[J-241-1996]
IN THE SUPREME COURT OF PENNSYLVANIA
MIDDLE DISTRICT

MARY JO LABAR,	:	No. 48 M.D. Appeal Docket 1996
	:	
Appellant	:	Appeal from the Order of the Superior Court, dated July 11, 1994, at No. 2101 Philadelphia 1993, remanding/vacating the Order of the Court of Common Pleas of Northampton County, dated May 28, 1993, at DR-19632
v.	:	
THOMAS S. LABAR,	:	
	:	434 Pa. Super. 612, 644 A.2d 777 (1994)
Appellee	:	
	:	ARGUED: December 10, 1996

OPINION

MR. JUSTICE ZAPPALA **DECIDED: JUNE 8, 1999**

This is an appeal by allowance from an order of the Superior Court, vacating the Northampton County Common Pleas Court's order of support entered against Appellee, Thomas S. Labar. At issue is the calculation of Appellee's income for purposes of determining his support obligation. For the following reasons, we affirm.

Mary Jo Labar (Wife) and Thomas S. Labar (Husband) were married on April 21, 1979, and separated on July 31, 1992. Two children were born of the marriage, who were ten and seven years old on the date of separation. On November 4, 1992, Wife filed a petition for support on behalf of herself and the children.

A domestic relations hearing conference was held on November 30, 1992. At the conference, Husband, who holds a fifty percent equity interest in a bowling alley, Blue Valley

Lanes, Inc., a Subchapter S Corporation, presented his 1991 federal income tax return in support of his claim that his 1991 disposable income[1] was $32,068, calculated as follows:

Interest income	$ 2,527.00
Salary from Blue Valley	26,000.00
½ of Blue Valley's taxable income[2]	3,541.00
Disposable income	$ 32,068.00

Wife countered that Husband's one-half share of Blue Valley's taxable income did not accurately reflect the value of Husband's interest in Blue Valley. Wife therefore sought to add to Husband's disposable income: (1) one-half of the depreciation deduction taken by Blue Valley on its 1991 federal income tax return; (2) Blue Valley's 1991 entertainment expense; and (3) Blue Valley's 1991 amortization expense.

The hearing officer agreed with Wife and recalculated Husband's disposable income

[1] A parent's ability to pay for support of his or her minor children is to be determined as of the time at which support payments are sought. Costello v. LeNoir, 462 Pa. 36, 337 A.2d 866 (1975).

[2] Because Blue Valley is organized as a Subchapter S Corporation, all capital gains and losses, for federal income tax purposes, pass through Blue Valley to the individual shareholders; thus, any federal tax liability on capital gains is the responsibility of each shareholder to be computed at that shareholder's marginal tax rate. *See* In re Estate of Dobson, 490 Pa. 476, 417 A.2d 138 (1980). Although a Subchapter S Corporation does not actually pay federal income taxes, it still must file a Subchapter S Corporation federal income tax return (Form 1120S) reflecting any capital gain, or loss and a Schedule K-1 for each shareholder reflecting the amount of gain or loss passed on to each shareholder. If a capital gain is claimed, the amount passed on to the shareholders must then be included as additional income to the shareholders for federal income tax purposes.

Blue Valley's 1991 tax return (Form 1120S) reflects income of $7,081; the Schedule K-1 for Husband reflects a fifty percent share of this income, $3,541. This $3,541 gain is reflected as income on Husband's 1991 individual federal income tax return (Form 1040), despite the fact that Husband never received a $3,541 disbursement from Blue Valley.

as follows:

Interest income	$ 2,527.00
Salary from Blue Valley	26,000.00
½ of Blue Valley's taxable income	3,541.00
½ of Blue Valley's depreciation	34,066.00
Blue Valley's entertainment expense	1,914.50
Blue Valley's amortization expense	560.00
Disposable income	$ 68,608.50

After crediting Husband for two loans related to the marital residence and his support obligation for a third child, the hearing officer recommended a support order in the amount of $474 per week. By order dated January 11, 1993, the trial court adopted the recommendation.

Husband filed timely objections and on April 1, 1993, the trial court held a *de novo* hearing focusing on the issue of whether the depreciation deduction was properly included in Husband's disposable income calculation.[3] The trial court determined that the depreciation deduction was properly included in the calculation and by order dated May 28, 1993, Husband's objections were dismissed. Husband's subsequent Motion for Reconsideration was denied.

On appeal, the Superior Court vacated and remanded for a recalculation of support. Labar v. Labar, 434 Pa. Super. 612, 644 A.2d 777 (1994). Husband contended before both the trial court and the Superior Court that it was error to include in his 1991 income calculation one-half of Blue Valley's 1991 depreciation deduction. Husband is correct in this contention, but not for the reasons he puts forth, or for the reasons advanced by the Superior Court in its opinion.

[3] Husband did not challenge the propriety of the inclusion of the entertainment and amortization expenses in the income calculation.

The sole issue in this case concerns the proper calculation of Husband's disposable income for use in determining his support obligation. In Commonwealth ex rel. Gitman v. Gitman, 428 Pa. 387, 237 A.2d 181 (1967), this Court held that in determining a husband-father's financial obligation to his wife and children, a court must make a thorough appraisal of the husband-father's actual earnings and perquisites, and the true nature and extent of his property and financial resources.

At the April 1, 1993 *de novo* hearing before the trial court, Husband, relying on Cunningham v. Cunningham, 378 Pa. Super. 280, 548 A.2d 611, alloc. denied, 522 Pa. 576, 559 A.2d 37 (1988), asserted that the hearing officer improperly included one-half of the depreciation deduction taken by Blue Valley on its Subchapter S Corporation tax return in his disposable income calculation.

Although instructive, Cunningham is not on point with this case. In Cunningham, Mr. Cunningham's most recent individual federal income tax return showed a gross income of $24,000, with over $17,000 in depreciation and depletion expenses claimed, for a net taxable income of approximately $7,000. Mr. Cunningham asserted that this net taxable income of $7,000, as reflected on his individual federal income tax return, was the proper measure of his disposable income for purposes of calculating his support obligation. The Superior Court disagreed, stating:

> It is well established that depreciation and depletion expenses, permitted under federal income tax law without proof of actual loss, will not automatically be deducted from gross income for purposes of determining awards of alimony and equitable distribution. In determining the financial responsibilities of the parties to a dissolving marriage, the court looks to the actual disposable income of the parties:
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>> [T]hat income must reflect actual available financial resources and not the oft-time fictional financial picture which develops as a result of depreciation deductions taken against ... income as permitted by the

> federal income tax laws. Otherwise put, "cash flow" ought to be considered and not federally taxed income.
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> Commonwealth ex rel. Hagerty v. Eyster, 286 Pa.Super. 562, 568-69, 429 A.2d 665, 668-69 (1981) (citations omitted). *Accord*, Flory v. Flory, 364 Pa.Super. 67, 527 A.2d 155 (1987); Parkinson v. Parkinson, 354 Pa.Super. 419, 512 A.2d 20 (1986).
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> Depreciation and depletion expenses should be deducted from gross income only when they reflect an actual reduction in the personal income of the party claiming the deductions ....

378 Pa. Super. at 282, 548 A.2d at 612-613 (emphasis added). The Superior Court determined that the depreciation and depletion deductions claimed by Mr. Cunningham did not represent actual reductions in his personal income; they were therefore not to be considered in the calculation of Mr. Cunningham's income for support purposes.

Thus, Cunningham stands for the proposition that deductions allowed under the federal tax laws, that do not represent actual reductions in a support obligor's personal income, will not be allowed in the disposable income calculation. Such reasoning is sound.

However, in this case, Husband received $26,000 from Blue Valley in 1991; he has not sought to reduce this actual net income received by claiming a depreciation deduction on his federal tax return. Instead, it is Wife who seeks to include in Husband's disposable income calculation one-half of the depreciation deduction Blue Valley took in determining the amount of taxable income passed on to its shareholders for federal income tax purposes. Wife seeks to do so because it is her basic contention that Husband should have received more remuneration from Blue Valley in 1991 than he actually did, implying that Husband was using Blue Valley to shelter income from the support obligation calculation.

While it is possible that a person could use a corporation to shelter income from the support obligation calculation by improperly retaining cash flows within the corporation rather than disbursing them to the shareholders, the mere fact that Blue Valley took a depreciation deduction against gross income in calculating net taxable income passed on to shareholders does not establish the presence of sheltered cash flows. This is because depreciation does not generate cash flow.

Depreciation and cash flow are not equivalents. Depreciation is an accounting mechanism which allocates the original cost of an asset to the periods in which the asset is used. Depreciation does not result in income. Rather, when depreciation expense is claimed, *taxable* income is decreased by the amount so claimed, resulting in a "marginal income tax savings," not an increase in income.[4]

The presence of a depreciation deduction (on a federal income tax return) or a depreciation expense (on consolidated financial statements) simply signals that a corporation has made capital expenditures, the costs of which it seeks to allocate to the periods in which the assets underlying the capital expenditures are being used. Only by asserting that the capital expenditures, for which depreciation deductions are currently being claimed, were made with cash flows that should have instead been disbursed to the shareholders, can it be argued that a corporation is improperly sheltering cash flows.

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[4] In contravention of these basic accounting principles, Husband erroneously testified before the trial court as follows:

> [We would] try to <u>generate cash flow using the depreciation</u> and whatever other moneys we could generate by building the business back up. ... So when we bought it we were looking at a long-range plan to put the bowling center back where it should be, by updating it year to year, taking the money and not putting the money in our pockets but putting it back in so that the community would have a good bowling center over the years.

(N.T., 4/1/93 at 12-13) (emphasis added).

Since depreciation does not generate cash flow, Husband cannot be correct.

The absurdity of the proposition that the depreciation deduction taken by Blue Valley in 1991 generated a cash flow that should be considered income to Husband in 1991 is further demonstrated by an examination of the business transactions underlying Blue Valley's 1991 depreciation deduction. In 1990,[5] Blue Valley borrowed $840,000 from United Penn Bank, approximately $430,000 of which was used to pay off the existing property mortgage and a loan incurred in acquiring a liquor license. The remaining money, approximately $410,000, was used to make capital expenditures for a computerized scoring system and pinsetters. In 1991, Blue Valley's capital expenditures consisted of $26,299 for a new lane machine. (N.T. 4/1/93 at 19).[6]

By asserting that the depreciation deduction taken by Blue Valley in 1991 should be considered additional income to Husband, Wife is necessarily arguing that all of the funds used for capital expenditures should not have been used for capital expenditures, but should have instead been disbursed to the shareholders as income.

This argument fails because it assumes without evidence of record that the funds used for the capital expenditures consisted of cash flows which Blue Valley could have elected to disburse to its shareholders. If the source of the funds used to make the capital expenditures had been, for example, retained corporate earnings, Wife could argue that the funds expended on capital expenditures (and not just the amount depreciated in any given tax year) were unnecessary disbursements made to shelter cash flows from the support obligation, and

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[5]The evidence of record does not reveal the nature of any of the business transactions underlying Blue Valley's pre-1990 capital expenditures.

[6]Curiously, Blue Valley's Statement of Cash Flows only reflects $25,129 in property and equipment purchases in 1991. (R.R. at 90a).

Husband would carry the burden of showing that the capital expenditures were necessary for the continued operation and smooth running of the business. *See* McAuliffe v. McAuliffe, 418 Pa. Super. 39, 613 A.2d 20 (1992). However, Blue Valley has been and continues to be a highly leveraged corporation. Consider the 1990 capital expenditures which were debt financed. That portion of the $840,000 loan which was spent on capital expenditures was loaned to Blue Valley by United Penn Bank for the exclusive purpose of making those same capital expenditures, which presumably serve as security for the loan. It would be untenable to argue that proceeds of a loan made to a corporation for the exclusive purpose of making capital expenditures should instead be disbursed as income to the two principal shareholders of the corporation. Yet that is precisely the implication of Wife's argument. As for the $26,299 in 1991 capital expenditures, Husband erroneously testified that "the depreciation, again, is used to pay for these capital improvements ...." (N.T. 4/1/93 at 19). Since depreciation does not generate cash flow, Husband cannot be correct. The source of these funds is therefore left to conjecture.[7]

This is not to say that Husband is correct in asserting that his disposable income is the sum of his actual net earnings and his one-half share of Blue Valley's taxable income. Utilizing one-half of the amount of Blue Valley's federally taxable income as the measure of Husband's interest in Blue Valley is an example of the "oft-time fictional financial picture" which develops as a result of the federal income tax laws. "'Cash flow' ought to be considered

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[7]A review of Blue Valley's Statement of Cash Flows (R.R. at 90a), would seem to suggest that the funds used to make the 1991 capital expenditures originated from $66,303 in "Net Cash Provided By Operations." If that is in fact the case, that the source of the funds used to make the 1991 capital expenditures was cash from operations, the burden would then shift to Husband to show that the cash expenditures were necessary for the continued operation and smooth running of the business. McAuliffe.

and not federally taxed income." Commonwealth ex rel. Hagerty v. Eyster, 286 Pa. Super. 562, 569, 429 A.2d 665, 669 (1981).

In situations where the support obligee contends that the support obligor's interest in a closely held corporation is not accurately represented by the support obligor's share of the corporation's taxable income, the court must make an appraisal of the true nature and extent of the support obligor's interest in the corporation. *See* Gitman. That appraisal can take the form of a valuation of the support obligor's equity in the corporation,[8] or it can take the form of an allegation that the corporation has sheltered cash flows by not making disbursements to its shareholders. When it is alleged that the corporation has sheltered cash flows, the sources of those cash flows must be identified; i.e., it must be shown that the cash flows *could have been* disbursed to shareholders. In cases where cash flows which could have been disbursed to shareholders have instead been disbursed for business expenses, the corporation must show that the expenditures were necessary for the continued operation and smooth running of the business in order to refute an allegation that the corporation has sheltered cash flows. McAuliffe.

This analysis differs from that employed by the Superior Court. Recognizing that a parent may not "voluntarily decrease" the ability to provide support by sheltering income through "unreasonable or unnecessarily large expenditures for his or her own benefit," Meltzer v. Witzberger, 505 Pa. 462, 472, 480 A.2d 991, 996 (1984), the Superior Court

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[8]A review of Blue Valley's 1991 Balance Sheet (R.R. at 87a), reveals why that would not be an attractive choice for Wife in this case. Blue Valley is a highly leveraged corporation. Even the most simplistic financial evaluation reveals that Blue Valley's assets, valued at $732,822, are offset by liabilities of $938,041. If Blue Valley were to liquidate its assets as of December 31, 1991, it would be unable to satisfy its debt obligations. Thus, the value of shareholder equity in Blue Valley is not a positive amount.

opined that the issue of the propriety of including the depreciation deduction in Husband's disposable income calculation involved two related, but independent inquiries:

> First, a choice of accounting methods may be utilized to raise or lower the depreciation expense taken so as to raise or lower net income. When gross income is reduced, this produces a marginal income tax savings, which then becomes income that is available to the business or that can be distributed to the proprietor as he or she chooses. Thus, in inquiring into whether the depreciation and depletion expenses reflected an <u>actual</u> reduction in Husband's personal income, ... we must look at whether any such marginal income created through tax savings was reinvested in the business or distributed to the Husband directly.
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> Second, even if the accounting method is unaltered, the proprietor may simply make substantial capital outlays, which will proportionately increase the depreciation expense, even though the capital outlays are necessary to maintain the business. Thus, we must also inquire as to whether the capital outlays underlying the reduction were necessary, ... or whether they represented an attempt to shelter income for purposes of avoiding spousal and child support obligations .... Each must be examined <u>separately</u> and the trial court must be clear as to which factor it is scrutinizing.

434 Pa. Super at 618-619, 644 A.2d at 780-781 (emphasis in original) (citations and footnotes omitted).

With regard to the first inquiry, the Superior Court found that the marginal income made available through the depreciation expenses was not distributed to the husband directly, but expended in the satisfaction of principal business loans and the purchase of new equipment. While the Superior Court accurately described the relationship between depreciation expense and net income, and the potential for marginal income tax savings arising therefrom, under the circumstances of this case there existed no marginal income tax savings available to Blue Valley. Blue Valley, by virtue of its Subchapter S Corporation status, does not actually pay federal income taxes (see *supra*, note 2) and therefore does not enjoy a marginal income tax savings as a result of the depreciation deduction. Instead, it is the shareholders of Blue Valley (i.e., Husband and his partner) who experience the income tax savings as a result of the depreciation deduction. Thus, as a result of the depreciation deduction taken by Blue Valley, Husband's net income after taxes is greater than it would be without the deduction, thereby *increasing* the amount of Husband's disposable income available for support.

With regard to the second inquiry, the Superior Court determined that because specific evidence of Husband's intent to shelter income was absent from the record, it was presumed from the facts that the expenditures were legitimate and necessary. While the Superior Court is correct that inquiry must be made into the necessity of the capital expenditures underlying the depreciation deduction, the court's analysis is incomplete. As explained above, before inquiry as to the necessity of capital expenditures is made, it must first be established that the sources of the funds used to make the capital expenditures were cash flows which *could have* instead been disbursed to shareholders.

Returning to the facts of the instant case, the presence of a depreciation deduction on Blue Valley's 1991 federal income tax return does not signal that Blue Valley has sheltered income. It simply indicates that Blue Valley has made capital expenditures it seeks to allocate to tax year 1991. Since the evidence of record does not reveal the nature of any of the business transactions underlying Blue Valley's pre-1990 capital expenditures, the source of the funds used to make these capital expenditures has not been identified. The source of the funds used to make the 1990 capital expenditures, as already discussed, consisted of debt financing, not cash that *could have been* disbursed to the shareholders. As far as the 1991 capital expenditures are concerned, Husband testified that amount consisted of $26,299.[9] As

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[9]The existence of 1991 capital expenditures is also revealed by an examination of Blue Valley's Statement of Cash Flows (R.R. at 90a). It is interesting to note that Blue Valley's (continued…)

noted previously though, the source of the funds used to make the 1991 capital expenditures is not on the record. It cannot automatically be assumed from the evidence of record that the source of the funds used to make the expenditures was sheltered cash flows.[10] If the source of the funds used to make these capital expenditures is identified as cash flows which could have instead been distributed to the shareholders, then and only then does the question arise whether the expenditures were unnecessary and therefore properly included in the calculation of Husband's disposable income.

Accordingly, the order of the Superior Court is affirmed and the case is remanded to the trial court for a recalculation of support consistent with this opinion.

Madame Justice Newman files a Dissenting Opinion in which Mr. Chief Justice Flaherty joins.

(…continued)
Statement of Cash Flows reveals that at the end of 1991, Blue Valley had $28,387 in excess cash. It would thus seem that other sources of cash flows that could have been disbursed to shareholders do exist. It is unclear from the record however, whether that is in fact the case.

[10]Even if the evidence of record did in fact show that the source of the funds used to make the expenditures was sheltered cash flows, the simple addition of Blue Valley's 1991 depreciation deduction would still result in an undervaluation of Husband's disposable income. The addition of the 1991 depreciation deduction to the disposable income calculation would only ensure that a mere portion of the total unnecessary capital expenditures made by Blue Valley was included in Husband's disposable income calculation, even though inclusion of the full amount of the unnecessary capital expenditures would be proper.