



CASH BUSINESSES AND DIVORCE



Things you will learn from this whitepaper:

1. What is a cash business?
2. How can forensic accountants help uncover unreported income?
3. What is a lifestyle analysis?
4. What kind of estimations can increase the accuracy of cash transactions analysis?

This whitepaper will have special interest to:

1. Attorneys and Judges involved in cases where a cash business is involved.
2. Partners of shareholders in a cash business.
3. Spouses of cash business owners.

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CASH BUSINESSES AND DIVORCE

Introduction

In November of 2012, Colorado passed Amendment 64—a measure that legalized and instituted regulation of marijuana for personal and recreational uses. A year later, in January of 2014, the commercial sale of this product officially began. In its first month, it generated more than \$14 million dollars in income, providing the government of Colorado with roughly \$3 million in taxes. In spite of such staggering fiscal success, this industry has encountered a major problem with reliable accountability.

Given that the possession and distribution of marijuana violates federal law, banks nationwide oppose its legal sale, forcing Colorado shops to remain cash-only businesses. Tax collectors worry that cash-only operations of this kind will result in understatements of sales and income and, thus, the state will ultimately not receive its lawful share in taxes.

Like marijuana shops, most other cash-only businesses lend themselves to potential fraud that can have major damaging effects, not only nationally or state-wide, but also for litigants in a matrimonial action.

Cash Businesses and Divorce

As opposed to child support, which is calculated based on a formula determined by each state, spousal support depends on a variety of factors and is, to a great extent, reliant on the discretion of the court. One of the key elements that helps a judge calibrate support is the spouses' income, assets, and the total marital estate. In a perfect world, financial and tax records would accurately reflect the monetary resources and need of both spouses. However, in the real world, this is often far from true—especially in cases involving cash-based businesses.

Cash-based businesses are enterprises where customers make a large percentage of payments in cash. Transactions handled in cash have an increased potential for occurring under the radar, dodging proper documentation and taxation. Moreover, property bought with cash can help conceal unreported income. In the case of divorce, therefore, the suspicion of unreported income is potentially detrimental to a non-business-owner spouse and the couple's children, and must, therefore, be thoroughly investigated.

The first and most important step a non-business-owner spouse must take before beginning divorce proceedings, preferably even at the beginning of the marriage, is to become familiar with the cash-based business and the way it is run financially. First-hand knowledge of the business's income and expenses, as well as debts and assets, can give the non-business-owner spouse the advantage of spotting wrongdoings. Identifying inconsistencies, though crucial, is not all that must be done. Determining the amount of money or the value of assets that have been swept under the rug often requires the skill of experts.



Forensic Accountants Uncovering Inconsistencies

Family attorneys are usually the first to delve into cash business inconsistencies and potential fraud during divorce proceedings. They must review the methods used for imputing income to unveil any unreported income, or prove that the suspicions of non-business-owner spouses are valid.

However, even with the proper documentation of financial and bank statements, tax returns, general ledgers, cancelled checks, credit card statements, and receipts, cash-based business owners might still be able to get away with fraud and gain leverage in a divorce case by understating their income. In these instances, family attorneys should consider using a forensic accountant that can dive into the details and uncover hard-to-find inconsistencies.

Lifestyle Analysis

Owing to extensive training and expertise, forensic accountants have a variety of tools useful for the investigation of underreported cash-based income. One tool is a *lifestyle analysis*, which, when prepared by an expert, can alert non-business-owner spouses of potential hidden assets. A lifestyle analysis reconstructs the spending habits, day-to-day living expenses, and the standard of living of a couple during the latter years of marriage, prior to the divorce. It scrutinizes several elements, including:

- *Financial statements,*
- *Credit reports,*
- *Personal and business income tax returns,*
- *Recurring and ordinary expenses (i.e. food, clothing, entertainment),*
- *Non-recurring or seasonal expenses, and*
- *Noticeable discrepancies.*

A detailed record of day-to-day expenses has the power of revealing inconsistencies between incoming money and spending. If a lifestyle analysis reveals that expenses exceed income, then a forensic accountant can determine there is a surplus of financial resources coming from an unknown source, which could be debt, loans, gifts, or unreported income and assets. Once inconsistencies are revealed, the next step is investigating what the unknown sources of income are.

You can learn more about lifestyle analysis in a separate whitepaper available on our website.

Assumptions and Estimations

Another tool forensic accountants utilize is basing informed assumptions on known facts, which can lead to more accurate estimations of unreported cash-based income. There are a variety of online resources and studies available that list statistics about common cash businesses that can provide a wealth of information about normal



operating expenses. By analyzing this data, a forensic accountant can make informed estimations on the day-to-day revenue, combined income, and expenses of these businesses.

This approach discovers the mark-up or profitability of the service or product the business sells and compares it to the reported numbers. Further estimations can be achieved by studying the percentage of cash versus credit card receipts. In many cash businesses, there is a predictable ratio of customers that pay with cash to those who use credit cards. Knowing the total number of transactions paid with credit can help estimate how much money might have been given out in cash.

Cash Flow Procedure

In addition to estimations, other expert practices can increase the accuracy of an investigation. *Cash flow* procedures examine how money comes in and who receives it. A business in which two or more people oversee the receipt, record-keeping, and the making of deposits has, ostensibly, good internal controls. If, however, the same person is responsible for the receipt, record-keeping, and making of deposits, suspicions may arise.

In cash businesses where cash registers are used, forensic accountants can perform an in-depth review of daily tapes and add them for the year. Also, in businesses where products are sold, they can compare the usage of product or the purchase orders to the reported sales. Lastly, payroll records can also serve as insight into how large the expenses of a business are.

Other Information Sources

A forensic exercise can also obtain further information about potential hidden assets and inconsistencies from other sources, including:

- *Income tax returns,*
- *Saving accounts,*
- *Checking account statements,*
- *Cancelled checks,*
- *Credit card receipts,*
- *Statements for cash value of insurance policies,*
- *Off shore accounts, and*
- *Loan applications.*

Using these sources, as well as the methods mentioned above, forensic accounting experts can skillfully analyze and estimate the total income of a cash business and the real income of its owner.



Conclusion

It is unlikely that a non-business-owner spouse will have thorough knowledge and understanding of the way the finances of their spouse's business function, let alone that of a cash-only business. Even when a business belongs to both parties, the money manager often has the advantage in knowing the structure and functions of the business.

During divorce proceedings, the income and assets of both spouses become the base points upon which alimony and child support are determined. For these reasons, it is important to consider the expertise of forensic accountants who can be of remarkable help to spouses who suspect inconsistencies or fraud, and who are unable to get to the root of the problem alone.

Forensic accountants can use various approaches such as estimations, cash flow calculations, and lifestyle analysis to unveil hidden income and undisclosed assets that have been obtained from cash-only businesses, whether the techniques are simple, such as taking petty cash directly from the cash registry, or as complex as "paying" salaries to nonexistent employees.

For more information on this topic please feel free to contact our office for assistance.

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