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Case specifics dictate whether Subchapter-S retained earnings factor into child support

The treatment of a Subchapter-S corporation's retained earnings often raises challenging legal questions for divorce attorneys.

Primarily, two issues arise: Can the retained earnings of a nonmarital sub-S corporation ever be classified as marital property? Can the retained earnings ever be imputed to the owner as income for child support purposes?

While a handful of Illinois cases provide guidance on the analysis regarding the marital or nonmarital character of the retained earnings, until now, no Illinois judicial precedent on the second issue existed.

In a case of first impression, the 1st District Appellate Court recently held in *In re Marriage of Moorthy and Arjuna*, 2015 IL App (1st) 132077, that the company's retained earnings should not be imputed as personal income to the father — and thus, he was not required to pay child support on those earnings. The significance of the ruling is that the court reasoned that a specific factual analysis should be conducted on a case-by-case basis when the issue arises of whether the retained earnings should be imputed as income to the support obligor. The factors the trial court must consider are:

- The extent of the obligor's ownership share in the corporation.
- The obligor's ability to decide whether corporate earnings should be retained or distributed.
- The corporation's history of retained earnings and distributions, in comparison to postdivorce corporation activities.
- Whether the retained earnings are excessive.
- Whether there is evidence that income is actually being manipulated.

Moorthy presented a post-judgment child-support modification issue, and the father was the majority owner and primary executive of a Subchapter-S corporation he acquired after the parties' divorce. Subchapter-S corpora-

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tions are entities often seen in family law cases because of their attractive tax treatment for small businesses. They are pass-through entities where a business does not pay income taxes at the corporate level. Instead, income is directly passed through to its shareholders based on their percentage of ownership, and the shareholders pay taxes individually on their allocated portion of the earnings.

The mother and support recipient in *Moorthy* argued that the touchstone consideration of whether to include retained earnings as income should center on whether the support obligor has control over the distribution of the earnings. When evaluating this argument, the 1st District relied on two prior Illinois cases addressing the marital and nonmarital characterization of retained earnings of a nonmarital company.

earnings were his nonmarital property and not subject to equitable distribution in the divorce case.

In contrast, the case of *In re Marriage of Lundahl*, 396 Ill.App.3d 495 (2009), resulted in an opposite result. Because the husband in *Lundahl* was the sole shareholder in a nonmarital company he owned and operated before the marriage, he could unilaterally declare dividends and distributions. The company's retained earnings had grown significantly during the marriage, and thus, their characterization as either marital or nonmarital was significant. Since the earnings were not needed for any business purposes or required for any capital expenditures, the earnings were in fact the husband's income, rather than assets of the corporation, and therefore marital property.

The analysis of both decisions centered on the owner's ability or inability to control the distribution and retention of the profits and the company's need to maintain the earnings for working capital.

In the case of *In re Marriage of Joynt*, 375 Ill.App.3d 817 (2007), the husband held a 33 percent nonmarital ownership interest in a Subchapter-S corporation. He was a minority shareholder, and he could not have unilaterally declared corporate dividends or distributions. The company's retained earnings were primarily used for corporate expenses; the husband's compensation was reasonable and fair; and there was no evidence that he was using the retained earnings to shelter his income. Therefore, the retained

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Relying on *In re Marriage of Brand*, 273 Kan. 346 (2002), a Kansas Supreme Court case, and *Taylor v. Fezell*, 158 WW.3d 352 (2005), a Tennessee Supreme Court case, the *Moorthy* court noted that heightened scrutiny is appropriate when the obligor has the power to control distributions, but that this in and of itself is not

dispositive of whether the retained earnings should be included as income when calculating support. A fact-specific analysis, including the last three factors listed above, must be done in each case to determine whether retained earnings should be imputed as income.

The father in *Moorthy* presented evidence that historically he did not make distributions except to pay taxes and he maintained a consistent \$50,000 salary. He further testified regarding the need to retain the funds as working capital to keep the business afloat and presented evidence of contracts and employees he was obligated to pay even if there were no projects available; business expenses that the company had with respect to the contract employees; and payroll, wages, taxes and insurance.

Since the mother did not present evidence by way of expert testimony or other means to contradict father's testimony that he needed to maintain the earnings as working capital for expenses throughout the year, the court deemed the retained earnings properly excluded from father's income.

The *Moorthy* case gives litigants and their attorneys concrete guidance for what a court should consider when earnings are retained in a business when there is a claim for imputed income for support purposes. If the support obligor is a majority owner of the company and has the power to declare dividends and distributions, the obligor will need to present evidence of the company's need to retain the earnings for working capital.

On the other hand, support recipients should consider retaining an expert to study the historical distributions and dividends the company has paid and whether there is evidence that the obligor is trying to shelter income in the company.

Although *Moorthy* dealt only with child support, the holding presumably would apply to spousal support and unallocated support awards.