How Money Is Invested Decides if It Counts in Child Support

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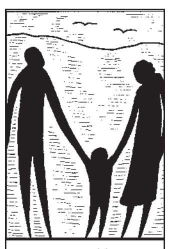
The characterization of a child support obligor's interest in company stock has major ramifications on how a court determines that party's income for purposes of calculating child support.

In the case of *In re Marriage of Pearlstein*, Cal.App.4th 1361 (2006), the court considers the limits of Family Code Section 4058, which sets forth the definition of a party's income by establishing the difference between stock options granted as part of an employee's compensation package and stock that an employee receives because of an equity interest in a business that is being sold.



Family Law

In ruling that an employee's equity interest in a company (unliquidated stock) is generally not income for purposes of calculating child support, *Pearlstein* sets limits on the ever-expanding definition of income for child support purposes.

In its opinion, the court went a step further in ruling that if a party actually realizes a gain from the sale of previously unliquidated stock (or from cash payments received from the sale of the business) this gain may be considered as income for purposes of calculating support, depending on how it is subsequently spent.

In *Pearlstein*, the parties, Irwin and Julie Pearlstein, were married in 1988. Nine months after marrying, the couple had a daughter, Alexandra.

After only two years of marriage the parties separated and soon thereafter divorced. In 1993 Irwin, who was experiencing financial difficulties, was $10,000 in arrears on his child support payments and in debt to the IRS. At that time, taking into account Irwin's financial troubles, the trial court ordered him to pay Julie the sum of $800 per month in child support.

In 1994, after Irwin's business failed, he became employed by his adult children from a former marriage, who had founded a company called Professional Resource Screening. There, he took a position as a consultant.

Initially he was not paid for his work, but later he earned a salary of $2,000 per month. It was also during this time that Irwin filed for bankruptcy, after which he obtained a new court order for child support, lowering his payments from $800 per month to $741 per month.

In 2001, Julie initiated contact with the Department of Child Support Services, which opened a case to collect child support arrears from Irwin in the amount of $14,184. In the same year, Professional Resource Screening was sold to and merged with a company called U.S. Search Screening Services Inc.

Prior to the sale of Professional Resource Screening, Irwin's children had gifted him 51 percent of the company stock, which he sold to U.S. Search Screening for (1) shares of U.S. Search Screening and (2) significant cash payments to be paid over time.

On Jan. 15, 2002, Irwin received the sum of $204,000, which was one of the cash payments that he was entitled to as a result of the merger between Professional Resource Screening and U.S. Search Screening. Upon receipt of these funds, Irwin promptly paid all of the outstanding child support arrears owed to Julie, and kept current on his present child support obligation.

Nonetheless, Julie continued to report to the Department of Child Support Services that Irwin was delinquent on his child support obligation, and in May 2002 the department filed a motion to modify child support.

In May 2003, Irwin filed his own motion to recover his tax refund, that had been improperly intercepted by child support services and paid to Julie.

After finally receiving and verifying documentation from Irwin's lawyer that he did not owe any child support arrears, child support services changed its position regarding the tax refund only slightly by claiming that because a modification increasing child support was pending and probable, it would be established at the upcoming motion for modification that Irwin again owed arrears. The tax refund improperly forwarded to Julie would simply be applied against the new, yet to be established, arrears figure.

In June 2003, U.S. Search Screening was acquired and merged into a new company called First Advantage Corporation. In this new deal, Irwin's U.S. Search Screening stock was converted into First Advantage stock, which, like the former, had SEC restrictions on its sale. In August 2003, the court began holding a consolidated hearing on the modification and overpayment orders to show cause.

On Dec. 28, 2003, Irwin retired and began receiving severance pay in the amount of $8,700 per month. In January 2004, Irwin sold 1,000 shares of his First Advantage Corporation stock for the sum of $19,000. A few days later he sold 202 more shares of First Advantage stock. Also in January 2004, Irwin began receiving cash payments in connection with the sale of Professional Resource Screening, in the amount of $64,000 per month, which would last for a period of 12 months.

After four sessions on the hearing on the issues of modification of child support and overpayment of child support, the court held on Jan. 21, 2004, its fifth and final session. Ultimately, the trial court made its final ruling as follows:

Child support to be paid by Irwin for the period of June 1, 2002, through Dec. 31, 2002, was increased to the sum of $3,884 per month, based on Irwin's average monthly gross income for calendar year 2002 of $54,175. Child support for the period of Jan. 1, 2003, through Dec. 31, 2003, was increased to the sum of $6,347 per month, based on Irwin's average monthly gross income for calendar year 2003 of $82,715.

Tentatively, the child support arrears for the period of June 1, 2002, through Dec. 31, 2003, was ordered in the sum of $84,803, payable at a rate of $2,500 per month. Effective Jan. 1, 2004, child support was increased to the sum of $11,869 per month, based on Irwin's projected average monthly gross income for calendar year 2004 of $143,415.

Of the $11,869 ordered, $5,718 was ordered paid into a "Chandler Trust" for Alexandra's educational expenses. Finally, regarding the overpayment (Irwin's tax refund check) to Julie in the amount of $4,456, said amount was offset against the attorney fees Irwin was ordered to pay Julie.

> **On appeal, Irwin contended that the trial court had improperly treated all of the proceeds, including cash and/or stock, received by him from the sale of Professional Resource Screening, as income, regardless of whether it was actually sold or spent. The court agreed.**

On appeal, Irwin contended that the trial court had improperly treated all of the proceeds, including cash and/or stock, received by him from the sale of Professional Resource Screening, as income, regardless of whether it was actually sold or spent. The court agreed.

The court began its decision by explaining that while Family Code Section 4058 defines income broadly, the definition is not limitless. Despite this broad definition, unrealized gain from the sale of one's equity interest in a business in not income.

The court then pointed out that income has traditionally been defined to be money that an obligor actually receives, not the unrealized increase in value of his/her assets. In supporting this long-established notion regarding income, the court cited several California cases, as follows:

"If the Legislature had intended that the unrealized increase in the value of an asset should be considered income, it would have said so." This is consistent with "[t]he traditional understanding of 'income' [as] the gain or recurrent benefit that is derived from labor, business, or property [citation], or from any other investment of capital [citation]." *In re Marriage of Scheppers.*

One example the court used was the unrealized increase in a house's worth. Such increase does not constitute income for support.

However, *Pearlstein* went on to state that while unrealized gain is generally not characterized as income, a supporting party's assets are not entirely irrelevant to determining his or her income for support. And where a supporting party has chosen to invest his or her funds in non-income producing assets, a court has discretion to impute income to those assets at a reasonable rate of return.

Also, where a supporting party is receiving income from an investment, such as dividends, that income can be considered for support purposes.

Further, in conceding its point that some assets must be considered in calculating income, the court cited the case of *County of Kern v. Castle*, 75 Cal.App.4th 1442 (1999), where a supporting party who had inherited a lump sum and various real property, used the lump sum to pay off his mortgage and back taxes. The appellate court concluded that while an inherited, mortgage-free house could not be characterized as income for the purposes of calculating income, it should be considered with regard to the reduction in the supporting parent's living expenses.

In other words, that party's expendable income increases because he does not incur the monthly expense of paying a mortgage.

In support of her position that the court's current orders should stand, Julie put forth the case of *In re Marriage of Cheriton*, 92 Cal. App. 4th 269 (2001). The *Cheriton* court ruled that when a supporting party has "considerable" wealth, that party's assets should be more liberally considered in determining income. In *Cheriton*, as a result of his work with the technology company, Cisco, the supporting spouse received vested Cisco stock options, valued at more than $45 million. However, the *Pearlstein* court distinguished its facts from those in *Cheriton* by stating that the father in *Cheriton* received stock options (a compensation package), which were tied to his past, present and future services. Stock options are different from unliquidated stock, which "was part of the consideration for his [Irwin's] sale of an existing capital asset, i.e., his stock in [Professional Resource Screening]. In this regard, the unliquidated stock received for equity, rather than as compensation, is indistinguishable from other types of acquired non-liquid assets that are not normally considered income for support purposes." Also distinguishable, the father in *Cheriton* had accumulated substantially more wealth than Irwin.

Regarding Irwin's receipt of cash payments from the sale of Professional Resource Screening, the court made clear that to the extent that those funds were spent on non-income producing investments and other things (i.e. credit cards), those funds could, at the court's discretion, be imputed as income to him.

Cash, the court explained, represents realized gain and when a party decides to spend the money, rather than reinvest it, a court has discretion to impute such expenditures as income for purposes of child support. The lower court ruled that all of the cash received by Irwin was income for support purposes, which was an abuse of discretion. The non-spent portion of the cash received by Irwin was not income.

Further, regarding the stock received by Irwin, the court, similar to its ruling on the cash payments, ruled that "to the extent Irwin sold the shares and spent the proceeds, as opposed to reinvesting them, the trial court had discretion to treat the realized gain as income." The court further opined that within the court's discretion, "a reasonable rate of investment return could be imputed to the value of the stock that was available for sale."

This analysis seems to turn the opinion on its head. On the one hand, the court rules generally that unliquidated stock cannot be considered income for child support purposes. On the other hand, the court indicates that unliquidated stock, as long as it is available for sale, could be imputed as income to a supporting party.

This case seems to consider the relationship between three forms of income: stock options, unliquidated stock and cash payments. The court makes clear that stock options are considered income for support purposes. The court seems to send the message that when an obligor receives unliquidated stock, refraining from selling the stock or selling it and reinvesting the proceeds effectively protects the obligor from a court's consideration of the proceeds as income in support cases.

As for cash payments, the court tells us that when a party refrains from spending it, the cash will not be considered as income for support.

Does this mean that the cash must sit in a liquid account, unspent? For example, the court does not explicitly make clear what ramifications using the cash to buy some other security (i.e. stocks, bonds, or mutual funds) have on the character of the funds. An argument can be made that investing the cash in an aggressive growth stock (no income) would have different ramifications than spending the cash on a classic dividend producing investment, such as a utility stock. Investing in the latter example would seem to at least open up the door for the court to consider the dividends as income for purposes of support. However, investment in the former example could also leave a litigant open to having income imputed — as long as the stock is "available for sale."

While the court states that it does not condone deliberately structuring one's investment transactions to minimize income for support, perhaps this opinion is a roadmap to do just that.

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