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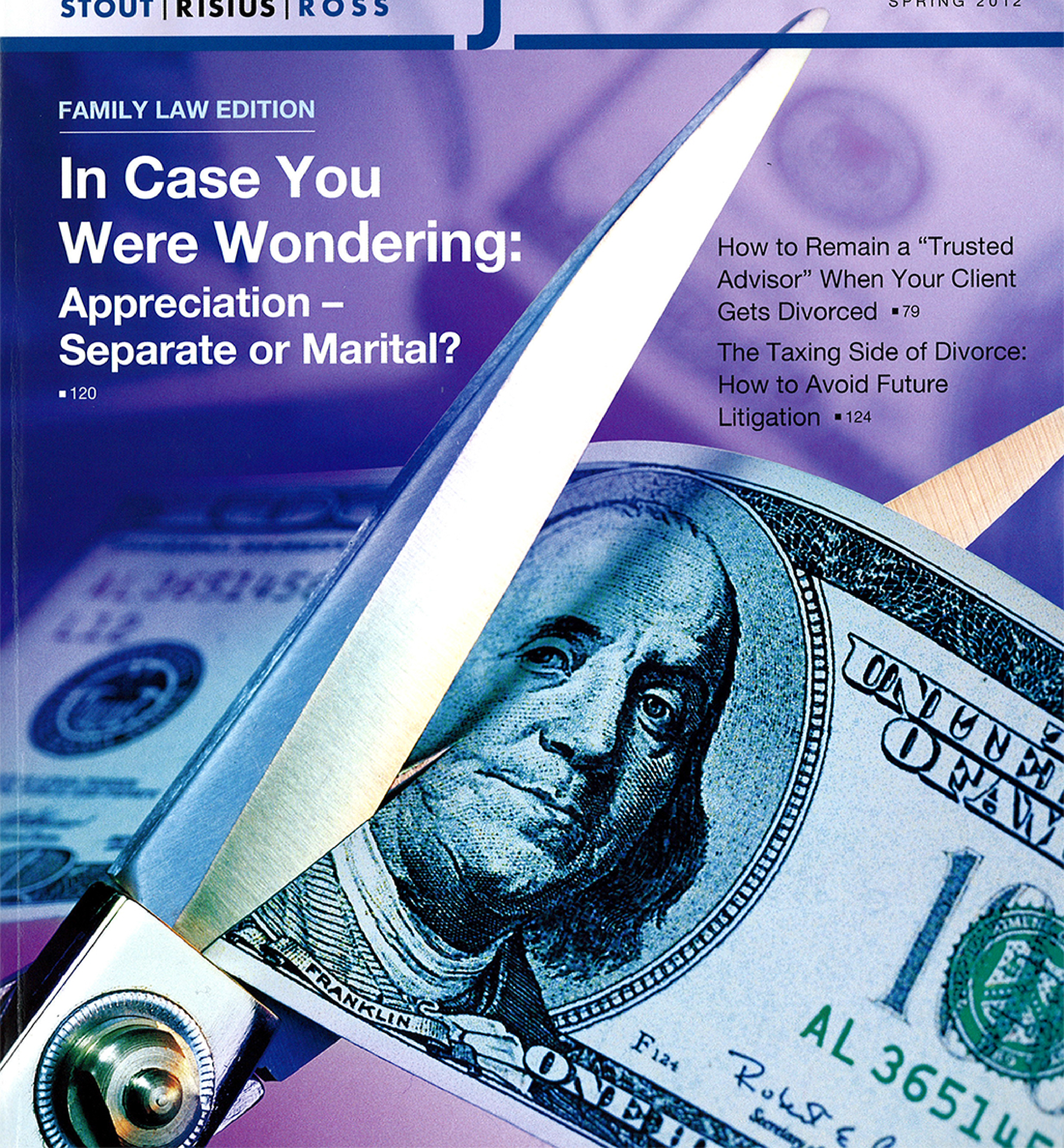

FAMILY LAW EDITION

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Guest Article

How To Remain A "Trusted Advisor" When Your Client Gets Divorced

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Introduction

Janet Langjahr, an attorney, in her Florida-based Family Law Blog, reports that wealth does not necessarily equate to "happiness" in a marriage. Janet cites an article, "The Rich and Unfaithful," in *Forbes Magazine*, which says that the wealthy are no happier in their marriages than those of modest means. About half of wealthy people describe themselves as "unhappy" in their marriages, and as many as 30 percent were considering obtaining a divorce[1]. Additionally, it is statistically confirmed that nearly one-half of all marriages end in divorce. Given these statistics, it is vital for wealth advisors, whether in financial advisory or trust and estate planning roles, to keep the future prospect of divorce in mind as they consult with their clients.

Following are divorce-related issues that trusted advisors should have a working knowledge of as they advise clients:

1. The legal concepts of "marital" vs. "non-marital" property, and how premarital businesses are treated during a divorce.
2. How the retained earnings of a premarital business are treated by divorce courts.
3. How "income" is defined in the divorce context.
4. What happens to the children's college savings when the parents divorce.
5. Assisting clients in obtaining access to the best counsel available.
6. Educating clients to become a single person with clear and obtainable objectives.

[1] Liz Moyer, *The Rich and Unfaithful*, Forbes Magazine, Oct. 09, 2007.

Classification of Business Interest

Most advisors to wealthy families are at least generally cognizant of the concepts of marital and non-marital property, also known as marital and separate property. While the definition may differ slightly from state to state, in most states marital property means all property acquired by either spouse subsequent to the marriage, unless otherwise excluded by a written premarital agreement.

Separate non-marital property (referred to hereafter as non-marital property) generally falls into five categories:

1. Property acquired by gift, legacy or descent
2. Property acquired in exchange for non-marital or separate property that is clearly traceable to the non-marital source
3. Property acquired by a spouse after a Judgment of Legal Separation
4. Property excluded by a valid agreement of the parties (e.g., either a pre- or post-nuptial agreement)
5. Property acquired prior to the marriage and not co-mingled or transmuted to marital property

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The determination of whether property is marital or non-marital gets exceedingly complicated when you consider assets that were originally non-marital property, but which may have increased in value, and the increase in value is attributable to the personal efforts of the contributing spouse during the marriage. The same is true when non-marital property has accumulated income that may be attributable to the personal efforts of a spouse. In light of these complicating factors, when advising clients regarding their business succession planning, it is important for a trusted advisor to be aware of how courts have interpreted these concepts.

Consider a scenario in which the husband owns 30 percent of the stock in MyCorp at the time of the parties' marriage. Five years into the marriage, MyCorp redeems the outstanding shares, making the husband 100 percent shareholder. Given the fact that the husband hasn't acquired any new shares during the course of the marriage, one would tend to think that no marital property has been created as a result of the stock redemption. However, case law from various jurisdictions has found otherwise. One such case is *In re the Marriage of Smith v. Smith*, 475 S.E.2d 881 (W. Va. 1996).

In the *Smith* case, the parties were married in 1987 and separated in 1992. The Wife was a homemaker during the marriage and the Husband worked for a closely held family insurance business, both prior to and during the marriage. At the time of the marriage, the Husband owned 28 percent of the outstanding stock of the business. A stock redemption during the marriage increased the Husband's percentage ownership from 28 to 44 percent. Upon divorce, the Trial Court found that the stock redemption (assuming the transaction was at Fair Market Value) did not increase the value of the stock held by the remaining shareholders because when a corporation redeems stock, the stock it redeems is often offset by a corresponding liability.

Upon appeal, the Appeals Court held that the Trial Court should have examined how the liability incurred as a result of the redemption was paid. If the liability created by the redemption was paid from corporate earnings generated as a result of the Husband's marital effort, the increase in value of the stock going forward then may well have become "marital property," subject to some division with the Wife as a part of her share of "marital property."

To the same effect is *In re the Marriage of McCloud v. McCloud*, 327 S.E.2d 910 (N.C. Ct. App.1985). Here, the parties were married in 1963 and, in 1970, the Husband inherited approximately 30 percent of the outstanding shares of a family-owned trucking business. Given the fact that the Husband had inherited the shares, the shares would typically make the stock non-marital property. In 1974, however, the trucking company redeemed all of the outstanding shares, other than the Husband's, with cash generated primarily by corporation borrowing, personally guaranteed by the Husband.

The Trial Court found that "acquired," as in "acquired during the marriage," is a dynamic concept. Therefore, the Court held that it must look at acquisition as an ongoing process and not merely evaluate property as of the inception of title. If a non-marital asset increases as a result of active appreciation attributable to marital efforts in the form of Husband's work and control, a portion of formerly non-marital stock becomes marital property. Here, because the loan that funded the stock redemption was paid with funds that were generated by the Husband's marital efforts, which would have otherwise augmented the marital estate (i.e., in the form of compensation to the Husband), that portion of the appreciation of the value of the company attributable to the transaction was marital property.

These decided cases demonstrate that, depending upon the legal structure of the business succession plan that you are creating for a family, marital property may be unintentionally created. A premarital agreement, clearly specifying what is to be marital or non-marital, is always the safest way to assure the end sought rather than relying upon the slippery language of statutory definitions. The worst possible end is the discretionary interpretation by a Judge who never ran a business! When creating succession plans for family-owned businesses, wealth advisors should consult with a family law speciality specialist in the client's home state to ensure that the plans do not unintentionally create marital property.

Classification of Retained Earnings of Non-Marital Businesses

Another divorce law concept with which advisors to wealthy clients and/or business owners should be familiar is that retained earnings of a closely held company, which is otherwise a non-marital asset, can often become marital property. As indicated earlier, the definition of marital and non-marital/separate property gets very complicated when the value of a non-marital asset increases during the parties' marriage and the increase in value can be attributed to the personal effort of the spouse that works for the business. This point is illustrated by the following scenario: Husband is the sole owner and shareholder of ABC Corporation, an Illinois Subchapter S corporation created in 1990. As you undoubtedly know, an S corporation is treated like a partnership for tax purposes; all income or loss is reported on the personal tax return of the stockholders. Husband and Wife marry in 2000. At the time of the marriage, the Husband has a million dollars in annual profits and $60,000 in retained earnings. The Husband in recent years has been reporting $400,000 per year in pass through S corporation income from ABC on his personal return and taking $300,000 in distributions from ABC to fund his lifestyle. The Wife files for divorce in 2005.

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Nothing has changed with respect to the structure of ABC Corporation since the marriage. However, at the time of the filing, ABC Corporation has $3,000,000 in annual revenue and the Husband was reporting $1.2 million per year in pass through S corporation income, but is still taking only $300,000 in distributions per year from ABC to fund his lifestyle (plus additional distributions for the payment of taxes on the pass through income only, thus causing an increase in retained earnings). As a result, ABC Corporation now has $2,000,000 in retained earnings. While ABC Corporation still remains clearly a non-marital asset, it may have marital property in the form of retained earnings that may be claimed by the Wife as marital property.

The importance of retained earnings by an S corporation cannot be understated. All of such earnings have had taxes paid on the annual accumulation such that any retained earnings can be distributed to the shareholder tax-free. While ABC Corporation is clearly non-marital in origin, what about the treasure trove of retained earnings? Is any or all of it marital or non-marital?

One answer to this question can be found in *In re Marriage of Lundahl*[2], a recent Illinois case. Here, the Husband was the sole owner at AIS, which he owned and incorporated prior to the marriage. Between the parties' marriage and divorce, AIS's retained earnings had grown significantly. Because the Husband had the power to distribute or not distribute the earnings, the earnings were not retained for any business purpose (i.e., there was no present urgent need for capital expenditures by the business) and the joint return of the parties' paid taxes on the earnings, the retained earnings were really the income from personal efforts of the Husband and properly classified as marital property. As such, without a premarital or post-marital agreement, to the contrary, if a spouse is retaining earnings within a non-marital business he or she controls, such retained earnings may become marital property.

Defining Income, Etc.

Another concept that is important for advisors to wealthy families to always keep in mind is the specialized definition of "income" under the divorce statute. Typically, divorce statutes define income for the purpose of calculating child support and maintenance obligations as the "total of income from all sources" without regard to either its source or its inclusion as "income" for federal tax purposes.

Courts have become more aggressive and inclusive through the years in finding imputed income for the purpose of ensuring that dependent spouses and children following a divorce are able to maintain the standard of living they enjoyed during the marriage. Often, descendents of affluent and generous parents will be underemployed, earning minimal wages and relying upon annual gifts from their parents to supplement their lifestyles. When wealthy parents or grandparents make periodic gifts, or contribute to the support of their adult children and/or grandchildren, those support "gifts" may ultimately be imputed to the dependent adult children as "income" for legal support purposes. The types of income that could be imputed to a parent for the purposes of setting child support and maintenance include trust distributions, the use and occupancy of homes and/or a vacation property owned or maintained by the wealthy parents, the payment of tuition or other activity expenses for grandchildren, the payment of vacation and/or travel expenses, and the like. A good basic rule of thumb to follow is that if an adult child has access, or has historically had access, to funds for the purposes of enhancing his/her own lifestyle, those funds will be treated as income for the purposes of calculating his/her support obligations to his/her spouse and offspring of the failed marriage.

There is a very strong propensity in divorce law for courts to require parents to find a way to support their children consistent with the pre-existing marital lifestyle of their dependents. Wealthy parents that support their adult children need to understand that as they take on the support of their adult children, they are also to a great extent taking on the support of their children's children and, potentially, their child's dependent spouse. While a Court can't require a wealthy parent to pay any particular expense, if that income nonetheless is imputed to their adult children, the Court has the power of contempt, sometimes coupled with jail time, to ensure that the cash flow is maintained. No grandparent would accept this result without providing some means to avoid it. In advising grandparents with respect to expenses they would like to pay on behalf of their grandchildren, it is always best to advise them to pay those expenses directly whenever possible and keep the money out of the potential support obligor's hands.

Some of the principles recited above are found in *In re the Marriage of Rogers*, 820 N.E.2d 386 (Ill. 2004). The Court included predictable and consistent annual tax-free gifts to the father from his parents in the father's "income" for the purposes of calculating child support. If there was evidence that such traditional gifts may well end in the future, the Court said it could re-determine support obligation after the gifts had actually ceased. The Court resoundingly rejected the grandparents' disingenuous claim that the funds provided to their son were "loans" because there was no history of documentation or any repayment and no reasonable expectation the funds would ever be repaid.

In re Marriage of Sharp, 860 N.E.2d 539 (Ill. App. Ct. 2006), the father's trust distributions were income for support purposes, although the distributions were subject to change year to year and in spite of spendthrift provisions of the trust that, by its terms, were not subject to support obligations.

[2] 919 N.E.2d 480 (Ill. App. Ct. 2009).

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When College Savings Have Unintended Consequences

Grandparents often consider making provisions for the payment of their grandchildren's educational expenses and college tuition. However, if you are in a jurisdiction in which a Court has the authority to require a parent to contribute to college expenses, prefunding these expenses on behalf of their grandchildren may not actually be the grandparents' wisest financial decision. The following states have statutes that provide for college expense contribution:

Alabama	Michigan (case law)
Arizona (case law)	Mississippi
Colorado (case law)	Missouri
Connecticut	Montana (case law)
District of Colombia	New Jersey
Florida	New York
Georgia	North Dakota
Hawaii	Oregon
Illinois	Rhode Island
Indiana	Utah
Iowa	West Virginia (case law)
Maryland (case law)	Washington
Massachusetts	

Pursuant to most statutes that provide for the payment of college educational expenses, the Court will consider the financial resources of both parents as well as the financial resources of the child at the time the child is applying to college. To the extent that grandparents have already created college savings for their grandchildren, and to the extent that those funds are sufficient to pay for the college education expenses, a grandparent might actually be freeing their child's ex-spouse from any contribution for college expenses. Again, if you are in one of the jurisdictions in which a divorce parent can be required to contribute to the college education cost of their child, the grandparents may want to consider not creating or prefunding those accounts until such time as the Court has a made a determination of the ex-spouse's obligation to pay.

Ensuring Clients Have Access to the Best Advice Available

Given the increasing trend toward family law practice becoming a more highly specialized practice area, the community of divorce lawyers with the training, experience, and level of expertise in tax, financial, and estate planning necessary to represent high net worth families with complicated assets is relatively small. For example, the American Academy of Matrimonial Lawyers, the only certifying group of its kind in the United States, has more than 3,000 members, out of a national family law census of 1,200,000 registered lawyers. It is a common occurrence at most prestigious family law firms that they will often be requested separately by both parties to represent them. To the extent that one spouse consults with several of the top attorneys in the jurisdiction, the other spouse may be limited in his/her options for hiring divorce counsel. The Rules of Professional Conduct for attorneys in every jurisdiction provide that in the event that a client has consulted with them incident to his/her divorce case and shared confidential information, that law firm can not represent the other spouse. If a client confides to a trusted advisor that he/she is contemplating divorce, the client should be encouraged to consult very quickly with an acknowledged specialist in family law in their jurisdiction.

Encouraging Your Client to Become an Educated Consumer

Finally, and perhaps most important, when a wealthy client is contemplating divorce, the divorce will have significant and far-reaching estate and financial planning implications. Just as wealthy clients should be encouraged to spend time understanding the financial planning and tax and estate planning processes and myriad options presented, so too should they understand the divorce process and self-determined options within the divorce process.

The days of filing a divorce case and pursing a contentious lawsuit through the traditional litigation model of filing pleadings, conducting depositions in support of discovery, and then going to trial is becoming a thing of the past. The appearance and growth in popularity of "alternative dispute resolution," in the form of mediation, arbitration, or the collaborative process, has significantly reduced trial of these matters. Divorcing clients have many more options today than they did 20 or 30 years ago. While alternative dispute resolution is not appropriate in all cases, if potential clients consult only with lawyers who have expertise with the litigation model, it is more likely than not that they will be unwittingly suckered into that process, whether or not it truly is necessary.

Clients contemplating divorce should become educated consumers, learn about the various processes and options, and consider those options both prior to and while they are consulting with divorce attorneys. For more information about divorce mediation and the resolution of divorce cases through the collaborative process, refer to: www.collablawil.org; www.cdsadr.org; or www.ccrchicago.org.

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