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Real Estate Depreciation is Income for Purposes of Child Support

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California's Second District Court of Appeal has ruled that depreciation may not be deducted from a real estate investor's gross rental income when determining the investor's (net) income for purposes of calculating child support. Asfaw v. Woldberhan (2007) 147 C.A.4th 1407.

Zeman Woldberhan (father) and Yesem Asfaw (mother), husband and wife, separated after having two (2) children together. The trial court entered an order awarding the parents joint legal and joint physical custody of the children, with the mother's home being the children's primary residence.

In determining the father's child support obligation, the trial court found that: (1) father's time with the children was 20 percent; (2) father's gross monthly income was \$3,350; (3) mother's gross monthly income was \$3,771; and (4) mother's monthly child care expense was \$350. Based on these findings, the trial court ordered: (1) father to pay mother child support in the amount of \$882 per month; (2) mother and father to each pay one-half of the children's private school tuition; and (3) father to pay mother's attorney fees in the amount of \$10,000.

Mother appealed, arguing that the trial court erred when calculating father's child support obligation when it reduced father's gross real estate rental income by \$57,000, the amount of the deduction allowed by tax law for depreciation of father's investment properties. In other words, mother argued that father should be required to pay child support on an additional \$57,000 of annual income (\$4,750 per month), which would result in father's monthly income for purposes of child support being \$8,100, instead of \$3,350.

A parent's child support obligation is determined by a formula, the components of which

require the computation of each parent's "annual gross income" and "annual net disposable income."¹ "Annual gross income is defined as "income from whatever source derived." Family Code § 4058. Rental income is expressly included in the definition of annual gross income. Family Code § 4058(a)(1). Income from a business, including real estate rental income, is to be "reduced by expenditures required for the operation of the business." Family Code § 4058(a)(2).

Thus, the question presented to the appellate court in Asfaw was whether, within the meaning of section 4058, depreciation of investment rental property constitutes an "expenditure [] required for the operation of [a real estate investment/rental] business."

It is well-settled that the first step in the process of interpreting a statute is to give the words contained in the statute their common and ordinary meaning (unless the context of a statute requires otherwise), so as to interpret the statute in a manner consistent with its plain language. A court should look beyond the words of the statute itself if, and only if, the actual statutory language is ambiguous or otherwise inconclusive.

It would seem that the plain language of section 4058(a)(1) is clear and unambiguous.

¹ "Net disposable income", which is not relevant to the decision in Asfaw, is defined as annual gross income minus state and federal taxes (actual tax liability, not withholdings); Federal Insurance Compensation Act (FICA) payments; mandatory union dues; health insurance premiums; child and spousal support actually paid; job-related expenses; and a deduction for hardship, if appropriate. Family Code § 4059.

Depreciation, although an accounting expense, is not an “expenditure.” As explained below, recognizing this fact should have been all that was necessary to decide Asfaw.

However, instead of starting with the words contained in section 4058, the Asfaw court began its analysis by turning first to legislative history, which is a dubious means, at best, for interpreting statutes. After a lengthy discussion, the appellate court stated that the legislative history of section 4058 is inconclusive regarding the deductibility of depreciation.

The Asfaw court then turned to related provisions in other California statutes, as well as to relevant provisions in the California Code of Regulations. If the plain language of section 4058 is ambiguous, which it is not, the court’s reference to related statutes and regulations would have been entirely appropriate, as statutes and regulations should be harmonized with each other where possible in order to avoid conflicts in the law. Although the court said it was “assist[ed]” by its reference to related statutes and regulations, this exercise still left the court uncertain as to whether depreciation of real property was an “expenditure” and, if so, whether depreciation is “required for the operation of [a] business.”

The court then surveyed several other states to determine how the issue of real estate depreciation has been handled elsewhere. While this might sound like a practical way to address the issue, doing so overlooks the fact that California Family Code § 4058 was enacted by the California legislature without reference to the law of any other state, as the court’s review of section 4058’s legislative history should have revealed. Thus, because section 4058 was not modeled on, or derived from, the law of another state, other states’ laws, and judicial interpretations thereof, are completely irrelevant to an interpretation of section 4058. Regardless, after several more pages of appellate opinion, the Asfaw court concluded that “[g]iven the varied treatment of depreciation in [other] states, that case law [of other states] is of only marginal assistance.”

Finally, the Asfaw court ended where it should have begun: with the actual words of section 4058. The Asfaw court noted that “expenditure” means “an actual outlay of cash or other consideration” and that the broader term “expense” encompasses much more than actual outlays of cash or other forms of consideration, including – where the term “expenditure” does not – such items as accounting entries and tax deductions for depreciation.

The Asfaw court, not being content to stop after defining the term “expenditure”, continued by unnecessarily stating that “[a] proprietor cannot operate a business without inventory, without employees, without paying taxes, and so forth. A business can [however] be conducted without a deduction for depreciation.”

Section 4058, as previously noted, states in relevant part that rental income from an investment property is to be “reduced by expenditures required for the operation of the business.” Only “expenditures” may be used to reduce gross rental and other business income. Thus, it is necessary to determine whether depreciation is “required for the operation of the business” if, and only if, depreciation is an “expenditure”. Once the court determines, as it (finally) did, that depreciation is not an expenditure, it need go no further. Accordingly, it is entirely irrelevant whether depreciation, – a non-expenditure – is required for the operation of a business.

The court’s decision in Asfaw is predicated on the fact that father conducted his real estate investment business as a sole proprietor, that is, as an individual. Thus, the effect of Asfaw may be not be as far-reaching as it might appear. For example, it is unclear whether the court would have reached the same result if father had been an employee of a single-member limited liability company (LLC) which, instead of father, might have owned and depreciated the rental properties prior to paying father a salary. It is even less clear how the court would have decided Asfaw if father had been an employee of a multi-member LLC, or other form of entity, which might have owned the properties. These issues have been left for another day.

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Mr. Earle is licensed to practice law in all California state trial and appellate courts, the United States Supreme Court, the United States Court of Appeals for the Ninth Circuit, and federal trial courts in the Northern District of California. He is also a licensed Real Estate Broker.

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