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DETERMINING SELF-EMPLOYMENT INCOME FOR CHILD SUPPORT PURPOSES: THE MASSACHUSETTS VIEW COMPARED WITH THE NATIONAL VIEW

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I. INTRODUCTION

Since 1988, the Massachusetts Child Support Guidelines ("Guidelines") have presumptively applied to all child support orders entered by Probate and Family Courts ("probate court") throughout the Commonwealth, including cases involving self-employed parents.[1] From 1988 to 2008, these Guidelines largely remained unchanged, defining income earned by small business-owning parents as simply "income from self-employment."[2] As a result, the proper approach to determining self-employment income principally fell on individual probate court judges during this period.[3] Under the Guidelines, probate court judges have considerable discretion, and Massachusetts statutory law defers to the Guidelines in all respects.[4] Because probate court findings in cases involving Guidelines issues have long been subject to review under the abuse of discretion standard, which requires significant deference to trial court findings, the Massachusetts Appeals Court and Supreme Judicial Court ("SJC") found little space to clarify the definition of self-employment income prior to 2009.[5]

In 2006, a task force, appointed by Chief Justice for Administration and Management Robert Mulligan, undertook a comprehensive review of the Guidelines and made substantial revisions.[6] Effective January 1, 2009, these revised Guidelines ("2009 Guidelines") provided a clear definition of self-employment income, describing it as "gross receipts minus ordinary and necessary expenses required to produce income."[7] The 2009 Guidelines definitively stated that self-employment income for child support purposes "[i]n many cases . . . will differ from a

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[1] *See* MASS. GEN. LAWS ch. 208, § 28 (2008); *see also* MASS. GEN. LAWS ch. 209, § 37 (2008); MASS. GEN. LAWS ch. 209C, §§ 1, 3 (2008).

[2] *See generally* 1 CHARLES P. KINDREGAN, JR. & MONROE L. INKER, FAMILY LAW AND PRACTICE § 10:3 (Mass. Prac. Series, 3d ed. 2010) (discussing evolution of Guidelines).

[3] *See id.*

[4] *See* Richards v. Mason, 767 N.E.2d 84, 88 (Mass. App. Ct. 2002) (discussing "presumptive application" of Guidelines).

[5] *See* Martin v. Martin, 874 N.E.2d 1137, 1140-41 (Mass. App. Ct. 2007) (remanding case to determine child support due to abuse of discretion).

[6] *See* 1 KINDREGAN & INKER, *supra* note 2, § 10:3 (noting Chief Justice Mulligan defined task force's objective as open and transparent evaluation of Guidelines). The task force conducted its review between late 2006 and October 2008. *Id*.

[7] THE TRIAL COURT OF THE COMMONWEALTH OF MASS., CHILD SUPPORT GUIDELINES 3 (2009) [hereinafter 2009 GUIDELINES], *available at* http://www.mass.gov/courts/childsupport/guidelines.pdf.

determination of business income for tax purposes."[8] The 2009 Guidelines also provided new guidance on the types of tax deductible business expenses not applicable in the child support context.[9]

Following the release of the 2009 Guidelines, Massachusetts courts announced decisions in several cases that applied and interpreted the Guidelines, thereby providing probate court judges with new guideposts when setting child support orders in cases involving self-employed individuals.[10] Despite the clarification provided by the 2009 Guidelines and subsequent case law reviewing self-employment income in child support cases, significant questions remain regarding the best approach and methodology for determining self-employment income. This Article seeks to provide judges, practitioners and litigants with guidance by identifying, organizing, and presenting state and federal law affecting self-employment income in child support cases from a broad range of jurisdictions.[11]

Part II of this Article examines the evolution of the Massachusetts Child Support Guidelines, including recent appellate decisions involving the 2009 Guidelines.[12] Part III.A details the critical "ordinary and necessary" test, which determines the deductibility of claimed business expenses from income through the lens of federal tax law.[13] Part III.B provides a primer on "deductible" versus "capital" expenses under the tax code.[14] Part IV analyzes the phrase "expenses required to produce income" included in the 2009 Guidelines, examining how other states define similar language by statute, rules of court and case law.[15] Part V concludes with a

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[8] *Id.*

[9] *See id.* ("Expense reimbursements, in-kind payments or benefits received by a parent, personal use of business property, payment of personal expenses by a business in the course of employment, self-employment, or operation of a business may be included as income if such payments are significant and reduce personal living expenses.").

[10] *See* J.S. v. C.C., 912 N.E.2d 933, 941 n.13 (Mass. 2009) (applying new definition of "business income" expressed in 2009 Guidelines); Halpern v. Rabb, 914 N.E.2d 110, 114 (Mass. App. Ct. 2009) (distinguishing income for tax purposes from income for child support purposes under 2009 Guidelines); Whelan v. Whelan, 908 N.E.2d 858, 866-67 (Mass. App. Ct. 2009) (holding deductibility of business expenses for child support determined differently than for tax purposes); Zoffreo v. Zoffreo, No. 08-P-1689, 2010 WL 9952, at *2 (Mass. App. Ct. Jan. 5, 2010) (determining father's tax deductions not deductible from income for child support purposes under 2009 Guidelines).

[11] *See infra* Parts II-V.

[12] *See infra* Part II (offering history of Massachusetts Child Support Guidelines).

[13] *See infra* Part III.A (examining ordinary and necessary business expenses under federal tax law in child support context).

[14] *See infra* Part III.B (discussing capital expenses as not part of "ordinary and necessary" definition).

[15] *See infra* Part IV (looking at other states' approaches on issue of business expenses).

comprehensive list of common business expenses to provide judges, practitioners and litigants with a reference guide to the deductibility of specific business expenses from income for child support purposes.[16]

II. THE EVOLUTION OF THE MASSACHUSETTS CHILD SUPPORT GUIDELINES

A. Ordering and Enforcement Prior to 2009

Massachusetts law states: "Upon a judgment for divorce, the court may make such judgment as it considers expedient relative to the care, custody and maintenance of the minor children of the parties . . . ."[17] Similarly, Massachusetts law provides that when "parents of minor children live apart from each other, not being divorced, the probate court . . . shall have the same power to make judgments relative to their care, custody, education and maintenance."[18] In all child support cases in Massachusetts, there is a rebuttable presumption that the amount of child support calculated by the Guidelines formula is the appropriate amount to be ordered.[19]

Prior to 1984, each state enforced child support through a considerable hodgepodge of laws under loose federal oversight, which led to the need for improved consistency and "greater fairness to families."[20] In 1984, Congress amended Title IV-D of the Social Security Act to resolve the child support crisis, mandating uniform state enforcement standards for child support orders throughout the country.[21] In response to

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[16] *See infra* Part V (reviewing deductibility of specific business expenses from child support income).

[17] MASS. GEN. LAWS ch. 208, § 28 (2008).

[18] MASS. GEN. LAWS ch. 209, § 37 (2008); *see also* MASS. GEN. LAWS ch. 209C, § 1 (2008) (requiring support for children born out of wedlock); MASS. GEN. LAWS ch. 209C, § 3 (2008) (applying presumptive affect of Guidelines to non-marital cases). Additionally, child support orders may be established in abuse prevention actions. *See* MASS. GEN. LAWS ch. 209A, § 3(e) (2008). Such orders are also used in care and protection proceedings. *See* MASS. GEN. LAWS ch. 119, § 28 (2008).

[19] *See* MASS. GEN. LAWS ch. 208, § 28 (2008) (applying presumptive affect of Guidelines in divorce proceedings); *see also* MASS. GEN. LAWS ch. 208, §§ 18-19, 28A, 37 (2008) (establishing authority to set child support pursuant to Guidelines at temporary order stage).

[20] *See* 1 KINDREGAN & INKER, *supra* note 2, § 10:3 (discussing need for uniformity of guidelines and enforcement among states with respect to child support).

[21] *See* Child Support Enforcement Amendments of 1984, Pub. L. No. 98-378, § 466, 98 Stat. 1305 (1984) (amending Social Security Act to improve child support enforcement). Following the 1984 Amendments to the Social Security Act, Congress produced the Family Support Act of 1988, which directed state courts to create a "rebuttable presumption, in any judicial or

this federal mandate, Massachusetts enacted the Child Support Enforcement Act of 1986.[22] In 1988, Massachusetts promulgated its first Child Support Guidelines ("1988 Guidelines"), which provided, in pertinent part:

> The child support guidelines are formulated for justices of the Trial Court's use, whether the parents of the children are married or unmarried, in setting temporary, permanent or final orders for current child support, in deciding whether to approve agreements for child support, and in deciding cases that are before the court to modify existing orders.[23]

The 1988 Guidelines defined income as "gross income from whatever source," and provided an enumerated list of income sources that included self-employment income.[24] The 1988 Guidelines also introduced a worksheet in which the respective gross weekly incomes of parents were used to calculate baseline weekly support, with adjustments for the number of children covered by the order and the age of the oldest child.[25]

The Massachusetts Chief Justice for Administration and Management then promulgated revised versions of the Child Support Guidelines in 1989, 1994, 2002 and 2006.[26] Somewhat strikingly,

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administrative proceeding for the award of child support, that the amount of the award which would result from the application of such guidelines is the correct amount of child support to be awarded." Family Support Act of 1988, Pub. L. No. 100-485, § 103, 102 Stat. 2343 (1988). The Family Support Act required that by 1990, each state develop a plan for the periodic review and potential adjustment of child support at the request of either parent. *See id.*; *see also* MASS. GEN. LAWS ch. 119A, § 1 (2008) (establishing enforcement agency in Massachusetts consistent with federal mandate); 45 C.F.R. § 302.56 (2007) (providing specific mathematical criteria for states' calculation of child support). "The department of revenue shall be the single state agency within the Commonwealth that is designated the IV-D agency pursuant to Title IV, Part D of the Social Security Act . . . ." ch. 119A, § 1.

[22] *See* ch. 119A, § 1 (noting creation of statute in 1986).

[23] THE TRIAL COURT OF THE COMMONWEALTH OF MASS., CHILD SUPPORT GUIDELINES 2 (1988) [hereinafter 1988 GUIDELINES], *available at* http://archives.lib.state.ma.us/bitstream/handle/2452/48856/ocm17537400.pdf.

[24] *See id.* (including salary, wages, overtime and tips in definition of income).

[25] *See id.* at 6 (noting "basic order" for children up to age six increases between ages seven and thirteen).

[26] *See* 1 KINDREGAN & INKER, *supra* note 2, § 10:3 (describing history of judicial review and revision of Guidelines in Massachusetts). *See, e.g.*, THE TRIAL COURT OF THE COMMONWEALTH OF MASS., CHILD SUPPORT GUIDELINES (2006), *available at* http://www.mass.gov/courts/formsandguidelines/csg2006.html; THE TRIAL COURT OF THE COMMONWEALTH OF MASS., CHILD SUPPORT GUIDELINES (2002), *available at*

revisions to the Guidelines during this period principally worked at the margins, with modest adjustments to baseline orders focusing on certain expenses, such as medical insurance and child care, while mostly leaving the core formula for determining basic support intact.[27]

B. Self-Employment Income Prior to 2009

Since their adoption, the Guidelines have maintained presumptive application in all cases seeking a child support order, but appellate review of probate court decisions affecting the child support obligations of self-employed parents was limited before 2009. Statutory and case law vested probate court judges with considerable discretion in matters affecting the care and custody of children, and the exercise of this discretion unsurprisingly resulted "in a range of proposed support orders" in child support cases involving self-employment income, where the Guidelines provided limited guidance to the presiding judge.[28] This discretion was largely a result of Massachusetts' abuse of discretion standard—the standard of review applicable to decisions in child support cases prohibiting appellate courts from disturbing lower court findings unless they are "clearly erroneous"—combined with the absence of a clear definition of self-employment income under the pre-2009 Guidelines.[29]

Lacking this clear definition, the Massachusetts Appeals Court was limited in its review of child support cases involving self-employment income because probate court judges possessed both considerable

http://archives.lib.state.ma.us/bitstream/handle/2452/48859/ocm49932311.pdf; THE TRIAL COURT OF THE COMMONWEALTH OF MASS., CHILD SUPPORT GUIDELINES (1994), *available at* http://archives.lib.state.ma.us/bitstream/handle/2452/48858/ocm29692830.pdf; COMMONWEALTH OF MASS. OFFICE OF THE CHIEF ADMIN. JUSTICE, CHILD SUPPORT GUIDELINES (1989), *available at* http://archives.lib.state.ma.us/bitstream/handle/2452/48857/ocm20480676.pdf.

[27] *See* 1 KINDREGAN & INKER, *supra* note 2, § 10:3 (summarizing substantive revisions to Guidelines).

[28] *See* Richards v. Mason, 767 N.E.2d 84, 88-89 (Mass. App. Ct. 2002) (discussing court's broad discretion in upholding child support order amounts); *see also* O'Meara v. Doherty, 761 N.E.2d 965, 969 (Mass. App. Ct. 2002) (finding no abuse of discretion in judge's determination of child support obligation); Canning v. Juskalian, 597 N.E.2d 1074, 1076 (Mass. App. Ct. 1992) (noting abuse of discretion standard in upholding support order).

[29] *See* Martin v. Martin, 874 N.E.2d 1137, 1139 (Mass. App. Ct. 2007) (internal quotation marks omitted) ("A trial court's findings of fact will be upheld unless . . . . the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.") (citations omitted). "Abuse of discretion" is defined in Black's Law Dictionary as "[a]n appellate court's standard for reviewing a decision that is asserted to be grossly unsound, unreasonable, illegal, or unsupported by the evidence." BLACK'S LAW DICTIONARY 11 (9th ed. 2009).

discretion and broad deference due to the abuse of discretion standard.[30] The Massachusetts Appeals Court repeatedly signaled its approval by affirming lower court decisions finding that the tax deductibility of a particular business expense did not guarantee that the same expense was deductible from a parent's income for child support purposes.[31] For example, in 1998 the Massachusetts Appeals Court in *Smith-Clarke v. Clarke*[32] held a "husband's lack of records substantiating claimed business expenditures and his commingling of business and personal expenditures made it reasonable for the judge to disregard certain claimed items . . . or to substitute a reasonable figure for others."[33] The court held, "[a]bsent substantiation of 1995 income, the judge could properly assume it approximated 1994 income."[34]

In 2005 in *Maillet v. Maillet*,[35] the Massachusetts Appeals Court remanded the case for review on issues similar to those found in *Smith-Clarke*.[36] In *Maillet*, the financial statement of a business-owning husband set forth gross income of just $800 per week, but the husband's corporation had much more substantial income reduced by questionable depreciation deductions.[37] The court held that the wife's access to her husband's accountant and records was "by itself . . . [in]sufficient to absolve the husband of his obligation to provide an accurate and current statement of his income."[38]

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[30] *See* Leonardo v. Leonardo, 665 N.E.2d 1034, 1036-37 (Mass. App. Ct. 1996) (refusing to overturn probate court judge's decision after applying abuse of discretion standard). *But see* Dep't of Revenue v. G.W.A., 590 N.E.2d 176, 179 (Mass. 1992) ("When a judge determines that application of the guidelines would produce an unjust or inappropriate result, the judge must attempt to fashion a more equitable order based on all the relevant considerations."). The SJC is also bound by the abuse of discretion standard. *See* Boulter-Hedley v. Boulter, 711 N.E.2d 596, 599 (Mass. 1999) (reviewing lower court's determination of child support under Guidelines using abuse of discretion standard).

[31] *See* Smith-Clarke v. Clarke, 691 N.E.2d 596, 598 (Mass. App. Ct. 1998) (ruling trial judge properly disregarded parent's business expenses).

[32] 691 N.E.2d 596 (Mass. App. Ct. 1998).

[33] *Id.* at 598.

[34] *Id.*

[35] 835 N.E.2d 281 (Mass. App. Ct. 2005).

[36] *Compare Maillet*, 835 N.E.2d at 285-87 (remanding to further determine husband's financials), *with Smith-Clarke*, 691 N.E.2d at 598 (vacating judgment to determine whether husband should place children on his group health insurance policy).

[37] *Maillet*, 835 N.E.2d at 286. "[Husband's] corporation in 2002 had income of $227,744 exclusive of suspended losses and depreciation." *Id.*

[38] *Id.* (finding self-employed husband in better position than wife to know his financials). Although the *Smith-Clarke* and *Maillet* decisions fall short of announcing a clear standard, when read together they strongly suggest the burden of proof to establish self-employed income rests with the self-employed parent. *See id.*; *see also* Smith-Clarke v. Clarke, 691 N.E.2d 596, 598

Prior to the 2009 Guidelines, the Massachusetts Appeals Court possessed authority to interpret the text of administrative regulations, such as the Guidelines, when the issue involved "the process of construing and interpreting legal terms, concepts, rules, standards, and principles" underpinning a particular regulation.[39] The requirement that a probate court judge explains any deviation from the Guidelines in detailed findings suggests the Massachusetts Appeals Court was well-positioned to interpret and apply a standard for self-employment income had the pre-2009 Guidelines provided even a limited definition of self-employment income.[40] It was not until the 2009 Guidelines were released, however, that the Massachusetts Appeals Court had the opportunity to meaningfully exercise this authority in child support cases involving self-employed parents.[41]

C. The 2009 Child Support Guidelines: Self-Employment Definition Receives Initial Appellate Review

In 2006, Chief Justice for Administration and Management Robert Mulligan appointed a Child Support Guidelines Task Force to conduct a comprehensive review of the Guidelines.[42] The resulting report ("Task Force Report") led to the adoption of revised Guidelines in early 2009, which included comprehensive changes in the mathematical formula used to calculate child support orders, as well as significant changes to the structure and definitions described in the Guidelines.[43]

(Mass. App. Ct. 1998). In dicta, the court in *Maillet* emphasized the self-employed parent's obligation to accurately disclose his or her self-employment income. *See Maillet*, 835 N.E.2d at 286 n.12 (dictum) (citing Krapf v. Krapf, 786 N.E.2d 318 (Mass. 2003)). In *Krapf*, the SJC held "spouses who enter into agreements with each other are held to standards higher than those we tolerate in the arm's-length transactions of the marketplace." *See Krapf*, 786 N.E.2d at 323. The court in *Krapf* noted spouses entering such agreements are essentially fiduciaries to one another, and they should be "held to the highest standards of good faith and fair dealing in the performance of their contractual obligations." *Id.*

[39] 40 ALEXANDER J. CELLA, ADMINISTRATIVE LAW AND PRACTICE § 1633 (Mass. Prac. Series, 2010); *see also* MASS. GEN. LAWS ch. 211B, § 9 (2008) ("The chief justice for administration and management in addition to his judicial duties and subject to the superintendence power of the supreme judicial court . . . shall have general superintendence of the administration of the trial court . . . .").

[40] *See* Gilman v. Dubin, 597 N.E.2d 1388, 1388 (Mass. App. Ct. 1992) ("At a minimum, the judge is to explain why she did not apply the guidelines. If good reason appears, the support order may be reinstated.").

[41] *See* 2009 GUIDELINES, *supra* note 7, at 3.

[42] *See* 1 KINDREGAN & INKER, *supra* note 2, § 10:3 (noting creation of task force).

[43] *Compare* 1988 GUIDELINES, *supra* note 23, at 2 (defining income for child support as "gross income from whatever source," including "self-employment income"), *with* REPORT OF

From 1988 to 2008, the Guidelines provided *no definition* of self-employment income beyond offering that it was among the sources of gross income for child support purposes.[44] However, the 2009 Guidelines included a specific definition of self-employment income for the first time:

> Self-Employment or Other Income. Income from self-employment, rent, royalties, proprietorship of a business, or joint ownership of a partnership or closely-held corporation, is defined as gross receipts minus ordinary and necessary expenses required to produce income. In general, income and expenses from self-employment or operation of a business should be carefully reviewed to determine the appropriate level of gross income available to the parent to satisfy a child support obligation. In many cases this amount will differ from a determination of business income for tax purposes.
> Expense reimbursements, in-kind payments or benefits received by a parent, personal use of business property, payment of personal expenses by a business in the course of employment, self-employment, or operation of a business may be included as income if such payments are significant and reduce personal living expenses.[45]

It is unsurprising that the Massachusetts Appeals Court, now armed with this new definition, announced a series of decisions applying the new language to cases involving child support obligations of self-employed parents.

In *Whelan v. Whelan*,[46] the Massachusetts Appeals Court interpreted the 2009 Guidelines' definition of self-employment income for the first time, holding "a judge must determine whether claimed business deductions are reasonable and necessary to the production of income, without regard to whether those deductions may be claimed for Federal or State income tax purposes."[47] In *Halpern v. Rabb*,[48] the Massachusetts

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THE CHILD SUPPORT GUIDELINES TASK FORCE 33-34 (2008) [hereinafter TASK FORCE REPORT], *available at* http://www.mass.gov/courts/childsupport/task-force-report.pdf (clarifying self-employment income as "gross receipts minus ordinary and necessary expenses required to produce income").

[44] *See* TASK FORCE REPORT, *supra* note 43, at 34 (noting concerns regarding lack of consistency among definitions and income calculation methods).

[45] 2009 GUIDELINES, *supra* note 7, at 3.

[46] 908 N.E.2d 858 (Mass. App. Ct. 2009).

[47] *Id.* at 867 (holding error to deduct pension, profit sharing and taxes from father's child

Appeals Court held that if a parent is the sole shareholder of a business, the burden of proof rests with the business-owning parent to demonstrate the reasonableness and necessity of "undistributed earnings for purposes of determining income available for child support."[49] The SJC held in *J.S. v. C.C.*[50] that retained earnings of a business should be "viewed as income available for child support" if such earnings enable the self-employed parent to expand his or her business.[51]

The 2009 Guidelines are silent regarding burden of proof in cases involving the child support obligations of self-employed parents, but the *Whelan* and *Halpern* holdings clarify this issue.[52] The cases articulate a clear methodology: (1) The judge *must* determine if claimed business expenses are reasonable and necessary to the production of income, and (2) the burden of demonstrating the reasonableness and necessity of claimed business expenses belongs to the self-employed parent.[53] Additionally, in the unpublished 2009 opinion *Haseotes v. Haseotes*,[54] the Massachusetts Appeals Court suggested those self-employed parents, who take the disingenuous position that their income for child support purposes is identical to their taxable income, may face an award of attorney's fees to the other parent if the case proceeds to trial.[55]

In 2010, the Massachusetts Appeals Court again addressed self-employment income in *Zoffreo v. Zoffreo*,[56] an unpublished decision upholding a trial court judge's finding that a husband had $390,000 in

support income); *see also* Halpern v. Rabb, 914 N.E.2d 110, 114 (Mass. App. Ct. 2009) ("In order to determine whether corporate earnings should be included in a parent's income for purposes of calculating child support and, if so, to what extent, a judge should examine whether the corporation's earnings are available to the parent for child support purposes.").

[48] 914 N.E.2d 110 (Mass. App. Ct. 2009).

[49] *Id.* at 115 (quoting J.S. v. C.C., 912 N.E.2d 933, 943 (Mass. 2009)); *see also* Smith-Clarke v. Clarke, 691 N.E.2d 596, 598 (Mass. App. Ct. 1998) (finding judge properly disregarded business deductions). In *Smith-Clarke*, the court found a lack of substantiation and commingling of personal and business expenditures, allowing the lower court to disregard or substitute reasonable figures for certain claimed business expense deductions from husband's gross income. *See Smith-Clarke*, 691 N.E.2d at 598.

[50] 912 N.E.2d 933 (Mass. 2009).

[51] *See id.* at 943 n.15 (explaining expenditures used to expand business increase net worth, making deductibility inappropriate for child support).

[52] *See Halpern*, 914 N.E.2d at 115 (assigning burden of proof to self-employed parent); *Whelan*, 908 N.E.2d at 867 (holding judge should assess reasonableness and necessity of claimed business deductions).

[53] *See supra* notes 46-52 and accompanying text (discussing recent appellate decisions post-2009 Guidelines).

[54] No. 08-P-1162, 2009 WL 2176663 (Mass. App. Ct. July 23, 2009).

[55] *See id.* at *5 (noting majority of litigation costs generated by father's income claims).

[56] No. 08-P-1689, 2010 WL 9952 (Mass. App. Ct. Jan. 5, 2010).

gross yearly income for child support purposes despite differing information on his tax returns.[57] The husband's tax returns displayed no taxable income except $37 in interest, but included $192,986 in deductions for depreciation, along with "$15,274 in itemized deductions and $25,000 in real estate losses."[58] *Zoffreo* extends *Whelan,* endorsing the trial court's approach of determining the father's income for child support purposes from his personal and corporate tax returns by re-categorizing the deductions claimed on the tax returns as income for child support purposes.[59]

These cases offer a starting point for understanding self-employment income under the 2009 Guidelines by focusing on the deductibility of a self-employed parent's business expenses from income for child support purposes. However, the cases alone fail to provide a comprehensive approach to answering the most important question within the definition of self-employment income under the 2009 Guidelines: What constitutes an "ordinary and necessary expense" that is "required to produce income," such that the claimed expense should be deducted from income for child support purposes?[60]

III. ORDINARY AND NECESSARY EXPENSES: WHERE THE GUIDELINES AND TAX CODE OVERLAP

The 2009 Guidelines define self-employment income as "gross receipts minus ordinary and necessary expenses required to produce income."[61] Defining gross receipts is a straightforward process: the Internal Revenue Service ("I.R.S.") states the term represents all of the "income you receive from your business."[62] However, determining what "ordinary and necessary" business expenses should be *deducted* from a self-employed parent's gross receipts to determine income for child support purposes is a more complicated endeavor.

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[57] *See id*. at *2 ("Simply, he has not shown that depreciation is a legitimate business expense used to produce income.").

[58] *Id*. at *2 n.7.

[59] *See id.* at *3 (detailing findings and rationale from trial court).

[60] *See* 2009 GUIDELINES, *supra* note 7, at 3.

[61] 2009 GUIDELINES, *supra* note 7, at 3.

[62] *See* INTERNAL REVENUE SERV., PUBLICATION 583, STARTING A BUSINESS AND KEEPING RECORDS 12 (Jan. 2007), *available at* http://www.irs.gov/pub/irs-pdf/p583.pdf; *see also* I.R.C. § 512(a)(1) (2006) ("[T]he gross income derived . . . from any . . . trade or business . . . less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business . . . .").

The Internal Revenue Code ("I.R.C.") defines tax deductible business expenses as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[63] Despite clearly borrowing language regarding "ordinary and necessary" expenses from the I.R.C., the 2009 Guidelines expressly note that income for child support purposes will differ from income for tax purposes.[64] The Task Force Report Executive Summary expands upon self-employment income under the 2009 Guidelines:

> The paragraph provides the following definition of gross income from self-employment, rent, royalties, proprietorship of a business, or joint ownership of a partnership or closely-held corporation: "gross receipts minus ordinary and necessary expenses required to produce income." This definition is intended to clearly instruct that gross receipts are not the same as gross income and *to distinguish taxable income from income used to calculate child support*.[65]

If the drafters of the 2009 Guidelines wanted to distinguish taxable income from income for child support purposes, why adopt the ordinary and necessary language that has long defined business expenses under the I.R.C.?[66] The most logical explanation is also the simplest: a claimed business expense must first satisfy the I.R.C.'s "ordinary and necessary" test to be deductible from income for child support purposes, and then must comply with a second test of being "required to produce income."[67] Read this way, the 2009 Guidelines impose a more restrictive approach: (1) the

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[63] I.R.C. § 162(a) (2006). The code section goes on to identify deductible business expenses, including:

> (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;
> (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

I.R.C. § 162(a)(1)-(3).

[64] *See* 2009 GUIDELINES, *supra* note 7, at 3; I.R.C. § 162(a); I.R.C. § 512.

[65] TASK FORCE REPORT, *supra* note 43, at 6 (emphasis added).

[66] *See id.*; *see also* I.R.C. § 162(a).

[67] *See* 2009 GUIDELINES, *supra* note 7, at 3.

expense must be "ordinary and necessary" as defined by the I.R.C., and (2) the expense must also be "required to produce income" to be deductible.[68]

Support for direct application of the I.R.C.'s ordinary and necessary test in child support cases is found in Massachusetts' requirement that self-employed parents file a sworn Financial Statement in child support proceedings using an official form, promulgated by the Commonwealth.[69] The form requires self-employed parents to provide the gross monthly receipts of their business, as well as the monthly cost of many business expenses found throughout the tax code, including: advertising, cost of goods sold, dues and subscriptions, depreciation, insurance, legal and professional services, repairs, supplies, meals and entertainment, utilities and phones, and wages.[70] The business expense categories set forth on the form are largely identical to those described in the I.R.S. Instructions for Schedule C, the ubiquitous tax form submitted by small business owners across the United States.[71]

The Financial Statement's complete adoption of business expense deductions derived from the tax code is unlikely a coincidence. The form unquestionably borrows from tax law, and is highly consistent with an interpretation of the 2009 Guidelines that incorporates the I.R.C.'s well-defined ordinary and necessary standard, followed by a more restrictive "required to produce income" test that prevents the deduction of certain tax-deductible expenses from child support income.[72] Accordingly,

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[68] *Compare* 2009 GUIDELINES, *supra* note 7, at 3 (noting ordinary and necessary expenses deductible if required to produce income), *with* I.R.C. § 162 (a)(1)-(3) (2006) (stating ordinary and necessary expenses deductible if incurred while "carrying on any trade or business").

[69] *See* PROBATE AND FAMILY COURT DEP'T, THE TRIAL COURT OF THE COMMONWEALTH OF MASS., FINANCIAL STATEMENT SCHEDULE A (2007) [hereinafter FINANCIAL STATEMENT SCHEDULE A], *available at* http://www.mass.gov/courts/courtsandjudges/courts/probateandfamilycourt/documents/cjd301scheduleaprintversion.pdf.

[70] *See id.* (listing all monthly business expenses required for self-employment income).

[71] *See generally* INTERNAL REVENUE SERV., INSTRUCTIONS FOR SCHEDULE C, PROFIT OR LOSS FROM BUSINESS (2010) [hereinafter SCHEDULE C INSTRUCTIONS], *available at* http://www.irs.gov/pub/irs-pdf/i1040sc.pdf (instructing business owners regarding deductions from gross receipts for business expenses). The close alignment between self-employment income under the 2009 Guidelines and net business income under the I.R.C. appears similar to a characterization by the Louisiana Court of Appeals of its own child support guidelines. *See* Scott v. Scott, 989 So. 2d 290, 295 (La. Ct. App. 2008) ("[T]he gross-receipts-less-ordinary-and-necessary-business-expense formula of the [child support guidelines] statute . . . closely parallels the net business income measure for taxes . . . ."). Louisiana's child support guidelines resemble Massachusetts' 2009 Guidelines, having long defined self-employment income as "[g]ross receipts minus ordinary and necessary expenses required to produce income . . . ." *See* LA. REV. STAT. ANN. § 9:315(C)(3)(c) (2008) (providing definitions of self-employment income and enumerating tax deductible business expenses includable in same).

[72] *See* 2009 GUIDELINES, *supra* note 7, at 3.

determining which expenses are deductible from income for child support purposes starts with an examination of ordinary and necessary expenses under the I.R.C.

A. Ordinary and Necessary as Defined by Tax Law

Under Massachusetts and federal tax law, "only 'ordinary and necessary' business expense deductions are allowable" when calculating a business-owner's taxable income.[73] In *Sherwin-Williams Co. v. Commissioner of Revenue*,[74] the SJC explained the incorporation of federal tax law into the law of the Commonwealth as follows:

> [Massachusetts law] provides that corporations may take such deductions as are allowable under the Internal Revenue Code . . . . To qualify as an allowable deduction under § 162, a taxpayer must demonstrate that an expenditure satisfies five requirements: (1) it was paid or incurred during the taxable year, (2) it was used to carry on a trade or business, (3) it was an expense, (4) it was a *necessary expense*, and (5) it was an *ordinary expense*.[75]

Just what constitutes an ordinary and necessary business expense has "been the subject of much discussion over the years."[76] Federal tax law defines ordinary expenses as those that are "normal, usual, or customary" in a given trade or industry.[77] In other words, an ordinary expense "must be, in the business context in which it arose, a 'common' or 'accepted' method to achieve a business objective in the circumstance."[78] The United States Supreme Court has noted that the particular transaction giving rise to an ordinary expense needs to be common or frequent for the specific type of business.[79] Interestingly, the threshold to demonstrate that an expense is

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[73] *See* Syms Corp. v. Comm'r, 765 N.E.2d 758, 765 n.14 (Mass. 2002) (interpreting federal tax code in state income tax case).

[74] 778 N.E.2d 504 (Mass. 2002).

[75] *Id.* at 519 (emphasis added); *see also* I.R.C. § 162 (2006) (defining trade or business expenses for deductibility purposes); Comm'r v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971) (establishing five elements for deductibility under I.R.C.).

[76] *Sherwin-Williams*, 778 N.E.2d at 519.

[77] *Id.* (quoting Deputy v. du Pont, 308 U.S. 488, 495 (1940)) (characterizing ordinary business expenses).

[78] *Syms Corp.*, 765 N.E.2d at 765 n.14 (citations omitted).

[79] *See* Deputy v. du Pont, 308 U.S. 488, 495 (1940) ("[T]he fact that a particular expense would be an ordinary or common one in the course of one business and so deductible . . . does not

necessary, seems to be lower; as a taxpayer need only show that the expenditures were "appropriate and helpful."[80]

B. Understanding Ordinary or Necessary: Capital Expenses

Black's Law Dictionary defines "capitalize" as follows: "[t]o treat (a cost) as a capital expenditure rather than an ordinary and necessary business expense."[81] As the Black's definition suggests, business expenses fall under two broad categories within the tax code: tax-deductible ordinary and necessary expenses, and all other non-deductible expenses broadly defined as "capital expenses."[82] The I.R.C. refers to capital expenses as including "permanent improvements or betterments . . . [and] envisions an inquiry into the duration and extent of the benefits realized by the taxpayer."[83] Accordingly, determining whether an expense is ordinary and necessary turns on the duration of the benefit the business will receive as a result of the expenditure.[84]

One simple test for determining whether an expenditure is an ordinary and necessary expense entails looking at whether it will result in a

necessarily make it such in connection with another business.").

[80] *See* Welch v. Helvering, 290 U.S. 111, 113 (1933) (citing McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819)). Section 162 conceptualizes the phrase "ordinary and necessary" expenses as requiring any payment asserted as a deduction "be reasonable in relation to its purpose." *See* Sherwin-Williams Co. v. Comm'r of Revenue, 778 N.E.2d 504, 521 (Mass. 2002). Therefore, while an expense may be ordinary and necessary on its face, it can also be unreasonable in terms of the amount. *See* Audano v. United States, 428 F.2d 251, 256 (5th Cir. 1970).

[81] BLACK'S LAW DICTIONARY 238 (9th ed., 2009).

[82] *See* INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992) ("Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization."); *see also* Comm'r v. Idaho Power Co., 418 U.S. 1, 19 (1974) (holding "equipment depreciation allocable to taxpayer's construction of capital facilities is to be capitalized"); Comm'r v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354-55 (1971) (discussing why additional premiums paid by bank to federal insurers equal capital expenditures); United States v. Hilton Hotels Corp., 397 U.S. 580, 584-85 (1970) (holding professional fees incurred by acquiring firm in minority stock appraisal proceeding as capital expenditures); Comm'r v. Tellier, 383 U.S. 687, 690 (1966) (holding legal expenses incurred in defending against securities fraud charges deductible under § 162(a)).

[83] *INDOPCO*, 503 U.S. at 88 (internal quotations omitted); *see also* I.R.C. § 263(a)(1) (2006) ("No deduction shall be allowed for . . . [a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.").

[84] *INDOPCO*, 503 U.S. at 90 ("The purpose for which the expenditure is made has to do with the corporation's operations and betterment . . . for the duration of [the business'] existence or for the indefinite future or for a time somewhat longer than the current taxable year.") (internal quotations omitted) (quoting Gen. Bancshares Corp. v. Comm'r, 326 F.2d 712, 715 (8th Cir. 1964)).

benefit to the business beyond the current tax year.[85] Expenditures that primarily benefit the business in the current tax year are ordinary and necessary expenses.[86] Expenditures that expand a business, invest in future operations, or result in benefits beyond the current tax year are considered capital expenses, not ordinary and necessary expenses.[87]

An ordinary and necessary expense may carry some future benefit, but it remains deductible so long as the primary benefit is enjoyed in the current tax year.[88] Similarly, even capital expenses generating immediate benefits are not ordinary and necessary if the primary benefit is enjoyed in a future tax year.[89] Applying this rule in the child support context is reasonably simple. First, the benefit resulting from the expense must be current or less than one year in duration, to qualify as an ordinary and necessary expense.[90] Further, to be ordinary and necessary the expense must be normal, usual, or customary for the industry or trade, and must be reasonable in amount to accomplish the business purpose.[91]

Under the tax code, business owners who incur capital expenses may still receive a tax benefit under the rules of capitalization, which encompass so-called "depreciable assets," such as "buildings, machinery and equipment, furniture and fixtures, and similar property having a useful

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[85] *Compare* Domestic Mgmt. Bureau v. Comm'r, 38 B.T.A. 640, 646-47 (1938) (holding costs of preparing and printing training manual as capital expenditures), *with* Rev. Rul. 96-62, 1996-2 C.B. 9 (determining routine update training materials costs as deductible).

[86] *See* Van Iderstine Co. v. Comm'r, 261 F.2d 211, 212-13 (2d Cir. 1958) (noting supplier payments ensuring continuing supply of raw materials deductible); T.J. Enter., Inc. v. Comm'r, 101 T.C. 581, 589 (1993) (noting expenses incurred to protect, maintain, or preserve taxpayer's business generally deductible); Snow v. Comm'r, 31 T.C. 585, 596 (1958) (holding payments made to protect and supplement taxpayer's income from existing law business deductible).

[87] *See supra* note 82 and accompanying text (listing decisions finding capital expenses); *see also* I.R.C. § 263(a)(1) (disallowing deductions for new buildings or permanent improvements made to increase property or estate value); United States v. Miss. Chem. Corp., 405 U.S. 298, 310-11 (1972) (holding securities as capital assets as they maintain more than one year); Nachman v. Comm'r, 191 F.2d 934, 935-36 (5th Cir. 1951) (holding payment to obtain liquor license as capital expenditure); Harman v. Comm'r, 72 T.C. 362, 367-68 (1979) (holding initiation fees required to obtain seat on New York Stock Exchange as capital expenditures).

[88] *See* Rev. Rul. 94-12, 1994-1 C.B. 36 (determining incidental repair costs generally deductible under § 162 regardless of possible future benefit); Rev. Rul. 92-80, 1992-2 C.B. 57 (noting advertising costs generally deductible under § 162 despite potential future effect on business activities).

[89] *See* FMR Corp. v. Comm'r, 110 T.C. 402, 418-19 (1998) (discussing mutual fund development costs resulting in long-term management contracts as capital expenditures).

[90] *See* J.S. v. C.C., 912 N.E.2d 933, 943 (Mass. 2009) (holding business expenditures with primary purpose of expanding business not deductible for child support).

[91] *See supra* notes 77-79 and accompanying text (discussing definition of ordinary and reasonable expenses); *see also supra* note 80 and accompanying text (noting ordinary expenses as reasonable expenses under circumstances).

life substantially beyond the taxable year."[92] However, not all capital expenses are depreciable.[93] For capital expenditures that are depreciable, the business may "recover" a portion of the expense's original purchase price on a yearly basis through the process of depreciation.[94] The Supreme Court has opined that depreciation "prevents the distortion of income that would otherwise occur if [the full cost of the] depreciation properly . . . were deducted from gross income" in the same year it was purchased.[95]

For purposes of the 2009 Guidelines, ordinary and necessary expenses should be determined in line with the well-established definitions found in the I.R.C. and tax case law: customary, commonplace, or frequent transactions that result in a "current" benefit to the business lasting no more than one year.[96] As the I.R.C. and federal case law make clear, the fact that the tax code permits a deduction for a capital expense does not make the expense ordinary and necessary.[97] Indeed, tax deductions permitting recovery of costs associated with depreciable property arising out of the I.R.C. capitalization provisions are not ordinary and necessary expenses under § 162, as their deductibility for tax purposes is derived from entirely separate provisions of the I.R.C.[98]

In the child support context, courts and practitioners should start their evaluation of any claimed business expense deduction by asking: Is this an ordinary and necessary expense under the I.R.C.? In many cases, the claimed expense may be tax deductible pursuant to a section of the I.R.C. wholly unrelated to the ordinary and necessary standard set forth in § 162.[99] Ultimately, unless the expense is ordinary and necessary, it should not be deducted from a self-employed parent's income for child support purposes.

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[92] Treas. Reg. § 1.263(a)-2(a) (2010) (listing examples of capital expenditures).

[93] *See* Sharon v. Comm'r, 66 T.C. 515, 530 (1976) (holding costs incurred by attorney for admission to various bars as capital expenditures), *aff'd*, 591 F.2d 1273 (9th Cir. 1978).

[94] *See* I.R.C. § 168 (2006) (reviewing methods of depreciation); *see also* I.R.C. § 167 (2006) (discussing depreciation generally).

[95] Comm'r v. Idaho Power Co., 418 U.S. 1, 14 (1974) (citations omitted). In *J.S. v. C.C.*, the SJC applied concepts similar to the capital expense rules in the child support context, holding gross receipts set aside to "expand the business . . . have the potential of increasing the business's value and thus the shareholder's personal net worth, and might properly be viewed as income available for child support." *J.S.*, 912 N.E.2d at 943 n.15. This reasoning is consistent with other state courts in disfavoring deduction of capital investments from income for child support purposes. *See* Rauch v. Rauch, 590 N.W.2d 170, 175 (Neb. 1999) (disallowing deduction of capital expenses from child support expanding father's business).

[96] *See supra* Part III.A (providing framework for defining ordinary and necessary expenses).

[97] *See supra* Part III.B (comparing capital expenses to ordinary and necessary expenses).

[98] *See generally* I.R.C. §§ 1250, 1255 (2006) (providing rules for depreciating capital assets).

[99] *See id.*

IV. WHERE THE OVERLAP STOPS: EXPENSES REQUIRED TO PRODUCE INCOME

The 2009 Guidelines provide that self-employment income for child support purposes, in many cases, "will differ from a determination of business income for tax purposes."[100] The question becomes: *How do they differ*? The only direction offered by the 2009 Guidelines in this regard focuses on business expenses that personally benefit the business-owning parent.[101] For further guidance on what expenses are required to produce income, it is necessary to look at other states' guidelines and regulations.

The mandate of the 2009 Guidelines that ordinary and necessary expenses be required to produce income reflects the majority view among other states' child support guidelines, many of which similarly define deductible business expenses as ordinary and necessary expenses either required to produce income[102] or required for self-employment or business

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[100] 2009 GUIDELINES, *supra* note 7, at 3.

[101] *See* 2009 GUIDELINES, *supra* note 7, at 3 (listing items personally benefiting self-employed parent). Similar provisions regarding in-kind benefits are common in other states. *See* McDaniel v. McDaniel, 653 So. 2d 1076, 1077 (Fla. Dist. Ct. App. 1995) (including company car value in income for child support because in-kind payment reduced living expenses); Mitchinson v. Mitchinson, 788 A.2d 23, 24 (Vt. 2001) (holding parent's business reimbursements did not reduce personal living expenses where parent not self-employed).

[102] *See* COLO. REV. STAT. § 14-10-115(5)(a)(III)(A) (2010) ("For income from self-employment . . . 'gross income' equals gross receipts minus ordinary and necessary expenses . . . required to produce such income."); LA. REV. STAT. ANN. § 9:315(C)(3)(c) (2008) (defining gross income as "[g]ross receipts minus ordinary and necessary expenses required to produce income"); MD. CODE ANN., FAM. LAW § 12-201(c)(2) (LexisNexis 2006) ("For income from self-employment . . . 'actual income' means gross receipts minus ordinary and necessary expenses required to produce income."); N.M. STAT. ANN. § 40-4-11.1(C)(2)(b) (2010) ("[F]or income from self-employment . . . 'gross income' means gross receipts minus ordinary and necessary expenses required to produce such income . . . ."); OKLA. STAT. tit. 43, § 118B(E)(1) (2001) ("Income from self-employment includes income . . . minus ordinary and necessary expenses required [to produce such income.]"); ALASKA R. CIV. P. 90.3 cmt. III(B) ("Income from self-employment . . . includes the gross receipts minus the ordinary and necessary expenses required to produce the income."); Thill v. Thill, 26 S.W.3d 199, 207 (Mo. Ct. App. 2000) ("'[G]ross income' is . . . gross receipts minus the ordinary and necessary expenses incurred to produce such receipts."); ARIZ. SUPREME COURT, ARIZONA CHILD SUPPORT GUIDELINES 4 (2005) [hereinafter ARIZONA GUIDELINES], *available at* http://www.azcourts.gov/Portals/31/Child%20Support/CSG2004.pdf ("For income from self-employment . . . gross income means gross receipts minus ordinary and necessary expenses required to produce income."); THE GEN. ASSEMBLY OF THE STATE OF OHIO, OHIO CHILD SUPPORT GUIDELINES 3 (2008), *available at* http://www.franklincountyohio.gov/commissioners/csea/pdf/csx2-10.pdf ("Self-generated income means gross receipts . . . minus ordinary and necessary expenses incurred by the parent in generating the gross receipts"); TENN. DEP'T OF HUMAN SERVS., CHILD SUPPORT GUIDELINES 17 (2008) [hereinafter TENNESSEE GUIDELINES], *available at* http://www.state.tn.us/sos/rules/1240/1240-02/1240-02-04.20080815.pdf ("Income from self-employment includes income . . .

operation.[103] An examination of the "required to produce income" standard begins with the observation that Massachusetts' 2009 Guidelines lack the additional specifics found in many other states' guidelines, some of which expressly enumerate tax deductible business expenses not deductible from child support income.[104] For example, a number of state child support guidelines discourage courts from deducting "amounts allowable by the I.R.S. for the accelerated component of depreciation expenses or investment tax credits" from child support income.[105] Additionally, many states specifically and expressly prohibit the exclusion of such tax deductions from child support income.[106]

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less ordinary and reasonable expenses to produce such income.").

[103] *See* GA. CODE ANN. § 19-6-15(f)(1)(B) (2010) ("Income from self-employment includes . . . gross receipts minus ordinary and reasonable expenses required for self-employment or business operations."); KY. REV. STAT. ANN. § 403.212(2)(c) (LexisNexis 2010) ("For income from self-employment . . . 'gross income' means gross receipts minus ordinary and necessary expenses required for self-employment or business operation."); MINN. STAT. § 518A.30 (2006) ("[I]ncome from self-employment . . . is defined as gross receipts minus costs of goods sold minus ordinary and necessary expenses required for self-employment or business operation."); UTAH CODE ANN. § 78B-12-203(4)(a) (LexisNexis 2008) ("Gross income . . . shall be calculated by subtracting necessary expenses required for self-employment or business operation from gross receipts."); IDAHO STATE JUDICIARY, IDAHO CHILD SUPPORT GUIDELINES 2 (2011), *available at* http://www.isc.idaho.gov/Idaho_ChildSupport_Guidelines.pdf ("Gross income is defined as gross receipts minus ordinary and necessary expenses required to carry on the trade or business . . . ."); CONFERENCE OF CHIEF DIST. JUDGES, NORTH CAROLINA CHILD SUPPORT GUIDELINES (2011) [hereinafter NORTH CAROLINA GUIDELINES], *available at* https://nddhacts01.dhhs.state.nc.us (follow "CSE Guidelines" hyperlink; then follow "North Carolina Child Support Guidelines" hyperlink; then follow "Income" hyperlink") ("Gross income . . . is defined as gross receipts minus ordinary and necessary expenses required for self-employment or business operation."); OR. DEP'T OF JUSTICE, CHILD SUPPORT GUIDELINE RULES, ADMINISTRATIVE RULE 137-050-0715(2)(e) (2011) [hereinafter OREGON GUIDELINES], *available at* http://www.oregonchild support.gov/laws/rules/050_0715.pdf ("Income from self-employment . . . [is gross receipts] minus ordinary and necessary expenses required for self-employment or business operation.").

[104] *See infra* notes 105-106 and accompanying text (detailing other states' guidelines discouraging or prohibiting accelerated depreciation deductions for child support).

[105] TEX. FAM. CODE ANN. § 154.065(b) (Vernon 2008) ("In its discretion, the court may exclude from self-employment income amounts allowable under federal income tax law as depreciation, tax credits, or any other business expenses shown by the evidence to be inappropriate . . . ."); *see also* MD. CODE ANN., FAM. LAW 12-201(g) (LexisNexis 2006) ("'Ordinary and necessary expenses' does not include amounts allowable by the Internal Revenue Service for the accelerated component of depreciation expenses or investment tax credits or any other business expenses determined by the court to be inappropriate for determining actual income for purposes of calculating child support."); VT. STAT. ANN. tit. 15, § 653(5)(A)(iv) (2010) (stating court may exclude I.R.S. depreciation amounts when determining ordinary and necessary business expenses).

[106] *See* COLO. REV. STAT. § 14-10-115(5)(a)(III)(B) (2010) ("'Ordinary and necessary expenses' does not include . . . the accelerated component of depreciation expenses or investment tax credits or any other business expenses determined by the court to be inappropriate for determining gross income for purposes of calculating child support."); KY. REV. STAT. ANN. §

Direct appellate commentary from other states on the "required to produce income" language is surprisingly sparse, but some states' reviews provide useful insight into how to understand this language. In *Scott v. Scott*,[107] the Louisiana Court of Appeals determined that self-employment income for child support purposes "closely parallels the net business income measure for taxes."[108] The Court of Appeals of New Mexico has noted that its standard is indicative of a legislative effort to approximate "actual cash flow," which is money *actually available* to a self-employed parent to support his or her children.[109]

Even state courts that do not use the "required to produce income" language in their child support guidelines appear to amplify the actual cash flow theory.[110] New York has held that "[p]aper losses and expenses not actually incurred should not be taken into account."[111] Pennsylvania

403.212(2)(c) (LexisNexis 2010) ("Straight-line depreciation . . . shall be the only allowable method of calculating depreciation expense in determining gross income. Specifically excluded from ordinary and necessary expenses for purposes of this guideline shall be investment tax credits or any other business expenses inappropriate for . . . calculating child support."); LA. REV. STAT. ANN. § 9:315(C)(3)(c) (2008) ("'Ordinary and necessary expenses' shall not include . . . accelerated component of depreciation expenses or investment tax credits or any other business expenses . . . inappropriate for determining gross income for purposes of calculating child support."); MINN. STAT. § 518A.30 (2006) ("Specifically excluded from ordinary and necessary expenses [for child support purposes] are . . . the accelerated component of depreciation expenses, investment tax credits or any other business expenses determined by the court to be inappropriate or excessive . . . ."); OKLA. STAT. tit. 43, § 118B(E)(2) (2001) (defining amounts allowed by I.R.S. for accelerated depreciation or investment tax credits as unreasonable in child support context); ALASKA R. CIV. P. 90.3 cmt. III(B) (disallowing "accelerated component of depreciation expenses, investment tax credits"); NORTH CAROLINA GUIDELINES, *supra* note 103 ("Ordinary and necessary business expenses do not include . . . the accelerated component of depreciation expenses, investment tax credits, or any other business expenses determined by the court to be inappropriate for determining gross income."); OREGON GUIDELINES, *supra* note 103 (excluding accelerated depreciation, investment tax credit, and other expenses from ordinary and necessary expenses); TENNESSEE GUIDELINES, *supra* note 102, at 17 ("[A]ccelerated depreciation or investment tax credits shall not be considered reasonable expenses.").

[107] 989 So. 2d 290 (La. Ct. App. 2008).

[108] *Id.* at 295. "One cannot avoid all or part of his child support obligation by exercising exclusive control over a corporation wholly owned by him in order to limit his own salary." *Id.* at 294-95; *see also* LA. REV. STAT. ANN. § 9:315(C)(3)(c) (2008).

[109] *See* Boutz v. Donaldson, 991 P.2d 517, 522 (N.M. Ct. App. 1999) (defining actual cash flow); *see also* N.M. STAT. ANN. § 40-4-11.1(C)(2)(b) (2010) (defining gross income); Major v. Major, 952 P.2d 37, 39 (N.M. Ct. App. 1997) (explaining actual cash flow as money "reasonably available to apply toward" child support).

[110] *See infra* notes 111-112 and accompanying text (detailing other states' decisions on actual cash flow).

[111] Dobbins v. Dobbins, 397 N.Y.S.2d 412, 414 (N.Y. App. Div. 1977) (disfavoring deductions from child support for non-cash expenses); *see also* Meier v. Meier, 306 S.W.3d 692, 700 (Mo. Ct. App. 2010) (disfavoring non-cash deductions "artificially reduc[ing] a spouse's reported gross income"); Fisher v. Fisher, 171 P.3d 917, 921-22 (Okla. Civ. App. 2007)

similarly elevates economic reality over creative accounting, observing that a self-employed parent's income "must reflect actual available financial resources and not the oft-times fictional financial picture which develops as the result of . . . the federal income tax laws."[112]

While a majority of states have adopted child support guideline language limiting business expense deductions to those required to produce income, the consensus among states regarding the precise meaning of this phrase varies.[113] To the extent that a majority view may exist, it appears to be that "[p]aper losses and expenses not actually incurred should not be taken into account."[114] This approach is consistent with the 2009 Guidelines and Massachusetts case law, which has historically disfavored so-called "paper" deductions that do not involve actual cash expenditures by the self-employed parent.[115]

(prohibiting child support income deductions not involving actual cash expense when taken); Houston v. Smith, 882 P.2d 240, 244 (Wyo. 1994) (limiting business deductions to those reducing net income).

[112] McAuliffe v. McAuliffe, 613 A.2d 20, 22 (Pa. Super. Ct. 1992) (disfavoring deductions from child support income for depreciation) (quoting Cunningham v. Cunningham 548 A.2d 611, 612-13 (Pa. Super. Ct. 1988)); *see also* Asfaw v. Woldberhan, 55 Cal. Rptr. 3d 323, 336 (Cal. Ct. App. 2007) ("[D]epreciation is a fictional loss that, in the real world represents tax savings and, therefore, additional cash available to the parent to meet child support obligations."); Stoner v. Stoner, 307 A.2d 146, 152 (Conn. 1972) ("Depreciation is a mere book figure which does not either reduce the actual dollar income of the [parent] or involve an actual cash expenditure when taken."); Roberts v. Roberts, 677 So. 2d 1042, 1047 (La. Ct. App. 1996) ("[D]epreciation is not an ordinary and necessary expense and is included in his gross income."); Stewart v. Stewart, 793 P.2d 813, 815 (Mont. 1990) (noting depreciation deductions not included in ordinary and necessary expenses, but considered for child support). *But see* Ogard v. Ogard, 808 P.2d 815, 819 (Alaska 1991) ("Depreciation is a means of reflecting on an annual basis the costs of capital equipment. Such costs are real and should not be disregarded unless it appears that equipment was acquired in order to avoid or reduce the obligor's child support obligation."); Turner v. Turner, 586 A.2d 1182, 1187 (Del. 1991) ("[S]ince depreciation is considered by generally accepted accounting principles to be an expense in determining net taxable income, it *may* also be a legitimate business expense for the purpose of computing . . . child support . . . .").

[113] *See supra* notes 102-103, 105-106, 108-109 and 111-112 and accompanying text (highlighting other states' child support guidelines and relevant decisions).

[114] *Dobbins*, 397 N.Y.S.2d at 414; *see also* cases cited *supra* note 111 and accompanying text (highlighting decisions disapproving of child support deductions for non-cash expenses).

[115] *See* Maillet v. Maillet, 835 N.E.2d 281, 286-87 (Mass. App. Ct. 2005) (finding business owner's depreciation expenses not deductible from gross income for child support purposes); *see also* 2009 GUIDELINES, *supra* note 7, at 3.

V. CALCULATING SELF-EMPLOYMENT INCOME: A PRACTICAL LIST OF DEFINITIONS FOR COMMONLY SEEN DEDUCTIBLE BUSINESS EXPENSES

A list of deduction definitions is provided below to support Massachusetts courts, practitioners, and litigants in determining the deductibility of business expenses for child support purposes. Courts and practitioners tasked with reviewing these deductions should note that the burden of proof for demonstrating the validity of claimed business expense deductions generally resides with the self-employed parent.[116] Furthermore, claimed deductions should be closely scrutinized at the temporary order stage of a child support case, which often occurs before the opposing parent has the opportunity to obtain business records through discovery.[117]

A. Capital Expenditures and Section 179 Expenses

The 2009 Guidelines limit the deductibility of business expenses from gross income to ordinary and necessary expenses.[118] Section 162(a) of the I.R.C., which is incorporated by reference in Chapter 63 of the Massachusetts General Laws, specifically provides that to be tax deductible business expenses must be "ordinary and necessary."[119]

When characterizing a payment as either an ordinary and necessary expense or a capital expenditure, the duration of the benefit created by the expenditure is critical.[120] Single, one-time expenditures and expenditures primarily aimed at expanding or investing in future operations are considered capital expenses, not ordinary and necessary expenses under §

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[116] *See* Smith-Clarke v. Clarke, 691 N.E.2d 596, 598 (Mass. App. Ct. 1998) (finding "[a]bsent substantiation of [current] income," judge may attribute appropriate income based upon available evidence).

[117] *See* 2 CHARLES P. KINDREGAN JR. & MONROE L. INKER, FAMILY LAW AND PRACTICE § 35:1 (Mass. Prac. Series, 3d ed. 2011) (discussing how temporary orders affect persons subject to them both immediately and long term). "These orders may also have a substantial impact on the final disposition, as setting a pattern to which the parties adjust or as influencing the final disposition by the court. They may also impact settlement negotiations, since a party in whose favor temporary orders have issued bargains from a position of some strength." *Id.*

[118] *See* 2009 GUIDELINES, *supra* note 7, at 3.

[119] *See* I.R.C. § 162(a) (2006); *see also* MASS. GEN. LAWS ch. 63, § 1 (2008).

[120] *See* INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 83-84 (1992) ("While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise.").

162(a).[121] If the primary benefit created by an expenditure is expected to last more than one year, it is not ordinary and necessary.[122] Simply put, a capital expenditure, even if it is partially recoverable through depreciation, is not an ordinary and necessary expense as defined by § 162(a), and it is therefore not deductible under the 2009 Guidelines.[123]

A small minority of states' guidelines have expressly allowed the deduction of reasonable capital expenses from child support.[124] However, a clear majority of states limit deductibility using the ordinary and necessary language of § 162(a), which does not include capital expenses.[125] In addition, recent Massachusetts appellate cases favor non-deductibility of capital expenses, as described in *J.S.*, which centered on the non-deductibility of gross receipts re-invested by a self-employed parent to expand his business at the expense of child support.[126]

Considerable attention has focused on § 179 of the I.R.C. in recent years, which permits a taxpayer to deduct the full purchase cost of certain capital expenditures in the year of purchase.[127] Section 179 provides that a

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[121] *See supra* Part III.A (discussing capital expenses found in several cases).

[122] *See* INTERNAL REVENUE SERV., PUBLICATION 334, TAX GUIDE FOR SMALL BUSINESS 33 (2011) ("If property you acquire to use in your business is expected to last more than 1 year, you generally cannot deduct the entire cost as a business expense in the year you acquire it.").

[123] *See INDOPCO*, 503 U.S. at 86 (citing Comm'r v. Lincoln Sav. & Loan Ass'n., 403 U.S. 345, 354 (1971)); *see also* Gen. Bancshares Corp. v. Comm'r, 326 F.2d 712, 716 (8th Cir. 1964) ("[W]here the expenditures have not resulted in the acquisition or increase of a corporate asset . . . these expenditures are not, [solely] because of that fact, [automatically] deductible as ordinary and necessary business expenses.") (citations omitted); 2009 GUIDELINES, *supra* note 7, at 3 (incorporating ordinary and necessary test articulated in § 162(a)).

[124] *See* IND. SUPREME COURT, INDIANA RULES OF COURT, CHILD SUPPORT RULES AND GUIDELINES 6 (2011) [hereinafter INDIANA GUIDELINES], *available at* http://www.in.gov/judiciary/rules/child_support/child_support.pdf ("[O]rdinary and necessary expenses . . . may include a reasonable yearly deduction for necessary capital expenditures."); Ogard v. Ogard, 808 P.2d 815, 819 (Alaska 1991) (interpreting depreciation as a reasonable representation of legitimate capital costs). *But see* Rauch v. Rauch, 590 N.W.2d 170, 175 (Neb. 1999) ("It would be unfair for [the father] to benefit from his choice to incur debt and build equity in his farm at the expense of his children.").

[125] *See supra* Part III.B (distinguishing capital expenses from ordinary and necessary expenses); *see also supra* notes 102-103 and accompanying text (detailing variety of other states' guidelines including ordinary and necessary language).

[126] *See* J.S. v. C.C., 912 N.E.2d 933, 943 n.15 (Mass. 2009) (comparing business owner's retention of earnings to expand business to distribution invested in new company).

[127] *See* I.R.C. § 179(d)(1) (2006) (defining property subject to full deduction), *amended by* Pub. L. No. 108-27, § 202(c) 117 Stat. 752 (2003). Section 179 expressly acknowledges that deductions under the section affect capital expenditures, referring to several code sections affecting capital assets. *Id.* "[Deductible property] means property which is tangible property (to which section 168 applies) or . . . which is section 1245 property (as defined in section 1245(a)(3)) and which is acquired by purchase for use in the active conduct of a trade or business." *Id.*

taxpayer may elect to have various capital assets, including heavy equipment, motor vehicles, and real property, counted "as a deduction for the taxable year in which the . . . property is placed in service."[128]

"[A]n income tax deduction is a matter of legislative grace," and Congress acted within its authority to create a deduction for capital purchases under § 179 that is distinct from the ordinary and necessary test of § 162(a).[129] However, in defining business expenses, the drafters of the 2009 Guidelines expressly disfavored the blanket application of all deductions available under the tax code to income for child support purposes.[130] There is no basis for interpreting "ordinary and necessary" expenses under the 2009 Guidelines to include deductions found in separate sections of the tax code, such as § 179—which permits the deduction of capital expenses not ordinary and necessary under existing tax law.

Where § 179 expenditures are unquestionably capital in nature, they are the antithesis of ordinary and necessary business expenses under § 162(a).[131] Where an expense must be ordinary and necessary to be deductible from income for child support purposes, § 179 expenditures and other capital expenses are not deductible from child support income.

B. Depreciation, Amortization and Depletion

A capital cost generally represents an actual cash expenditure for a business owner, but the more confounding concept of depreciation represents an accounting method that permits taxpayers to recover capital costs over the theoretical useful life of a capital asset.[132] I.R.S. Publication 946 carefully explains how business owners use the depreciation recovery allowance to recoup a portion of their capital costs in the years following a capital purchase: Depreciation is an annual income tax deduction that allows you to recover the cost or other basis of certain property over the time you use the property. It is an allowance for the wear and tear,

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[128] *See* I.R.C. § 179(a).

[129] *See* INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992) (citation omitted) (noting "deductions are specifically enumerated" in I.R.C.).

[130] *See* 2009 GUIDELINES, *supra* note 7, at 3 (stating child support income differs from determination of business income for tax purposes).

[131] *See INDOPCO*, 503 U.S. at 83-87 (comparing § 162(a) expenses with those deemed capital expenses).

[132] *See* INTERNAL REVENUE SERV., PUBLICATION 946, HOW TO DEPRECIATE PROPERTY 3-14 (2011) (providing overview of depreciation).

deterioration, or obsolescence of the property.[133]

Amortization uses an accounting method similar to depreciation, but permits the recovery of capital costs relating to the start-up of a business.[134] A minority of state child support guidelines expressly prohibit the deduction of I.R.S.-allowed amounts for accelerated depreciation.[135] A number of states disfavor or expressly prohibit the deduction of so-called "straight-line" depreciation,[136] which requires owners to recover capital costs at a slower rate than the accelerated approach.[137] Not in dispute, however, is that "[d]epreciation expense reduces the taxable income of an entity but does not reduce the cash."[138] As the California Supreme Court has stated, "depreciation is a fictional loss that, in the real world, represents tax savings and, therefore, additional cash available to the parent to meet child support obligations."[139]

Although a tax deduction for depreciation does not represent an out-of-pocket expense in the years following a capital purchase, some states have recognized that some businesses must periodically purchase capital assets, and that such costs are often legitimate.[140] A minority of states, such as Alaska, have accordingly reasoned "[d]epreciation is a means of reflecting on an annual basis the costs of capital equipment."[141]

In addition to the common-sense prohibition on accelerated depreciation deductions codified by many states, treating claimed deductions for straight-line depreciation with skepticism in the child

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[133] *Id.* at 3. "To be depreciable, the property must . . . be property you own . . . be used in your business or income-producing activity . . . have a determinable useful life [and] . . . be expected to last more than one year." *Id.*

[134] *See* INTERNAL REVENUE SERV., PUBLICATION 535, BUSINESS EXPENSES 26 (2011) ("Amortization is a method of recovering (deducting) certain capital costs over a fixed period of time. It is similar to the straight line method of depreciation.").

[135] *See supra* note 106 and accompanying text (highlighting states completely barring deduction of I.R.S.-allowed accelerated depreciation); *see also* BLACK'S LAW DICTIONARY 506 (9th ed. 2009) (defining accelerated depreciation as writing off cost of assets more rapidly than straight-line method).

[136] *See* BLACK'S LAW DICTIONARY 506 (9th ed. 2009) (defining straight-line depreciation); *see also* Roberts v. Roberts, 677 So. 2d 1042, 1047 (La. Ct. App. 1996) (noting depreciation not ordinary or necessary expense).

[137] *See generally* INTERNAL REVENUE SERV., PUBLICATION 946, HOW TO DEPRECIATE PROPERTY (2011).

[138] BLACK'S LAW DICTIONARY 506 (9th ed. 2009).

[139] Asfaw v. Woldberhan, 55 Cal. Rptr. 3d 323, 336 (Cal. Ct. App. 2007).

[140] *See* Stoner v. Stoner, 307 A.2d 146, 151 (Conn. 1972) ("[D]epreciation should not categorically either be deducted as an expense or treated as income, but rather . . . the extent of its inclusion, if any, should depend on the particular circumstances of each case.").

[141] Ogard v. Ogard, 808 P.2d 815, 819 (Alaska 1991) (interpreting depreciation as reasonable representation of legitimate capital costs).

support context is also consistent with actual cash flow theory.[142] Though most states treat the deductibility of depreciation from self-employment income with as much disfavor as the deductibility of capital expenses, depreciation is not ultimately an ordinary and necessary business expense under § 162(a).[143] A plain reading of the 2009 Guidelines, which adopt only the ordinary and necessary expense standard set forth in § 162(a), suggests that deductions from income for depreciation (and amortization and depletion) are not permitted under the 2009 Guidelines.

C. Meals and Entertainment

Meals and entertainment are a particularly thorny expense for states adhering to an actual cash flow theory, where such expenses unquestionably reduce the cash flow of a business, but may not be required to produce income.[144] A court determining the deductibility of meals and entertainment expenses must first require the business-owning parent to meet I.R.S. standards for documenting meals and entertainment expenses.[145]

Meals and entertainment are arguably best analyzed under the business-expense standard used by a minority of states, which, although similar to the majority approach connecting deductibility to expenses "required for the production of income," limits the deductibility of expenses to only those expenses *actually* "required for . . . business

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[142] SUPREME COURT OF ARK., ADMINISTRATIVE ORDER 10, CHILD SUPPORT GUIDELINES III(c) (2007) [hereinafter ARKANSAS GUIDELINES], *available at* http://courts.state.ar.us/opinions/2007a/20070614/Admin_Order_10_supp.pdf ("Depreciation should be allowed as a deduction only to the extent that it reflects [an] actual decrease in value of an asset.").

[143] *See* I.R.C. § 162(a) (2006). *See generally* I.R.C. §§ 1255, 1250 (2006) (providing rules for depreciating capital assets).

[144] *See* Fisher v. Fisher, 171 P.3d 917, 921-22 (Okla. Civ. App. 2007) (noting depreciation does not involve an "actual" cash expense).

[145] *See generally* INTERNAL REVENUE SERV., PUBLICATION 463, TRAVEL, GIFT, AND CAR EXPENSES (2011) (requiring businesses record restaurant name and location, date of meal and attendees). According to current I.R.S. publications, a business or self-employed taxpayer may deduct expenses to entertain a client, customer or employee only if the expenses meet the directly-related or associated tests. *See id*. at 9. To meet the directly-related test, the parent needs to (1) show that the main purpose of the combined business and entertainment was the "active conduct of business," (2) engage in business during the entertainment, and (3) have "had more than a general expectation of getting income or some other specific business benefit at some future time." *Id*. at 9-10. "To meet the associated test for entertainment expenses . . . [the parent] must show that the entertainment is: associated with the active conduct of [the parent's] trade or business, and directly before or after a substantial business discussion . . . ." *Id.* at 10.

operation."[146] Alternatively, New Jersey takes the sensible approach of excluding entertainment expenses altogether from deductions from child support income.[147]

Probate courts evaluating meals and entertainment expenses should treat these expenses with significant skepticism absent a clear showing that the claimed expenses meet the directly-related or associated test outlined in I.R.S. Publication 463.[148] Furthermore, expenses meeting these tests should be required for business operation, such that a self-employed parent can demonstrate that failing to incur the meal or entertainment expense would have resulted in a direct, measurable loss of gross receipts.[149] While many business owners choose to expense meals and entertainment costs in the ordinary course of business, the 2009 Guidelines mandate that an expense is required to produce income to be deductible.[150] Therefore, the best way for a self-employed parent to demonstrate that a meal or entertainment expense was required to produce income would be to explain how it affected operations and how business would have suffered if the expense was not incurred.

D. Equipment, Repairs, and Betterments with a Useful Life or Value Exceeding One Year

I.R.S. rules prohibit business deductions for tools, equipment, hardware, software, repairs, office supplies, and other goods and tangible assets with a useful life exceeding one year, because they are a non-deductible capital expense.[151] In addition to the tax code provisions and case law distinguishing ordinary and necessary expenses from capital

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[146] *See supra* notes 102-103 and accompanying text (listing states using "required for the production of income" language in child support guidelines).

[147] N. J. SUPREME COURT, APPENDIX IX-B, USE OF THE CHILD SUPPORT GUIDELINES 4 (2009), *available at* http://www.judiciary.state.nj.us/csguide/app9b.pdf (excluding certain I.R.S. allowed ordinary and necessary expenses).

[148] INTERNAL REVENUE SERV., PUBLICATION 463, TRAVEL, GIFT, AND CAR EXPENSES 9-10 (2011) (describing necessary factors for tax deductibility).

[149] *See id*. In addition, courts analyzing such claimed expenses at the temporary order stage are also advised to treat meals and entertainment deductions skeptically, particularly if the opposing party has not yet had the opportunity to review business records documenting the claimed expenses. *See* Marriage of Gudmundson, 929 P.2d 319, 322 (Or. Ct. App. 1996) (explaining burden of proof in claiming deductions for child support purposes). In *Gudmundson*, the court found the tax return alone was not sufficient for establishing claimed offsets. *See id*.

[150] *See* 2009 GUIDELINES, *supra* note 7, at 3.

[151] *See* INTERNAL REVENUE SERV., PUBLICATION 535, BUSINESS EXPENSES 3 (2011) (defining capital expenses and listing examples); Rauch v. Rauch, 590 N.W.2d 170, 175 (Neb. 1999) (declining to allow deductions for purchase of assets increasing net value of business).

expenditures, courts can look to the reasoning in *J.S.* and similar cases, which note a self-employed parent's re-investment of gross receipts in improvements or expansion are not deductible from child support if the expenditures increase the value of the business or the business owner's net worth.[152] As with claimed meals and entertainment deductions, courts at the early stages of a case should review such claimed expenses with skepticism and common sense if claimed expenses for tools, equipment, hardware, repairs or office supplies appear disproportionately high for the short-term needs of a particular business or industry.[153]

E. Charitable Contributions, Political Contributions and Club/Membership Fees

Charitable contributions of a business are not ordinarily deductible from business income. The I.R.S. provides "if the payments are charitable contributions or gifts, [a parent] cannot deduct them as business expenses."[154] Likewise, gifts from a business to a political party or a particular candidate's campaign are not deductible.[155] Any club or membership fees paid by a business are not also ordinarily deductible under I.R.S. rules.[156]

F. Supplies and Materials Not Consumed During a Tax Year

While ordinary and necessary supplies and materials are generally deductible, such deductions are limited to materials and supplies "actually consumed and used during the tax year."[157]

G. Taxes Paid by a Business

The I.R.S. permits the deduction of "various federal, state, local,

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[152] *See* J.S. v. C.C., 912 N.E.2d 933, 943 n.15 (Mass. 2009).

[153] *See* MINN. STAT. § 518A.30 (2006) ("The person seeking to deduct an expense . . . has the burden of proving, if challenged, that the expense is ordinary and necessary.").

[154] INTERNAL REVENUE SERV., PUBLICATION 535, BUSINESS EXPENSES 44 (2011) ("Cash payments to an organization, charitable or otherwise, may be deductible as business expenses if the payments are *not* charitable contributions or gifts.") (emphasis added).

[155] *See id.* at 45 ("[E]xpenses paid or incurred to take part in any political campaign of a candidate for public office are not deductible.").

[156] *See id.* at 44 ("Generally, amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or any other social purpose are not deductible.").

[157] *See id.* at 46.

and foreign taxes directly attributable to [the parent's] trade or business," but not federal income tax.[158] A few states permit the deduction of self-employment taxes for purposes of child support, but Arizona is one example wherein its child support guidelines expressly prohibit deductions for self-employment taxes paid.[159] Oklahoma requires judges to attribute hypothetical Federal Insurance Contributions Act ("F.I.C.A.") taxes to self-employed individuals because self-employed individuals sometimes structure their business to avoid F.I.C.A. taxes.[160] Despite the I.R.S. allowance of a deduction for state income taxes paid, and a few states' allowance of deductions for self-employment taxes, such deductions appear inconsistent with the 2009 Guidelines.[161]

H. Retained Earnings and Pass-Through Income

The SJC specifically addressed the deductibility of earnings retained by a business in *J.S.*, where it noted:

> Earnings retained in order to maintain the business as currently operated should not be included in gross income. Earnings retained in order to expand the business, on the other hand, have the potential of increasing the business' value and thus the shareholder's personal net worth, and might properly be viewed as income available for child support—just as a distribution invested in another corporation would be.[162]

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[158] INTERNAL REVENUE SERV., PUBLICATION 535, BUSINESS EXPENSES 15 (2011) (defining deductions for taxes paid by business).

[159] *Compare* Marriage of Redler, 827 P.2d 1363, 1365 (Or. Ct. App. 1992) (finding self-employment tax as ordinary and necessary expense and deductible), *with* ARIZONA GUIDELINES, *supra* note 102, at 4 ("Ordinary and necessary expenses include one-half of the self-employment tax actually paid.").

[160] OKLA. STAT. tit. 43, § 118B(E)(3) (2001) ("The . . . court shall deduct from self-employment gross income an amount equal to the employer contribution for F.I.C.A. tax which an employer would withhold from an employee's earnings on an equivalent gross income amount.").

[161] *See* 2009 GUIDELINES, *supra* note 7, at 3 (listing no reference to self-employment or other taxes paid). *But see* KAN. SUPREME COURT, KANSAS CHILD SUPPORT GUIDELINES 4 (2010), *available at* http://www.kscourts.org/rules-procedures-forms/child-support-guidelines/2010-guidelines-final.pdf ("Reasonable Business Expenses shall include the additional self-employment tax paid over and above the FICA rate.").

[162] J.S. v. C.C., 912 N.E.2d 933, 943 n.15 (Mass. 2009). "[T]he judge should weigh affirmative evidence of an attempt to shield income by means of retained earnings." *Id.* at 942.

In *J.S.*, the court addressed the pass-through income of a business, noting a judge should not automatically include pass-through income, but instead decide what portion, if any, of pass-through income should be treated as available for child support purposes.[163]

I. Cost of Goods Sold, Rent, Employee Pay, Advertising, Insurance, Dues and Publications and Other Common Business Expenses

While deductions for business expenses such as meals and entertainment warrant special scrutiny from the courts, Schedule A of the Massachusetts Financial Statement form includes numerous business expense categories that often raise few red flags in child support actions, including: cost of goods sold, rent, employee pay, advertising, insurance, interest, legal and professional fees, and bad debts.[164] These seemingly innocuous business expenses generally constitute legitimate deductions from child support income in many cases involving self-employed parents, but courts must be mindful that representations made by self-employed parents on their individual or corporate tax returns are generally not reviewed for accuracy absent an I.R.S. audit.[165] Along with parents who intentionally misrepresent their income and expenses on tax returns, there are many mistakes and accounting shortcuts that otherwise honest, self-employed parents may make while preparing tax returns, which can distort income for child support purposes.[166] Where self-employed parents bear the burden of demonstrating the legitimacy and accuracy of their claimed business deductions from income for child support purposes, courts and practitioners would be well advised to familiarize themselves with I.R.S. expense definitions and record-keeping requirements for small businesses.[167] It may be helpful for courts to require self-employed parents

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[163] *Id.* at 941 n.13 (noting pass-through income available for child support purposes not deductible from income).

[164] *See* FINANCIAL STATEMENT SCHEDULE A, *supra* note 69; *see also* SCHEDULE C INSTRUCTIONS, *supra* note 71.

[165] *See* Crowe v. Fong, 701 N.E.2d 359, 364 (Mass. App. Ct. 1998) ("Where, as here, the production of documentation to support [father's] claimed expenditures was a matter entirely within his control, his making 'these important records unavailable for examination could properly be treated by the . . . court as conduct in the nature of an admission.'") (quoting Kane v. Kane, 434 N.E.2d 1311, 1313 (Mass. App. Ct. 1982)).

[166] *See generally* INTERNAL REVENUE SERV., PUBLICATION 535, BUSINESS EXPENSES (2011) (providing detailed guide for small business owners regarding business expense deduction rules under I.R.C.).

[167] *See id.* (defining and explaining business expense deductions). Courts should cautiously view individual and corporate tax returns of parents who refuse or claim to be unable to provide

to demonstrate that the good purchased by the business was actually sold, or the cost of the purchase was passed on to a customer through receipts or invoices.

J. In-Kind and Personal Benefits, Including Auto, Travel, Home Office, Medical Insurance and Retirement Benefits

Like many states' guidelines, the 2009 Guidelines address in-kind benefits and expenses resulting in a personal benefit to a parent.[168] Other states have articulated similar "offsets" where in-kind benefits or personal expenses paid by a business directly result in the reduction of a parent's living expenses.[169] Schedule A of the Massachusetts Financial Statement form includes numerous business expense deductions categories from which a self-employed parent can potentially enjoy a personal benefit: auto expenses, travel, telephone, medical insurance, retirement/employee benefits, and home office and utilities.[170]

If a business-owning parent declines to assign a reasonable sum of additional gross income in consideration of the personal benefit the parent received from a business expenditure, a court would likely be justified in attributing that reasonable sum.[171] Particularly at the early stages of a case,

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I.R.S.-required records when determining income for child support purposes. *See* Robinson v. Tyson, 461 S.E.2d 397, 399 (S.C. Ct. App. 1995) (affirming family court's imputation of income based partially on husband's refusal to show earning potential).

[168] *See* 2009 GUIDELINES, *supra* note 7, at 3.

[169] *See* COLO. REV. STAT. § 14-10-115(5)(a)(I)(X) (2010) ("Expense reimbursements or in-kind payments received by a parent in the course of employment, self employment, or operation of a business [shall be counted as income] if they are significant and reduce personal living expenses . . . ."); MINN. STAT. § 518A.29(c) (2006) ("[E]xpense reimbursements and in-kind payments . . . shall be counted as income if they reduce living expenses."); ALASKA R. CIV. P. 90.3 cmt. III(B) (requiring significant expenses reducing living expenses); ARKANSAS GUIDELINES, *supra* note 142, at III(c) ("A self-employed payor's income should include contributions made to retirement plans, alimony paid, and self-employed health insurance paid . . . ."); INDIANA GUIDELINES, *supra* note 124, at 6 (counting expense reimbursements or in-kind payments if significant and reduce personal living expenses); NORTH CAROLINA GUIDELINES, *supra* note 103 (listing expense reimbursement and in-kind payment examples counted as income); TENNESSEE GUIDELINES, *supra* note 102, at 17 ("Excessive promotional, excessive travel, excessive car expenses or excessive personal expenses, or depreciation on equipment, the cost of operation of home offices, etc., shall not be considered reasonable expenses.").

[170] *See* FINANCIAL STATEMENT, SCHEDULE A, *supra* note 69.

[171] *See* McDaniel v. McDaniel, 653 So. 2d 1076, 1077 (Fla. Dist. Ct. App. 1995) (holding company car counts as in-kind payment); ARIZONA GUIDELINES, *supra* note 102, at 4 ("Expense reimbursements or benefits received by a parent in the course of employment or self-employment or operation of a business shall be counted as income if they are significant and reduce personal living expenses.").

courts should be mindful of the self-employed parent's ultimate burden of proof to demonstrate that he or she has not derived a personal benefit from expenses paid for by the business, where the business owning parent's knowledge and control over documents relating to the business' expenditures is superior to that of the other parent.[172]

VI. CONCLUSION

In 2009, Massachusetts enacted revised Child Support Guidelines that defined self-employment income for child support purposes as gross receipts minus ordinary and necessary expenses required to produce income. Where gross receipts are easily identified as all income received by a business, most disputes over self-employment income in child support cases turn on the two-step test for deducting business expenses. Under the 2009 Guidelines, a parent who seeks to deduct the cost of a business expense from his or her self-employment income must first demonstrate that an expense is ordinary and necessary, and next show the expense was required to produce income.

Step one, the "ordinary and necessary" test, is directly adopted from Section 162(a), which defines ordinary and necessary business expenses for federal tax purposes. Step two, the "required to produce income" test, places limitations on which ordinary and necessary business expenses may be deducted from self-employment income in child support cases, consistent with the majority view among other states.

This Article provides courts, practitioners, and litigants with a practical entry point to understanding the similarities and differences between gross income for tax purposes and child support purposes, and incorporates key components of tax law and other states' treatment of self-employment income in the child support context into a discussion of self-employment income under the Massachusetts Child Support Guidelines.

Concluding with a quick and accessible guide on the deductibility of most common business expenses in the child support context, courts, practitioners, and litigants will now have an improved roadmap for determining self-employment income for child support purposes.

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[172] Maillet v. Maillet, 835 N.E.2d 281, 286 (Mass. App. Ct. 2005) (placing burden on parent to legitimize expenses while other parent's failure to challenge remains insufficient).