, 506 N.W.2d 715, 721 (N.D. 1993) (holding that trial court erred in allowing obligor to deduct principal payment to his father in calculating net income from self-employment); *Houmann v. Houmann*, 499 N.W.2d 593, 594 (N.D. 1993) (holding that trial court incorrectly calculated net income of a self-employed farmer by failing to include (add) depreciation as part of his net income from self employment); *Zacher v. Zacher*, 493 N.W.2d 704, 706-07 (N.D. 1992) (holding trial court's explanation that it departed from guideline amounts due to the fluctuating income of self-employed farmer was inadequate and constituted clear error); *Clutter v. McIntosh*, 484 N.W.2d 846, 850 (N.D. 1992) (holding that referee's finding of income of a business owner was not clearly erroneous).

108. *See supra* note 5 and accompanying text.

109. *See* N.D. ADMIN. CODE § 75-02-04.1-01(8) (proposed July 31, 1998) (providing that "[n]et

amendments, net income from self-employment includes "distributed or undistributed" gross income of "any organization or entity which the obligor is to a significant extent able to directly or indirectly control"110 In addition, "specified" rather than "actual" expenditures of the organization or entity are subtracted from gross income.¹¹¹

The proposed amendments significantly change how net income from self-employment is calculated.¹¹² First, they clearly adopt the Internal Revenue Code's definition of adjusted gross income by requiring expenses attributable to the cost of producing business income to be deducted from gross income.¹¹³ However, the proposed amendments deviate from the Internal Revenue Code in one respect. In arriving at adjusted gross income, the proposed amendments prohibit the deduction allowed by section 179 of the Internal Revenue Code.¹¹⁴ This section allows a taxpayer to elect to expense certain depreciable business assets.¹¹⁵ In 1999, the maximum amount that a taxpayer may elect to expense under this section is \$19,000.¹¹⁶

Second, the proposed amendments eliminate the requirement that business expenses not requiring actual cash expenditures be added back to arrive at net income.¹¹⁷ In other words, the proposed amendments delete the requirement that depreciation be added back to adjusted gross income in arriving at net income from self-employment.

Third, the provision allowing a deduction for business costs incurred and paid, but not expensed for federal tax purposes, has also been eliminated.¹¹⁸ Thus, the proposed amendments delete the provision allowing courts to reduce adjusted gross income by principal loan payments when there is a net reduction in total principal owed.

income' from self-employment means gross income, whether distributed or undistributed, of any organization or entity which the obligor is to a significant extent able to directly or indirectly control, less specified expenditures attributable to the cost of producing income to that organization or entity").

110. *See id.*

111. *Id.*

112. *See* N.D. ADMIN. CODE § 75-02-04.1-05 (proposed July 31, 1998).

113. *See* N.D. ADMIN. CODE § 75-02-04.1-05(1) (proposed July 31, 1998). The text of this proposed amendment provides that:

[e]xcept for elections to expense certain depreciable business assets under internal revenue code section 179 [26 U.S.C. § 179], expenses attributable to the cost of producing business or rental income must be allowed as a deduction from gross income in the same amount as allowed as a deduction in arriving at adjusted gross income for federal income tax purposes.

Id.

114. *See* N.D. ADMIN. CODE § 75-02-04.1-05(1) (proposed July 31, 1998).

115. *See* I.R.C. § 179(a) (West Supp. 1998).

116. *See* I.R.C. § 179(b)(1) (West Supp. 1998).

117. *See* N.D. ADMIN. CODE § 75-02-04.1-05 (proposed July 31, 1998). Under the proposed amendments, current North Dakota Administrative Code section 75-02-04.1-05(2) is deleted and replaced with the last sentence of current North Dakota Administrative Code section 75-02-04.1-05(1).

118. N.D. ADMIN. CODE § 75-02-04.1-05 (proposed July 31, 1998).

Fourth, the drafters of the proposed amendments must have perceived an abuse by obligors in the area of deferred income. The proposed amendments state that “[n]on-farm business[es] may be able to delay the receipt of income into a later year or years.”¹¹⁹ As a result, the proposed amendments require an “increase in value of deferred income . . . [to] be added to net income from self-employment if the amount of deferred income exceeds one hundred twenty-five percent of the previous year’s deferred income.”¹²⁰

Fifth, the proposed amendments add a new income source, “net income from rents.”¹²¹ Although the phrase “net income from rents” is not specifically defined, the proposed amendments do provide that:

net income from rents is equal to the net income of the obligor’s rental property reduced by an amount the obligor shows must be paid to some other interest holder (except a lender):

- a. As a matter of law; or
- b. Under an agreement if the obligor also shows the agreement was fairly negotiated at arms length.¹²²

The proposed amendments further define “obligors rental property as property held for rent by:

- a. The obligor;
- b. The obligor and others, if the property is, to a significant extent, subject to direct or indirect control by the obligor; or
- c. An organization or entity which is, to a significant extent, subject to direct or indirect control by the obligor.¹²³

The proposed amendments also increase the number of, and change the calculation of, the expenses the obligor can deduct once gross income is determined.¹²⁴ In addition, the proposed amendments create a

119. See N.D. ADMIN. CODE § 75-02-04.1-05(5) (proposed July 31, 1998).

120. *Id.*

121. See N.D. ADMIN. CODE § 75-02-04.1-01(5) (proposed July 31, 1998).

122. N.D. ADMIN. CODE § 75-03-04.1-05(6) (proposed July 31, 1998).

123. See N.D. ADMIN. CODE § 75-02-04.1-01(11) (proposed July 31, 1998).

124. See N.D. ADMIN. CODE § 75-02-04.1-01(7) (proposed July 31, 1998). As amended, this section of the North Dakota Administrative code would provide:

Net income means total gross annual income less:

- a. Federal income tax obligation based on the obligor’s actual adjusted gross income (as defined by the internal revenue code) and applying:
 - (1) The tax filing status of single;
 - (2) Tax tables for a single individual for the most recent year published by the internal revenue service;
 - (3) One exemption for the obligor; and
 - (4) One additional exemption for each child for whom the obligor may lawfully

new subsection which states, "No amount may be deducted to determine net income unless that amount is included in gross income."¹²⁵ Finally, the proposed amendments allow courts to use a formula for imputing gross income to an obligor if he or she makes a voluntary change in employment resulting in reduction of income.¹²⁶

V. PROBLEMS WITH CURRENT AND PROPOSED NORTH DAKOTA CHILD SUPPORT GUIDELINES FOR OBLIGORS WHO ARE BUSINESS OWNERS

The legislative histories of the Child Support Enforcement Amendments of 1984 and the Family Support Act of 1988 make it clear that Congress intended state guidelines to treat both children and obligor

claim an exemption.

- b. State income tax obligation equal to fourteen percent of the amount determined under subdivision a;
- c. Federal Insurance Contributions Act (FICA) and medicare deductions or obligations;
- d. A portion of premium payments, made by the person whose income is being determined, for health insurance policies or health service contracts, intended to afford coverage for the child or children for whom support is being sought, determined by dividing the payment by the total number of persons covered and multiplying the result times the number of such children;
- e. Payments made on actual medical expenses of the child or children for whom support is sought to the extent it is reasonably likely similar expenses will continue;
- f. Union dues and occupational license fees where required as a condition of employment;
- g. Employee retirement contributions, deducted from the employee's compensation, other than FICA, where required as a condition of employment;
- h. Employee expenses for special equipment or clothing required as a condition of employment or for lodging expenses incurred when engaged in travel required as a condition of employment (limited to thirty dollars per night);
- i. Employer reimbursed out-of-pocket expenses of employment, if included in gross income, but excluded from adjusted gross income on the obligor's federal income tax return;
- j. Employer provided retirement benefits and other employment benefits, if not currently received, to the extent the obligor had no significant influence or input as to whether the obligor could have currently received payment in lieu of the retirement or other employment benefit;
- k. Current income to the extent it has been included in net income in determining child support in a prior year; and
- l. Gains, to the extent they relate to elections to expense certain depreciable business assets under internal revenue code section 179 [26 U.S.C. 179], previously included in calculating net income from self-employment and considered in determining child support in a prior year.

Id.

125. *Id.* N.D. ADMIN. CODE § 75-02-04.1-02(12) (proposed July 31, 1998).

126. *See* N.D. ADMIN. CODE § 75-02-04.1-07(9) (proposed July 31, 1998). As amended, this section states,

If an obligor makes a voluntary change in employment resulting in reduction of income, monthly gross income equal to one hundred percent of the obligor's greatest average monthly earnings, in any twelve consecutive months beginning on or after thirty-six months before commencement of the proceeding before the court, for which reliable evidence is provided, less actual monthly gross earnings, may be imputed without a showing that the obligor is unemployed or underemployed.

Id.

parents fairly by striking a balance between the needs of children and the parent's ability to pay.¹²⁷ The dilemma faced by the drafters of the North Dakota guidelines is how to measure fairly the ability of an obligor parent to pay child support when he or she owns a business.

Measuring the ability of an obligor to pay child support is relatively simple when the obligor is an employee rather than a business owner. Under the guidelines, the starting point for measuring the ability of an obligor/employee to make child support payments is gross pay. The guidelines reduce gross pay by: 1) federal and state income tax; 2) Federal Insurance Contributions Act (FICA) and Medicare tax; 3) health insurance premium payments; 4) actual medical expenses of children supported; 5) union dues; and 6) required unreimbursed employee expenses.¹²⁸ It is important to note that all reductions are either tax withheld from the obligor's paycheck or cash expenditures made by the obligor. Once cash available from employment is determined, income from any other source, such as interest and dividends, is added to arrive at total cash available to pay child support. In sum, the current guidelines measure an obligor/employee's ability to pay child support using essentially the net cash flow available to an obligor/employee.

Measuring the ability of an obligor to pay child support is more complicated when the obligor is a business owner rather than an employee. The net cash flow approach used by the guidelines to measure the ability of an obligor/employee to pay child support is not the approach used by the guidelines when the obligor is a business owner. Instead, the guidelines attempt to measure the ability of a business owner to pay child support by using a combination of Internal Revenue Code concepts and cash flow concepts. Combining Internal Revenue Code concepts with cash flow concepts has created confusing terminology and child support calculations. The confusing terminology and calculations have, in turn, created difficulty for courts, attorneys and obligors.

Another factor that complicates the measurement of a business owner's ability to pay child support is that frequently the business is small and closely held. Owners often manipulate the income stream of the business to achieve the lowest combined income and payroll tax liability for the business and its owners. In other words, net income for federal income tax purposes often bears little relationship to the economic earnings and cash flow generating capacity of the business.

Finally, the current and proposed guidelines appear to be drafted with the self-employed business owner in mind. While the guidelines

127. See *supra* note 22.

128. See N.D. ADMIN. CODE § 75-02-04.1-01(7) (1995).

are fairly clear when applied to self-employed, sole proprietors, they become much more confusing when business owners transact business in forms other than sole proprietorships. In the 1990s, new and expanded business-entity choices swept the nation.¹²⁹ In North Dakota today, business owners can conduct business using separate legal entities such as C corporations. They can also conduct business using conduit entities, such as S corporations, general partnerships, limited partnerships, limited liability companies, limited liability partnerships, or limited liability limited partnerships.¹³⁰ Neither the current nor proposed guidelines take into account the numerous legal entity choices business owners have today to conduct business in North Dakota.

VI. PROPOSAL FOR DETERMINING NORTH DAKOTA CHILD SUPPORT AMOUNTS FOR OBLIGORS WHO ARE BUSINESS OWNERS

The net cash flow approach used when the obligor is an employee should be adopted and used when the obligor is a business owner. Although a net cash flow approach is not simple when the obligor is a business owner, it is the most equitable approach. Using a net cash flow approach treats both children and obligor parents fairly because it is the best measure of a business owner's ability to pay child support.

When calculating the child support obligation of a business owner, legal entities can be divided into two groups: 1) separate legal entities, such as C corporations; and 2) conduit entities such as sole proprietorships, S corporations, general partnerships, limited partnerships, limited liability companies, limited liability partnerships, and limited liability limited partnerships.¹³¹ Separate legal entities such as C corporations only affect owner cash flow when an obligor/owner receives monetary distributions from such entities. Such distributions usually take the form of salary, rents, interest, or dividends. Conduit entities, on the other hand, affect owner cash flow whether or not an obligor/owner receives monetary distributions from them. It is important to note that in conduit entities, an obligor/owner is income taxed on his or her pro rata share of net income from the business regardless of whether the obligor/owner receives cash distributions equal to his or her share of business net

129. See Mary B. Bader & David J. Hauff, *Registration and Operation of North Dakota and Minnesota Limited Liability Partnerships*, 72 N.D. L. REV. 555, 556 (1996). See also Mary B. Bader, *Organization, Operation, and Termination of North Dakota and Minnesota Limited Liability Companies*, 70 N.D. L. REV. 585, 586 (1994).

130. S. 2271 (N.D. 1999). Senate Bill 2271 was introduced in the North Dakota Legislature on January 18, 1999 and signed into law by the Governor on March 22, 1999. It created a brand new legal entity in North Dakota, the limited liability limited partnership.

131. *Id.*

income. As a result, the obligor/owner of a conduit entity is often credited with, and income taxed on, "phantom income."

A. CALCULATION OF NET CASH FLOW FROM C CORPORATIONS

As previously noted, calculating the proper amount of child support is difficult under both the current and proposed guidelines when an obligor owns a C corporation. The current and proposed guidelines both determine adjusted gross income from self-employment, and they then adjust this amount for various items to determine net income from self-employment. However, unless C corporation income is distributed in monetary form to owners, it is not reflected on the owners' individual income tax return.

The question becomes whether a controlling obligor/owner's pro rata share of C corporation net income is "net income from self-employment." In other words, is it appropriate for a court to pierce the corporate veil and include C corporation net income as part of the controlling obligor/owner's net income from self-employment? In *Quamme*, the North Dakota Supreme Court answered this question affirmatively.¹³² It is also worth noting that the proposed guidelines modify the definition of net income from self employment to include distributed or undistributed gross income of an entity the obligor is able to control.¹³³

If a C corporation's veil is pierced, the obligor/owner's gross income will include the sum of all monetary distributions (including salary, rent, interest and dividends) made to the obligor/owner plus his or her pro rata share of corporate income. However, to the extent the corporation needs to retain corporate income for business purposes and does not distribute it to an obligor/owner, he or she will be credited with gross income from the corporation but will have no cash available to pay the child support obligation.

Rather than piercing the corporate veil of a C corporation, it is more conceptually sound to calculate the net cash flow of a C corporation available to an obligor/owner to make child support payments. This method calculates the maximum amount of cash that could be distributed to the obligor/owner without interrupting business operations of the C corporation. In a closely-held C corporation, this amount of cash is known as "dividend paying capacity" or "net cash flow" of the corporation.

132. See *supra* notes 48-63 and accompanying text.

133. See *supra* notes 110-11 and accompanying text.

The formula used to calculate the net cash flow of a C corporation is set forth below:

$$\begin{aligned}
 & \text{Sales} \\
 & - \text{Cost of goods sold} \\
 & = \text{Gross profit} \\
 & - \text{Operating expenses} \\
 & = \text{Net operating income} \\
 & - \text{Interest expense} \\
 & = \text{Net income before taxes} \\
 & - \text{Corporate income tax expense} \\
 & = \text{Net income} \\
 & + \text{Non-cash expenses} \\
 & = \text{Gross cash flow} \\
 & \pm \text{Working capital needed to support operations} \\
 & = \text{Net operating cash flow} \\
 & - \text{Non-current asset purchases} \\
 & - \text{Existing loan principal payments} \\
 & + \text{New loan proceeds} \\
 & = \text{Net cash flow from C corporation}
 \end{aligned}$$

When using this formula to calculate net cash flow of a C corporation, a number of points are worth mentioning. Non-cash expenses, such as depreciation, are added to net income to determine gross cash flow. For a C corporation to continue business uninterrupted, gross cash flow plus any new loan proceeds must be sufficient to finance working capital needs, non-current asset purchases, and existing loan principal payments. The net cash flow of a C corporation can only be determined after all three of these items are appropriately financed.

When existing loan principal payments are subtracted from gross cash flow and new loan proceeds are added to gross cash flow, it must be assumed that a reasonable capital structure exists for the C corporation. The reasonableness of a C corporation's capital structure is based on the relative proportion of debt and equity used to finance the corporation's asset base. Reasonable capital structure information is available for a variety of different industries in a number of financial publications.¹³⁴ If the C corporation does not maintain a reasonable capital structure, its net cash flow is too easily affected by an obligor/owner. For example, a controlling obligor/owner could reduce net cash flow available from a C corporation simply by paying off existing corporate loans.

134. See generally ANNUAL STATEMENT STUDIES: 1998-1999 (Robert Morris & Associates eds., 1998); LEO TROY, ALMANAC OF BUSINESS AND INDUSTRIAL FINANCIAL RATIOS (Prentice Hall 29th ed. 1998); and FINANCIAL STUDIES OF THE SMALL BUSINESS (Financial Research Associates 21st ed. 1998).

Under both the current and proposed guidelines, child support obligation amounts ordinarily are based upon recent past transactions because such transactions are deemed to be reliable indicators of future circumstances.¹³⁵ For the same reasons, net cash flow of a C corporation should be calculated for the year of the divorce and, if appropriate, for some period of time preceding that year. Moreover, as under the current and proposed guidelines, if circumstances materially affecting the child support obligation amount are likely to change in the near future, consideration should be given to likely future circumstances.¹³⁶

Because of the complexity of the calculations, an expert may be needed in certain cases to calculate the net cash flow of a C corporation for the requisite time period. The disadvantage of using an expert is out-of-pocket expense to the parties. However, an expert seems warranted when amounts are material in view of the financial significance of the calculation to an obligor/owner and his or her children.

Once the net cash flow of a C corporation is determined, this amount must be adjusted to arrive at the net cash available to an obligor/owner to make child support payments. First, any monetary distributions received by the obligor/owner (including salary, rent, dividends and interest) must be added to net cash flow of the C corporation. Second, the net cash flow plus monetary distributions must be reduced by applicable obligor/owner personal income taxes to arrive at net cash available to an obligor/owner to make child support payments. The reason obligor/owner personal income taxes are a reduction in the calculation is not obvious. If an obligor/owner receives a distribution from the C corporation equal to this amount (monetary distributions plus net cash flow of the C corporation), he or she would personally have to pay income taxes on this amount. Thus, it is only after the obligor/owner's personal income taxes are subtracted that the net cash available to an obligor/owner is determined. In sum, net cash flow of the C corporation plus all monetary distributions minus obligor/owner personal income taxes is the amount of cash available to an obligor/owner to make child support payments.

B. CALCULATION OF NET CASH FLOW FROM CONDUIT ENTITIES

As previously noted, conduit entities affect the cash flow of an owner regardless of whether the owner receives a monetary distribution.

135. N.D. ADMIN. CODE § 75-02-04.1-02(7)-(8) (1995). The proposed amendments to the guidelines do not alter these provisions in the current guidelines.

136. *Id.*

Owners of conduit entities must recognize and pay personal income taxes on their pro rata share of entity income even if this income is not distributed to them. Thus, when owners recognize their pro rata share of entity income without an equal cash distribution, "phantom income" exists for income tax purposes. Phantom income is income with no associated cash receipt on which owners pay personal income taxes.

Since an owner's pro rata share of entity income is included as income on his or her personal income tax return, it appears that both the current and proposed guidelines include this amount in determining net income from self-employment. When phantom income exists, an obligor/owner will be forced to pay child support without receiving cash from the entity sufficient to pay this obligation.

As with C corporations, a better measure of the obligor/owner's ability to pay child support is the net cash flow of the conduit entity. The formula used to calculate the net cash flow of a conduit entity is set forth below:

Sales

- Cost of goods sold
- = Gross profit
- Operating expenses
- = Net operating income
- Interest expense
- = Net income
- + Non-cash expenses
- = Gross cash flow
- ± Working capital needed to support operations
- = Net operating cash flow
- Non-current asset purchases
- Existing loan principal payments
- + New loan proceeds
- = Net cash flow from conduit entity

Note that no entity income taxes are subtracted in the formula above. In a conduit entity, income taxes are not assessed at the entity level. Instead, net income flows through and is taxed to the owners of the conduit entity.

The discussion and calculations regarding net cash flow of a C corporation are for the most part also applicable to conduit entities. However, one difference is worth noting. In contrast to a C corporation, the net cash flow of a conduit entity is not reduced by the personal income taxes of the obligor/owner. The reason for the difference is that if net cash flow of a conduit entity is distributed to an obligor/owner, no

income tax would be paid by the obligor/owner unless the distribution exceeded his or her basis in the conduit entity.¹³⁷ Conduit entity owners are taxed on their share of net income, not on the monetary amount of net income distributed to them.¹³⁸ Monetary distributions to conduit entity owners are not income taxed, but instead reduce their income tax basis in the conduit entity.¹³⁹ Therefore, net cash flow of the conduit entity, with no reduction for obligor/owner personal income taxes, represents the amount of cash available to an obligor/owner of a conduit entity to make child support payments.

C. COMPARATIVE EXAMPLE

The example set forth below illustrates the calculations discussed thus far. Assume Smith, Inc. is in the retail computer industry and is organized as a C corporation. The obligor/owner of Smith, Inc. is John Smith. He owns all of the shares of stock of Smith, Inc. John Smith's only source of income is from Smith, Inc. He and his wife divorced in 1999. The effective income tax rate for Smith, Inc. is thirty percent. The effective personal income tax rate for John Smith is thirty-five percent. The sum of the existing loan principal payments and new loan proceeds (used to purchase depreciable assets) is adjusted to allow Smith, Inc. to maintain a 1.8 debt-to-equity ratio. This example assumes that a 1.8 debt to equity ratio is the industry average debt to equity ratio for retail computer businesses with \$1.0 million or less in annual sales.¹⁴⁰ John Smith's total salary for 1999, which is included in Smith, Inc.'s operating expenses, is \$75,000. Smith, Inc.'s depreciation expense, which is included in operating expenses, is \$50,000. All other amounts have been taken from Smith, Inc.'s financial statements or other accounting records.

Net cash flow of Smith, Inc. is calculated as follows:

Sales	\$1,000,000
- <u>Cost of goods sold</u>	<u>(650,000)</u>
= Gross profit	350,000
- <u>Operating expenses</u>	<u>(230,000)</u>
= Net operating income	120,000
- <u>Interest expense</u>	<u>(20,000)</u>
= Net income before taxes	100,000

137. See I.R.C. §731(a)(1) (West Supp. 1998).

138. See I.R.C. § 702 (West Supp. 1998).

139. See I.R.C. § 731(a)(1) (West Supp. 1998).

140. The average debt-to-equity ratio is taken from ANNUAL STATEMENT STUDIES: 1998-1999, *supra* note 134.

-	<u>Corporate income tax expense</u>	<u>(30,000)</u>
=	Net income	70,000
+	<u>Non-cash expenses</u>	<u>50,000</u>
=	Gross cash flow	120,000
±	<u>Working capital needed to support operations</u>	<u>(25,000)</u>
=	Net operating cash flow	95,000
-	Non-current asset purchases	40,000
-	Existing loan principal payments	(25,000)
+	<u>Projected new loans</u>	<u>20,000</u>
=	Net cash flow	50,000

Under the current guidelines, if the corporate veil of Smith, Inc. is pierced and John Smith is required to recognize his pro rata share of C corporation net income, his net income from self-employment and his net income for purposes of calculating child support amounts is as follows:¹⁴¹

John Smith's pro rata share of Smith, Inc.'s net income	\$70,000
Depreciation expense	+50,000
Net reduction in principal obligations	<u>(5,000)</u>
John Smith's net income from self-employment	\$115,000
John Smith's net income from self-employment	\$115,000
John Smith's salary	<u>+75,000</u>
John Smith's annual gross income	\$190,000
John Smith's personal income tax on salary (\$75,000)(35%) ¹⁴²	<u>(26,250)</u>
John Smith's annual net income	\$163,750

Under the proposed guidelines, if the corporate veil of Smith, Inc. is pierced and John Smith is required to recognize his or her pro rata share of C corporation net income, his net income from self-employment and his net income for purposes of calculating child support amounts is as follows:

John Smith's pro rata share of Smith, Inc. net income	\$70,000
John Smith's salary	<u>+75,000</u>
John Smith's annual gross income	145,000

141. For comparative reasons, the authors have chosen to use annual amounts rather than the monthly amounts required under the current guidelines.

142. The current guidelines do not discuss how to account for the personal income tax of the owner on corporate net income if the corporate veil is pierced. Conceptually, it would seem that a deduction would be appropriate. In the example involving Smith, Inc., John Smith's personal income tax would increase from \$26,250 to \$50,750 (\$75,000 salary + \$70,000 Smith, Inc.'s net income) x .35 (John Smith's effective tax rate), reducing his annual net income from \$163,750 to \$139,250.

John Smith's personal income tax on salary (\$75,000)(35%) ¹⁴³	<u>(26,250)</u>
John Smith's annual net income	\$118,750

If net cash flow from Smith, Inc. is used to measure John Smith's ability to pay child support, the cash available to John Smith to make child support payments is calculated as follows:

Net cash flow from Smith, Inc.	\$50,000
John Smith's salary	<u>+75,000</u>
Net cash flow from Smith, Inc. plus monetary distributions to John Smith	125,000
John Smith's personal income tax on net cash flow of Smith, Inc.(\$125,000)(35%)	<u>(43,750)</u>
Cash available to John Smith to make child support payments	\$81,250

Assume Smith, Inc. is a conduit entity, such as an S corporation, rather than a C corporation. If net cash flow from Smith, Inc. is used to measure John Smith's ability to pay child support, the cash available to John Smith to make child support payments is calculated as follows:

Net cash flow from Smith, Inc. ¹⁴⁴	\$80,000
John Smith's salary	<u>+75,000</u>
Net cash flow from Smith, Inc. plus monetary distributions to John Smith	155,000
John Smith's personal income tax on Smith, Inc. income plus his salary (\$175,000)(35%)	<u>(61,250)</u>

143. The proposed guidelines do not discuss how to account for the personal income tax of the owner on corporate net income if the corporate veil is pierced. Conceptually, it would seem that a deduction would be appropriate. In the example involving Smith, Inc., John Smith's personal income tax would increase from \$26,250 to \$50,750 ((\$75,000 salary + \$70,000 Smith, Inc.'s net income) x .35 (John Smith's effective tax rate)), reducing his annual net income from \$118,750 to \$94,250.

144. If Smith, Inc. is an S corporation, net cash flow is calculated as follows:

Sales	\$1,000,000
- Cost of goods sold	<u>(650,000)</u>
= Gross profit	350,000
- Operating expenses	<u>(230,000)</u>
= Net operating income	120,000
- Interest expense	<u>(20,000)</u>
= Net income	100,000
+ Non-cash expenses	<u>50,000</u>
= Gross cash flow	150,000
± Working capital needed to support operations	<u>(25,000)</u>
= Net operating cash flow	125,000
- Non-current asset purchases	(40,000)
- Existing loan principal payments	(25,000)
+ Projected new loans	<u>20,000</u>
Net cash flow	\$80,000

Cash available to John Smith to make child support payments¹⁴⁵ \$93,750

In the example above, if John Smith conducted business as a self-employed, sole proprietor, the cash available to him to make child support payments is \$93,750.¹⁴⁶ This is the same amount of cash available to him as the obligor/owner of an S corporation.¹⁴⁷

VII. CONCLUSION

The example above illustrates that applying either the current or proposed guidelines for business owners who are obligors is difficult because of the confusing terminology, complexity of the calculations, and unanswered questions. Moreover, the annual net income arrived at

145. The reason for the \$12,500 decrease in cash available to John Smith if he conducts business using a C corporation rather than an S corporation is a combination of two factors. First, the net cash flow from an S corporation is \$30,000 more than from a C corporation because no income tax is assessed on Smith, Inc. Second, the amount of personal income tax owed by John Smith is \$17,500 less if he conducts business using a C corporation rather than an S corporation. In this example, if Smith, Inc. is a C corporation, John Smith is deemed to pay tax of \$43,750 on \$125,000 (\$50,000 of net cash flow plus \$75,000 of salary). If Smith, Inc. is a S corporation, John Smith pays tax of \$61,250 on \$175,000 (\$100,000 of corporate net income plus \$75,000 of salary). The \$30,000 increase in net cash flow reduced by the \$17,500 of additional income tax paid or deemed paid by John Smith accounts for the \$12,500 of additional cash available to him if he conducts business using an S corporation rather than a C corporation.

146. If John Smith is a self-employed, sole proprietor, the net cash flow from the sole proprietorship would be calculated as follows:

Sales	\$1,000,000
- Cost of goods sold	(650,000)
= Gross profit	350,000
- <u>Operating expenses</u>	(155,000)
= Net operating income	195,000
- <u>Interest expense</u>	(20,000)
= Net income	175,000
+ <u>Non-cash expenses</u>	50,000
= Gross cash flow	225,000
± <u>Working capital needed to support operations</u>	(25,000)
= Net operating cash flow	200,000
- Non-current asset purchases	(40,000)
- Existing loan principal payments	(25,000)
+ <u>Projected new loans</u>	20,000
Net cash flow	\$155,000
Net cash flow from sole proprietorship	\$155,000
- <u>Obligor's personal income tax on net income</u>	(61,250)
= Cash available to obligor to make child support payments	\$93,750

The calculation of net cash available to a partner in a partnership (general, limited or limited liability) or a member of a limited liability company would be the same as the calculation for a sole proprietor except that the owner's proportionate share of entity net cash flow would be used.

147. The comparative example has intentionally omitted the calculation of payroll taxes at the owner and entity level. However, payroll taxes at the owner and entity level will impact obligor/owners of C corporations and conduit entities. Payroll taxes reduce entity net cash flow as well as the cash available to obligor/owners.

using current and proposed guidelines is not an accurate measure of the obligor/owner's ability to pay child support.

The proposed net cash flow method is consistent with the treatment of an obligor/employee under the current guidelines. More importantly, the proposed net cash flow method focuses on the cash available to a business owner, which is the most accurate way to measure the ability of the absent parent to pay child support. Although the calculations proposed are somewhat complicated, their accuracy far outweighs any additional complexity. As is currently the case, under the proposed net cash flow method, competent expert calculations and testimony may be necessary to assist courts in making an appropriate child support amount determination when the obligor is a business owner and the child support amount is material. Using a net cash flow approach to measure the ability of a business owner to pay child support treats both children and parents fairly.

