

Forensic Puzzles

Family Law Section
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Agenda

Hidden Income
Lifestyle Analyses
Hidden Assets
Cash Businesses

- Clues
- Means
- Procedures
- Case studies

Hidden Income Clues

- Standard of living appears to exceed income.
 - Could also be funded by debt
- The level of asset purchases are higher than expected, given reported income.
 - Expensive cars, homes
- Substantial cash accumulation or spending by either party.

- Operates business inherently susceptible to cash
 - Landscaper
 - Contractor
 - Restaurant
- Less common:
 - Compensation through goods or services.

Hidden Income - How It Can be Carried Out

By Non Business Owners

- Wages
 - Paid for employment with cash - for ex., nanny
 - Payment in kind
- Deferring receipt of income

- Interest and Dividend / Capital Gain Income
 - Put savings, brokerage accounts, Certificate of Deposit (“CDs”) in another person’s name
- Rental Income
 - Non disclosure of rental income received in cash
- Other Cash Flow (not income)
 - Borrowing on a Home Equity Line of Credit to pay for living expenses

Hidden Income - How it Can Be Carried Out By Business Owners

- Perquisites - personal expenses paid by a business
- Payment in kind - for ex., general contractor or landscaper
- Deferring receipt of income

- Accepting cash from customers and not recording the income
- Shareholder loan receivable on the company's books - may be previously taxed - not on tax return
- Overpaying a vendor and getting a kickback in return
- Creating bogus vendors and expensing the payments (see example)

Forensic Puzzle #1 - the Hidden Bonus

- Lawyer at large law firm
- Income was down leading to divorce
- Divorced commenced in March

Puzzle: Did he have a bad year or was he trying to hide money?

Clues

Timing of prior bonuses - usually paid in February - none this year

Why?

Forensic Puzzle #1 - Solution

- Interviewed CFO of firm
- Inquired about payment of current year bonuses and timing
- Turned out the lawyer voluntarily deferred bonus until April (post DOC)

Next puzzle - where did it go?

- Reviewed support checks to spouse - new checking account not previously disclosed
- Subpoena sent to bank - statements obtained/reviewed
- Voila! Missing bonus found!

Forensic Puzzle #2 - the Consulting Fee Question

- Husband was a successful doctor with a large medical practice
- Wife had concerns about hidden income

Puzzle: Reviewed general ledger - saw large consulting fees paid to an unknown vendor - why?

- Found the address of the vendor in the public domain
- Turned out it was the girlfriend's house
- Vendor was a shell company used to divert money to the girlfriend

Forensic Puzzle #3 - The Back Story

- The husband is a carpenter near the Finger Lakes
- He works 40 hours per week
- He has been working in the carpentry business for the past 20 years
- He receives a W-2 from his employer, Cut A Rug, Inc. reflecting \$35,000/year

Forensic Puzzle #3 - Clues

- The family lives in a home with annual property taxes of \$5,000

Puzzle: how can they afford this obligation?

According to the wife, the family goes to the town treasurer once per quarter and pays cash for their property taxes

Forensic Puzzle #3 - A Possible Solution

Determine if the industry in which the husband works is known for paying cash wages to employees

Common industries include: Home repairs, home services, car repair services, household care services, transportation services, moving services

Review the husband's W-2 to determine his reported income.

Compare this to what he could be expected to earn

<https://www.labor.ny.gov/stats/lswage2.asp>

Forensic Puzzle #4 - The Back Story

- The wife owns three local Italian restaurants in Buffalo NY near Niagara Falls; husband does not work
- The family goes to Lake Como Italy each summer for four months and rents a modern six bedroom cottage on the lake

- The husband purchased a Maserati in Canada using Canadian dollars
- He takes his Chow Chow for weekly spa appointments

Forensic Puzzle #4 - The Back Story

- The restaurants accept payment with credit card or cash
 - Cash can be either US Dollars or Canadian Dollars
- Husband said that wife keeps Canadian Dollars in a safe
- Sales at the three stores combined total \$1.5 million sales and \$300,000 of net income
- Reported take home income by wife is \$200,000/year (wages of \$150,000 + cash distributions of \$50,000)

Forensic Puzzle #4 - Clues

- Reported take home income by wife is \$200,000/year
(wages of \$150,000 + cash distributions of \$50,000)
- The parties' lifestyle appears to exceed their income
- Large purchases made with cash

Forensic Puzzle #4 - Some Possible Solutions

Look for personal expenses paid through the business (Italian trip recorded as a business trip?)

Try to back into the solutions. Determine from review of the bank account statements that the Maserati was not purchased with money from any other source

Compare each the husband's and wife's representation of spending with income

Lifestyle Analysis

Why?

- Disconnect between reported income and lifestyle
- Educate client as to lifestyle relative to post-divorce income
- Establish basis for support
 - Family money supporting lifestyle
 - Support from trust(s)/Separate Property
 - Public servants/celebrity
- Illustrate a (sudden?) change in lifestyle
- Highlight historical items that may not/cannot continue going forward
- Anomalies, Non-recurring events

What is Needed

- Monthly or periodic statements for all accounts
 - Bank accounts, Debt, Credit Cards, Investment Accounts - Just a starting point
- Cancelled Checks

- Payee, memo entries - not evident from the statements alone
- Invoices, Receipts, Bills, Wire documentation
 - Further insight such as the address for which a utility bill was paid, men's or women's wear, source/destination of funds, etc.
- Complete Statements of Net Worth
- Tax returns, W-2s, wage statements, 1099s
- Business Records?

Forensic Puzzle # 5 - Background

- Client is anxious concerning marital vs. post-divorce lifestyle
- Client has no real understanding of lifestyle in monetary terms
- Assets comprised largely of Husband's separate property
- Will my needs be met considering likely equitable distribution and support?

Process

- Request documents
- Schedule activity

- Classify activity (typically SNW categories to begin with)
- Client input regarding activity and classification
- Remove non-recurring events/Normalize
- Pivot tables to slice and present data in useful form
- Graphic illustration
 - Spending over time
 - Categorical spending
 - Income - support and return on assets

Findings/Results

- Normalized lifestyle trending at roughly \$9,000/month
- Estimated after-tax return on investable assets of roughly \$450,000 is \$1,500/month
- Maintenance of \$7,000/month, estimated to yield \$5,600/month after tax.
- Anticipated income will not support normalized lifestyle
- Discussion as to what is necessary/what can be eliminated

- Frame maintenance/support discussions

Limitations

- ATM/Cash Withdrawals?????
- Discovery Limitations
 - Historical statements
 - Memory
- COST! - Obtain electronic records wherever possible
- Which years/number of years
- Pre-marital/post marital
- Non-recurring expenses
- Gifts between the spouses
- Client representations - he said/she said

HIDDEN ASSETS

Hidden Assets - Summary

- Hidden assets are sometimes harder to find than hidden income.
- Income from unknown sources can alert you to hidden assets

- Sometimes personal expenses can be disguised as business assets. Or personal assets can be disguised as business assets
 - For example, that machinery and equipment on the books is actually spending for the parties' daughter's wedding.
 - Personal bank account on books of business

Hidden Assets - Clues

- Review Schedule B in the parties' personal tax return (interest/dividends)
- Identify banks/brokerage firms and account #s
- Do those accounts still exist?

NOTE - careful - some interest/dividend income may be passed through from an entity and not actually received (phantom)

Other parts of a tax return to review

Income from partnerships and S-corps (Schedule E)
Rental Real Estate (Schedule E)
Sales of assets from accounts (Schedule D).

Loan applications showing assets unknown

Unlike a divorce, when someone is getting a loan, they may want to paint a bright financial picture for the lender

Consider issuing subpoena to bank (also for income)
Credit memos?

Receipts/payments from/to obscure/generic LLC
names

Credit cards are being paid, but you cannot tell
where they are being paid from.

If you have credit card statements, and cannot tell
where they are being paid from, it may be from a
hidden asset. Conversely, if you have the bank
statements and cannot match up all the credit
card payments to the credit card statements,
there could be a hidden credit card.

Large expense items (clothes, art, gift cards,
jewelry...etc.)

Note these can be converted to cash, and can be a
source of hidden assets.

Hidden Assets - How It Can Be Carried Out By Non Business Owners

Over-withholding on taxes to get a large refund
after the divorce

This should be fairly simple to detect by an accountant's review of the tax returns, assuming the return was prepared

Interest and Dividend / Capital Gain Income
Put savings, brokerage accounts, Certificate of Deposit ("CDs") in another person's name.

Hidden Assets - How It Can Be Carried Out By Business Owners

Ownership changes in a business

Confusing journal entries to move activity from 1 account to another
(more on that later)

Leaving assets or money on the books of the Company. This could be in the form of not taking distributions

Under-reporting of inventory (overstates expenses and understates income)

Forensic Puzzle #6 - the Jeweler

- Reported inventory was about \$700,000 almost every year
- Obtained average cost of a jewel - did a rough calculation how many jewels would be in inventory
- During site visit, saw many more
- From interview with wife, found alternate manual records of the jewelry and added them up
- Actual inventory = almost \$19 million!

Forensic Puzzle #7 - the Hidden Bank Account

- Company's books were audited each year
- Buried in the general ledgers was an account called "Capital One Special" that did not appear in the financials
- Turned out this was an additional bank account to fund the President's personal expenses
- Example of a journal entry for this account:

Forensic Puzzle #8 - The Equipment Manufacturer

- Reported inventory was very low

- Client indicated it was historically under reported in order to depress income
- Took the unusual step of performing an inventory count
- Many large items were not on the Company's inventory compilation
- Next question -how to value it?

Forensic Puzzle #9 - the House

- Husband bought a house for his girlfriend and had 1 of his businesses pay for it
- Because the business tax returns were on extension, it had not previously been identified as a business asset
- He denied buying the home during his EBT
- Ultimately a Private Investigator tracked them down to a home that was unfamiliar
- Subpoena then issued to bank for the Company; statements provided showing the outflow

Forensic Puzzle #10 - Business Assets that were Expensed

- The IRS permits expensing of business assets up to \$1MM (in 2019) under Section 179
- This reduces income and will not increase assets

- Review of tax returns and general ledgers can identify asset purchases - may include vehicles, machinery and other assets

Practice Tips

- Consider getting copies of prior tax returns from IRS (Form 4506)
- New York State Form DTF-505 - back to 1990
- Consider issuing subpoena to bank for loan applications and other info
- Account analysis of “in’s and out’s” can be valuable - identify transfers to unknown accounts or previously undisclosed credit cards
- UCC filings

Cash Businesses

- Restaurants/Bars
- Car Washes
- Grocery/Liquor Stores
- Convenience Stores
- Construction/Landscaping
- Wholesale Produce/Meat
- Anything you saw on Breaking Bad and/or Ozark
 - Think money laundering

Clues

- Cash paid for various living expenses
- Lifestyle exceeds reported income
- Knowledge of safe deposit boxes, safe(s), stashes of cash
- Notes to family members, "If anything ever happens to me..."

Forensic Puzzle #11 - Background

Court appointed expert appraised interest in a produce and meat wholesaler. During due diligence and in report Neutral stated:

- Outside accountants do not test inventory, purchases or cost of goods sold
- Internal controls ineffective at tracking inventory
- Internal controls ineffective at tracking/recording cash sales
- There was a change in accountants two years prior to the valuation date and expenses currently recorded appear to

be inconsistent with expenses previously reported

- The company was subject to tax audits in the year it changed accountants
- The Neutral was not provided access to prior or current accountant workpapers
- Source documentation such as “sales tickets” and “cash ledgers” are destroyed each month and only summary schedules maintained

We are asked to review and comment on Neutral report, with allegations that Parties always lived off cash, with a lifestyle that exceeded reported income

Documents Requested - Why?

- Tax Returns and Financial Statements for five years prior to and through the valuation date
- Sales Journals, General Ledgers (Quickbooks), Check Registers
- Sales Tickets/Invoices, Purchases Invoices
- Bank Statements with check images/cancelled checks

- All other documents and information the Neutral stated reliance on

Analysis

- Review bank statements and cancelled checks
- Review General Ledger activity - only summary level, no detail
- Review purchase invoices
- Review sales invoices
- Prepare financial spreads and analyze gross margin trends
- Compare with industry standards
- Adjust sales to "right size" margins
- Compare to reported sales
- Difference = unreported cash sales?
- Inquire as to cash paid for certain expenses
- Reconcile reported income with lifestyle

Findings/Conclusions

- Margins are much lower than industry composites
- Suggests unreported revenues in notoriously cash business

- Lifestyle analysis not robust due to late retention
- Pending acquisition - Buyer deposed and corroborated unreported revenues of roughly \$2 million annually!
- Unreported assets?

Forensic Puzzle # 12 - Background

- Grocery store chain
- 50% interest
- Retained by wife who thought she held 25% (half of husband's interest)
- There had already been a fraudulent conveyance of assets, leaving wife with 25% of shell company, elevating husband to 50% with one other partner
- Collusion with other 50% partner

Procedures

- Among many other analyses, requested and reviewed cancelled checks

- Identified numerous checks endorsed back to the Company
- Circumstance limited to a handful of recurring suppliers, one of which was a produce supplier

Findings

- Suppliers were endorsing checks back to the business and instead being paid cash at 80% of invoice
 - Business records expense at higher invoice amount, but actually pays just 80%
 - Supplier receives cash in excess of what it would, net after tax if it were to report those cash receipts
 - Company deducts expense at invoice amount and supplier walks with cash
- Estimate of net effect on earnings, coupled with other findings = \$3 million annually in underreported income

Forensic Puzzle # 13 - Background

- Court appointed to appraise several meat stores/butchers
- Conducted site visits with owner/husband

- Called back to meet with wife and her brother, who worked at stores for some time
- Allegations that there are suit cases of cash in the parties' attic
- Partner was relative of notorious crime boss
- We want YOU to conduct procedures to uncover amount of unreported cash

Conclusion

"Given the stature and notoriety of your husband's partner, I am sure the IRS has an eye on this - if they haven't found anything, what makes you think we will?"

FURTHERMORE, "I am Court appointed and I would need acquiescence of both parties, or expansion of the scope of the Order to undertake that analysis..."

BUT, “you are free to hire your own expert and we will take into account their findings!”