Nuggets from the Tax Return

Many times, before we have an opportunity to actually roll up our sleeves and do fieldwork analysis of a business' financial records, we are provided with tax returns – sometimes of the individuals, sometimes of the business, sometimes of both. While none of our readers should believe for an instant that merely having the tax returns to review is an adequate substitute for the type of analysis and investigation vital to the investigative accounting and business valuation procedures we need to employ in virtually all cases, having those returns at least gives us the ability to make some initial observations that will help us to better focus on what we need to do.

For instance, let us deal with the matter of business tax returns. A review of same might provided us with some or all of the following:

Gross Revenues – this gives us a basic idea as to the size of the business – which often weighs heavily on what we perceive to be the extent of analysis and discovery necessary, as well as the procedures we might employ in doing our work.

Gross Profit – assuming that we have at least a basic understanding of the type of business involved, we may be able to make comparisons of the reported gross profit to those considered normal for the industry. If we find that the reported margins are within a reasonable range of normal, we have that much more comfort as to the veracity of the reported revenues and costs. Alternatively, if there is a significant difference between industry norms and the subject company (generally meaning a much lower gross profit for the subject company), then our attention is immediately drawn to this very important area for further analysis.

Payroll – does the reported payroll make any sense? Some businesses may pay a portion of their payroll off the books – and the figures on the tax returns may be obviously too low. In other cases, there might be payments for no-show jobs or paramours – resulting in obviously inflated payroll levels.

Depreciation – how aggressive is the business in taking a depreciation deduction? Is it taking advantage of such accelerated depreciation methods as Code Section 179 and first year bonus depreciation – and therefore is depreciation far in excess of economic reality?

Pension and Other Fringe Benefits – to what extent is the company deducting for a retirement plan, and perhaps other fringe benefits? Certainly, if for a retirement plan, we are now aware that such a plan exists, and that there is probably an asset (perhaps significant) that needs to be considered (if this, for instance, is a marital dispute).

Partners or Shareholders – depending on the form of the return, there may be considerable information as to who are the owners, shareholders and officers, how much compensation each is getting, and what percentage of the company is owned by each of them. There may also be information as to changes in capital structure, contributions or withdrawals by partners and other similar financial information. Each of these can be very important, and in some cases for several reasons. For instance, was there a change in ownership position during the year, or from year-to-year? If so, how did that come about, what consideration was paid, who sold what interest, how was it valued, etc.?

Net Book Value Equity – other than for a Schedule C for a sole proprietorship, most business tax returns (i.e. corporations, LLCs and partnerships) will have a balance sheet. The equity, or partners' capital, will give the reader at least a basic idea as to the book value net worth of the company. Usually, if the company is even moderately successful, that is the lowest value one would consider.

The above dealt with business tax returns. Let us now turn to personal tax returns.

Pension Income – even if not taxable (usually because it was rolled over into another account), there might be an indication of a distribution from a pension or an IRA. Where did the money come from, and where did it go? Also, in the same vein, there might be an indication of a contribution to a Keogh plan. Similarly as to a deduction on a corporate return, this indicates the existence of a retirement plan – an asset that might need further analysis.

Interest and Dividend Income – Schedule B lists the sources of interest and dividend income. The presence of same indicates the existence of bank accounts, brokerage accounts, CDs, and possibly other financial vehicles. These need to be considered as part of the discovery process.

Schedule D – the presence of this schedule generally suggests activities on the stock or bond markets. This then tells us that there are some assets, possibly many, possibly of significant value, in the form of stocks or bonds or both. We would want to see the brokerage statements so as to give us a comfort level as to what assets exist.

Schedule E – the presence of this schedule, depending of course on what parts of it are filled out, might indicate the existence of rental property, an asset throwing off royalty income, investments in partnerships or S corporations, an interest in estates or trusts.

If understood and used correctly, tax returns can provide a wealth of information – and at the very least, raise many questions and help us focus our efforts. However, they are rarely, if ever, by themselves sufficient for the financial analysis and investigation necessary in almost any litigation matter.