

# How to Read a Tax Return



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By:

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# All Returns

- Horizontal Analysis of Tax Returns over a number of years will help highlight unusual or non-recurring items.
- We will start with individual returns and excerpts of an analysis our firm recently performed.

# Highly Variable Personal Income

Personal Tax Returns	2009	2010	2011	2012	2013
Wages	\$ 187,719	\$ 178,319	\$ 355,558	\$ 417,181	\$ 1,055,804
Taxable interest	1,771,892	463,915	349,338	148,419	199,676
Ordinary dividends	16,425	79,259	32,455	793,266	598,197
Capital gain (loss)	103,308	(3,000)	433,694	430,532	(3,000)
Other gains (losses)	-	-	-	(5,217)	3,114
IRA distributions	-	271	324	310	336
Rental income	2,811	2,873	2,676	(176,986)	(34,667)
Other income (foreign source)	71,822	163,380	-	-	-
Total income	2,153,977	885,017	1,174,045	1,607,505	1,819,460

# Drill Down Wages

W-2 Income	2009	2010	2011	2012	2013
Company A	\$ 161,719	\$ 152,319	\$ 167,623	\$ 209,164	\$ 267,422
Foundation	26,000	26,000	26,000	26,000	26,000
Wages from form 8919					
Unspecified on return	-	-	161,935	-	-
Foreign Source	71,822	163,380	-	182,017	762,382
<b>Total W-2</b>	<b>\$ 259,541</b>	<b>\$ 341,699</b>	<b>\$ 355,558</b>	<b>\$ 417,181</b>	<b>\$ 1,055,804</b>

# Drill Down Interest

Taxable Interest	2009	2010	2011	2012	2013
Arvest (3 accounts)	\$ 218	\$ 161	N/A	\$ 196	\$ 117
Company A	1,425,981	59,178	N/A	2,969	119
Investment Firm A	365,352	502,433	N/A	372,491	363,735
The Northern Trust Company	3,952	2,000	N/A	80	-
K-1 Trust	22	51	N/A	1	1
K-1 Trust 2	<u>45</u>	<u>30</u>	<u>N/A</u>	<u>20</u>	<u>46</u>
Total	1,795,570	563,853	N/A	375,757	364,018

# Drill Down Dividends

Dividends	2009	2010	2011	2012	2013
Company A	\$ -	\$ -	\$ -	\$ 38,200	\$ 61,328
Company B	-	-	-	606,982	395,125
Investment Firm A	16,193	79,019	32,194	147,748	141,446
Investment Firm B	<u>232</u>	<u>240</u>	<u>261</u>	<u>336</u>	<u>298</u>
Ordinary dividends	\$ <u>16,425</u>	\$ <u>79,259</u>	\$ <u>32,455</u>	\$ <u>793,266</u>	\$ <u>598,197</u>

# What We Quickly Learned

- Individual is self employed and either in a cyclical industry or possesses the ability to control key elements of his income.
- Businesses owned are C Corporations.
- One of the Businesses is in a Foreign Country.
- We need to investigate the rental loss in 2012 and 2013 as this may signal a new business venture.
- A major debt appears to have been paid off in 2009. We need to nail down the use of those funds.

# What We Quickly Learn

- The capital loss in 2013 created a capital loss carryover of \$2.2 million. This may prove to be a key element in dividing the marital estate or providing tax parity to the parties but it is not assignable.
- There will clearly be business valuations required of the closely held businesses.
- There is significant liquidity available. Assuming that it is generated from marital assets, this may provide flexibility in dividing the marital estate – an uncommon situation with highly valuable closely held business interests.



# What to look for in a Horizontal Analysis

- Assets or income streams that fall off the map.
- Impact or existence of pass through entities.
- Unused losses or other tax carry forwards that will need to be taken into account in settlement. (Example: At Risk losses don't follow the asset. They stay with original owner where they were generated.)
- Assets that may need to be appraised.

# What to Look for in a Horizontal Analysis

- Complex or highly variable income streams that may merit hiring a financial expert.
- Income streams that are too low to provide the observed or claimed lifestyle of the parties.

# Don't Forget the Basics

- At Frost, we like to start our review of most divorce cases with a thorough review of two or three years of tax returns, and that usually begins with W-2 income.

# Three Key Areas of the W-2

- Box 1 – (Taxable) Wages Tips & Other Comp
- Box 5 – Medicare Wages & Tips
- Box 12 – Up to 26 Codes to describe elements of compensation, many of which are not included in Box 1, and some of which are not included in Box 1 or Box 5.

# *Why You Always Want the W-2's*

THE 1040 DOES NOT INCLUDE ALL THE DETAILS REFLECTED ON THE W-2.

THE DETAIL REFLECTED ON THE W-2 WILL HELP YOU TO IDENTIFY AND PROVE INCOME ELEMENTS AND EVEN ASSETS THAT YOU MAY NOT OTHERWISE LEARN ABOUT UNTIL TOO LATE TO VERIFY OR QUANTIFY – IF EVER.

# Why you always want check stubs

- Some compensation packages are extremely complex. In some cases, the W-2 will include a summary and reconciliation of figures on the W-2 that help you understand each element of income. (See ADP Payroll example).
- More often than not, W-2s don't have summaries. Check Stubs will assist you and your expert to identify and reconcile income elements on the W-2 – and also help you to assess earnings variability from pay period to pay period.

# And why you always want this!

A list of all checks written to or for the benefit of a business owner or executive over the relevant time frame (generally, the last two to three years) will allow your expert to:

1. Trace disbursements to bank deposits.
2. Potentially identify unreported income.
3. Potentially identify hidden assets.
4. Potentially quantify asset dissipation.

## W-2 SPECIFICS :

### Box 1 - Taxable Wages

- This box usually does not include all economic benefits received. Some examples:
  - Section 125 – Flex Benefit Plans
  - Elective Deferrals to any Qualified Plan
  - Non-Qualified Plan Contributions
  - Medical, Dental, Vision Plan Benefits



## Box 5 - Medicare Wages and Tips

- Wages and tips subject to Medicare tax are generally more inclusive of all items of earned income than is Box 1. For example, the items marked with double asterisks (\*\*\*) on the following slides are items that are included in Box 5 but are not included in Box 1 of Form W-2.

# Form W-2 Reference Guide for Box 12 Codes\*\*

<b>A</b>	<b>Uncollected social security or RRTA tax on tips</b>
<b>B</b>	Uncollected Medicare tax on tips (but not Additional Medicare Tax)
<b>C</b>	Taxable cost of group-term life insurance over \$50,000
<b>D</b>	Elective deferrals to a section 401(k) cash or deferred arrangement plan (including a SIMPLE 401(k) arrangement**)
<b>E</b>	Elective deferrals under a section 403(b) salary reduction agreement**
<b>F</b>	Elective deferrals under a section 408(k)(6) salary reduction SEP**
<b>G</b>	Elective deferrals and employer contributions (including non-elective deferrals) to a section 457(b) deferred compensation plan**
<b>H</b>	Elective deferrals to a section 501(c)(18)(D) tax exempt organization plan**
<b>J</b>	Nontaxable sick pay (NOT INCLUDED IN EITHER BOX 1 or BOX 5)

# Form W-2 Reference Guide for Box 12 Codes

<b>K</b>	<b>20% excise tax on excess golden parachute payments</b>
<b>L</b>	Substantiated employee business expense reimbursements (Not in Either Box)
<b>M</b>	Uncollected social security or RRTA tax on taxable cost of group-term life insurance over \$50,000 (former employees only)
<b>N</b>	Uncollected Medicare tax on taxable cost of group-term life insurance over \$50,000 (but not Additional Medicare Tax)(former employees only)
<b>P</b>	Excludable moving expense reimbursements paid directly to employee (Not in Either Box)
<b>Q</b>	Nontaxable combat pay** (Not in Either Box)
<b>R</b>	Employer contributions to an Archer MSA**
<b>S</b>	Employee salary reduction contributions under a section 408(p) SIMPLE plan**
<b>T</b>	Adoption benefits

# Form W-2 Reference Guide for Box 12 Codes

V	Income from exercise of nonstatutory stock option(s)
W	Employer contributions (including employee contributions through a cafeteria plan) to an employee's health savings account (HSA)**
Y	Deferrals under a section 409A nonqualified deferred compensation plan**
Z	Income under a nonqualified deferred compensation plan that fails to satisfy section 409A**
AA	Designated Roth contributions under a section 401(k) plan
BB	Designated Roth contributions under a section 403(b) plan
DD	Cost of employer-sponsored health coverage (Not in Either Box 1 or 5)
EE	Designated Roth contributions under a governmental section 457(b) plan

# Retirement Plan Coverage

Box 13 – If box 13 is checked, the employee is participating in some kind of employer sponsored retirement plan. The following slides provide guidance on when you should see an X in Box 13. If you see that X, you know:

1. An income adjustment may be in order to reflect true economic benefits being received, and
2. To be on the lookout for a qualified retirement account asset on the list of marital assets.

# Form W-2 Box 13 Retirement Plan Checklist

## Decision Chart

Type of Plan	Conditions	Check Retirement Plan Box?
Defined benefit plan (for example, a traditional pension plan)	Employee qualifies for employer funding into the plan, due to age/years of service – even though the employee may not be vested or ever collect benefits	Yes
Defined contribution plan (for example, a 401(k) or 403(b) plan, a Roth 401(k) or 403(b) account, but not a 457 plan)	Employee is eligible to contribute but does not elect to contribute any money in this tax year	No
Defined contribution plan (for example, a 401(k) or 403(b) plan, a Roth 401(k) or 403(b) account, but not a 457 plan)	Employee is eligible to contribute and elects to contribute money in this tax year	Yes

# Form W-2 Box 13 Retirement Plan Checklist

## Decision Chart

Type of Plan	Conditions	Check Retirement Plan Box?
Defined contribution plan (for example, a 401(k) or 403(b) plan, a Roth 401(k) or 403(b) account, but not a 457 plan)	Employee is eligible to contribute but does not elect to contribute any money in this tax year, but the employer does contribute funds	Yes
Defined contribution plan (for example, a 401(k) or 403(b) plan, a Roth 401(k) or 403(b) account, but not a 457 plan)	Employee contributed in past years but not during the current tax year under report	No (even if the account value grows due to gains in the investments)
Profit Sharing Plan	Plan includes a grace period after the close of the plan year when profit sharing can be added to the participant's account	Yes

# Non Qualified Plans

- Non-Qualified Plans do not always show up in Box 11. It's up to you to craft your discovery to catch that. But if you see a dollar value in box 11 for any year, you need to further investigate as it generally means one of two things:
  - A current year distribution from a NQP.
  - A current year vesting event for a NQP.
  - More details follow for your future reference.



# Nonqualified Deferred Compensation Reporting

## Example Chart

Example	How to report on Form W-2
<p>Example 1 – Deferral, immediately vested (no risk of forfeiture).            Regular wages: \$200            Defer, vested: \$20            Employer match, vested: \$10</p>	<p>Box 1 = \$180 (\$200 - \$20)            Boxes 3 and 5 = \$210 (\$200 + \$10)            Box 11 = \$0</p>
<p>Example 2 – Deferral, delayed vesting (risk of forfeiture) of employee and employer portions.            Regular wages: \$200            Defer, not vested: \$20            Employer match, not vested: \$10</p>	<p>Box 1 = \$180 (\$200 - \$20)            Boxes 3 and 5 = \$180 (\$200 = \$20)            Box 11 = \$0</p>
<p>Example 3 – Deferral, immediately vested. Prior year deferrals and employer matches are not vesting.            Regular wages: \$200            Defer, vested: \$20            Vesting of prior-year deferrals and employer matches: \$100 = \$15 (earnings on \$100)</p>	<p>Box 1 = \$180 (\$200 - \$20)            Boxes 3 and 5 = \$315 (\$200 + \$100 + \$15)            Box 11 = \$115 (\$100 + \$15)</p>

# Nonqualified Deferred Compensation Reporting

## Example Chart

Example	How to report on Form W-2
<p>Example 4 – No deferrals, but there are distributions. No vesting of prior year deferrals.            Regular wages: \$100            Distribution: \$50</p>	<p>Box 1 = \$150 (\$100 + \$50)            Boxes 3 and 5 = \$100            Box 11 = \$50</p>
<p>Special Rule for W-2 Box 11: Distributions and Deferrals in the Same Year – Form SSA-131</p>	<p>If, in the same year, there are NQDC distributions and deferrals that are reportable in boxes 3 and/or 5 (current or prior year deferrals), do not complete box 11. Instead, report on Form SSA-131 the total amount the employee earned during the year. Generally, Box 1 will report distributions and current year deferrals that are vested (employee and employer portions). Do not consider prior-year deferrals that are vesting in the current year. If there was a plan failure, the box 1 amount in this calculation should be as if there was no plan failure. Submit the SSA-131 to the nearest SSA office or give it to the employee.</p>

# Nonqualified Deferred Compensation Reporting

## Example Chart

Example	How to report on Form W-2
<p>Example 5 – Deferral, immediately vested, and distributions. No vesting of prior year deferrals.            Regular wages: \$200            Defer, vested: \$20            Employer match, vested: \$10            Distribution: \$50</p>	<p>Box 1 = \$230 (\$200 - \$20 = \$50)            Boxes 3 and 5 = \$210 (\$200 + \$10)            Box 11 = \$0            Form SSA-131 - \$210 (\$230 (Box 1) - \$50 (distribution) + \$30 (vested employee and employer deferrals))</p>
<p>Example 6 – Deferral, delayed vesting, and distributions. No vesting of prior year deferrals.            Regular wages: \$200            Defer, not vested: \$20            Distribution: \$50</p>	<p>Box 1 = \$230 (\$200 - \$20 + \$50)            Boxes 3 and 5 = \$180 (\$200 - \$20)            Box 11 = \$50</p>

# Nonqualified Deferred Compensation Reporting

## Example Chart

Example	How to report on Form W-2
<p>Example 7 – Deferral, immediately vested, and distributions. Prior-year deferrals and employer matches are not vesting.            Regular wages: \$200            Defer, vested: \$20            Distribution: \$50 Vesting of prior-year deferrals and employer matches: \$100 + \$15 (earnings on the \$100)</p>	<p>Box 1 = \$230 (\$200 - \$20 = \$50)            Boxes 3 and 5 = \$315 (\$200 + \$100 + \$15)            Box 11 = \$0            Form SSA-131 - \$200 (\$230 (Box 1) - \$50 (distribution) + \$20 (vested deferral))</p>
<p>Example 8 – Deferral, delayed vesting, and distributions. Prior-year deferrals and employer matches are not vesting.            Regular wages: \$200            Defer, not vested: \$20            Distribution: \$50            Vesting of prior-year deferrals and employer matches: \$100 + \$15 (earnings on the \$100)</p>	<p>Box 1 = \$230 (\$200 - \$20 + \$50)            Boxes 3 and 5 = \$295 (\$200 - \$20 + \$100 + \$15)            Box 11 = \$0            Form SSA-131 = \$180 (\$230 (Box 1) - \$50 (distribution))</p>

# Reportable Gambling Winnings

Gambling winnings are reported on Form W-2G if:

1. The winnings (not reduced by the wager) are \$1,200 or more from a bingo game or slot machine,
2. The winnings (reduced by the wager) are \$1,500 or more from a keno game,
3. The winnings (reduced by the wager or buy-in) are more than \$5,000 from a poker tournament,

# Reportable Gambling Winnings

4. The winnings (except winnings from bingo, slot machines, keno, and poker tournaments) reduced, at the option of the payer, by the wager are:
  - a. \$600 or more, and
  - b. At least 300 times the amount of the wager, or
5. The winnings are subject to federal income tax withholding (either regular gambling withholding or backup withholding).

# Proving Gambling Losses

- Losses may be more relevant than winnings in a divorce case. Three methods to prove
  - Testimony based on casual observations— may not be persuasive.
  - Cash withdrawals linked in time to gambling events (generally spotty).
  - Players cards in casinos – Spouses usually know whether these exist but if not they can be researched. These cards track losses as well as non-reportable winnings.

# Passive Activity Losses

- Some pass through losses are not deductible in the year incurred. They have to “wait”, indefinitely, until passive gains are available to offset the losses, or the passive activity is sold.
- Should these deferred gains be allowed against income for child support? It’s arguable. If you want to argue it, you need to be able to find it. Look first at page 2, Schedule E, then Form 8582. Then, surrender, and call a tax professional!



# Things you can learn from a business tax return

- Page 1
  - Date Business Started
  - Total Assets
  - Method of Accounting
  - Number of Partners
  - Annual Sales
  - Ordinary Income
  - Interest Expense

- Page 2
  - Related entities
  - Whether it had a foreign bank account
- Page 5
  - Balance sheets at beginning and end of the year
  - Contributions to Capital in current year
  - Distributions of Capital in current year

# Things you can learn

- Form 1125-A
  - Inventory valuation methods
- Form M-3
  - Type of financial statements issued and whether audited.
  - Book Tax Differences and whether they are permanent or temporary (that will turn around later.)

# Things you can learn.....

- Form 4562
  - Capital expenditures in current year
  - Total Depreciation Expense current year
  - There may or may not be a depreciation detail included in the returns. To be sure you get that, include as separate discovery item. This is the place to look for the toys – sports cars, boats, duck clubs, four wheelers.

# Things you can learn....

- Other Deductions – white paper schedules
  - Detail of all other expenses including amortization needed to calculate EBITDA
  - Always look for professional and legal to spot case costs and you'll need to obtain a detail of underlying expenditures. Best to ask for native files if they exist (Quickbooks, Peachtree Sage, Quicken)
  - Look for high dollar items; start there to look at underlying detail.

# Things you can learn

- Schedules K-1 Percentage each partner or member or stockholder owns.
- Names and addresses of other owners.
- Whether Distributions were pro-rata to ownership.
- Whether Contributions were pro-rata to ownership.
- An indication of tax basis in the partnership – may or may not be actual tax basis.

# Other Frost Professionals With Skills You Need!

- BV & Litigation Support Professionals
  - Angie Hopkins, CPA/ABV, CFE, MAFF 501.975.013 – More than 15 years of BV & Litigation Experience; focused entirely on these areas.
  - Ted Duncan, CPA/ABV, CVA 501.975.0248 – More than 15 years of BV and Litigation Experience and more than 35 years of attestation (audits, reviews and compilations.)
  - Chris Bedwell, CPA 479.695.4359 – more than 10 years of BV and Litigation Experience; focused entirely on these areas.

# Have a Great Time at the Annual Meeting!



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