

Navigating Divorces with Small Business Income and Valuation Considerations

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Not every divorce case involves significant funds, however, many of those cases contain complications warranting a financial expert. For example, many cases involving one or both spouses with ownership interests in small businesses may have total owner earnings anywhere from \$50,000 to \$250,000. The prospect of paying legal bills may be daunting, and adding a financial expert into the mix will only add to those pressures. Notwithstanding the difficult proposition of the parties affording their bills, the presence of

even one relatively small business in the marital estate adds complexities worthy of exploration, such as:

- **Measuring income**
- **Detecting hidden income and/or assets**
- **Valuing business assets**
- **Navigating settlements and payouts**

— Measuring Income

To measure income one or both parties derives from owning a small business there are three primary components: (1) compensation expenses paid to the parties (2) net profits of the business (note: assumes a passthrough business entity), and (3) additional benefits embedded in the expenses of the business.

Compensation expenses paid to the parties are usually somewhat straight forward. This is commonly a W-2 type payroll compensation which is easily identifiable. However, in a partnership setting, this will likely instead come in the form of guaranteed payments reported on each owner's Schedule K-1 reporting document. In rare

instances, owners may take compensation as if a 1099 subcontractor, whether those instances are being properly reported or otherwise.

It is important to understand that in many instances, these compensation items have been deducted from the profits of the business. Therefore, it is generally expected that adding the parties' compensation expenses on top of their share of the business profits will generally be more representative of their total reported income from the business. An additional nuance is identifying whether the compensation expense is showing on a gross basis or is presented net of various deductions. It is important to be aware of the

substance of those deductions and how they might impact the income calculation.

Profits of the business, after paying all of expenses of the business (including any owner compensation), is another element worth exploring. There may be difficulty in simply assigning the owner's specific share of the profits – as in the instance of a partnership with variable interests. Even if the owner's share of profits can be properly measured, there may still be some question of whether the owner can extract those profits from the business (e.g., when there are other more influential owners involved, or when asset-intensive businesses fundamentally constrain cash flow availability). Furthermore, a financial expert may suggest that reasonable adjustments to the historical profit figures are needed and help to establish an ongoing expectation.

In addition to the owners' compensation and share of the profits, there may be additional discrete benefits to an owner embedded in the expenses

of the business. This can be a contentious topic. Some of these benefits may represent perfectly legal tax deductions (i.e., health insurance, business purpose vehicle expenses, among others), even when there is some potential to measure a personal benefit. In more extreme instances there could be issues of tax fraud. Regardless of legality, areas of interest often include the contents of automotive, meals, travel, entertainment, and personal legal expenses. It is also helpful to determine the owners' share of the firm's retirement contributions.

— **Detecting Hidden Income and Assets**

Financial experts can uncover hidden income and assets through meticulous analysis of business documents and financial records. If you ever wondered how you and your spouse could live an upper-middle-class life style on \$100,000 of annual income, this topic may be for you. Some of this issue may be an extension of the third component of measuring income. A somewhat extreme example would be when parties own a business that would typically report costs such as "materials" and "subcontractors," and it is later admitted that those costs contain among other more legitimate things, the parties' \$150,000 kitchen renovation.

In addition to three core components of income described above (compensation, profits, and other

embedded benefits), there may also be income entirely unreported. This might include off-book cash payments, or more easily traced payments that have simply been wiped from the accounting records. A working theory of whether something like this is going on, and a strategy to uncover such activities may be necessary. Similar to the example of the parties' kitchen renovation buried in business.

Similar to the example of the parties' kitchen renovation buried in business expenses, other business records may contain a trail towards unreported assets. For example, owners' distributions funneled into undisclosed investments, or purchases of personal hard assets buried in the business expenses.

— Valuing Business Assets

However small or large, if the parties own an interest in a business, it may be worth pursuing whether that asset is worth \$25,000, \$1,000,000, or any other number you might imagine. Pairing an expert with proper due diligence can help to gauge expectations without necessarily committing to a very formal, lengthy valuation report.

The due diligence and rough estimations might cost thousands less than what a formal written opinion will. However, whether that initial consulting on value yields a significant asset or not can provide peace of mind and ability to keep the case moving forward.



— Realities of Settling: Payouts of Asset Division and Support

Financial experts assist in setting realistic expectations for settlements and payouts. They address liquidity issues and help devise practical solutions for dividing business interests. For example, privately held business interests frequently pose a liquidity problem. The interest may be worth X dollars, but that doesn't mean X dollars are going to materialize today. So how do you split the asset today? When there are no other substantial liquid assets in the marital estate, or other offsetting assets more generally, this may necessitate an extended timeframe for payout from one party to another. This topic will often

result in questions around realistic payout timeframes, whether or not interest is charged, and if collateral/security is needed.

In addition, depending on case law and jurisdiction, there may be the perception of a double-dip, and whether that is to be avoided. The double-dip conceptually would be the use of an income stream as part of deriving an asset valuation, and then using that same income stream a second time as part of the support equation. A financial expert can help talk through this issue and what might be reasonable.

— CONCLUSION

Navigating a Costly Endeavor in Small Cases

A frequent reason divorcing parties avoid experts on small cases is the cost component. It can be a costly endeavor. However, there are a few simple strategies attorneys, and the divorcing parties can take to get the expert help warranted and also minimize costs.



Establish clear objectives

Knowing what type of help you want to receive from an expert can help narrow the scope.



Prioritize your needs

This can be a team effort between the expert, counsel, and the parties. Prioritizing needs will enable the expert to focus on the areas of the case that move the needle.



Provide an organized set of documents

Often, a costly component to performing a financial analysis is the review and preliminary analysis of document production. Whether it is receiving irrelevant documents, difficult to read documents, or documents produced in small pieces, these issues increase costs.

Financial experts can assist you regardless of the size of your matter. A consultation can provide you with guidance and the peace-of-mind your case is heading in the right direction.



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