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## Retained earnings of a business: Marital or non-marital property?

Property division is one of the most complex parts of any divorce case. The issues are even more complex when a spouse has an ownership interest in a family or closely owned company.

This not only leads to issues pertaining to determining income and cash flow, but also whether the interest in the company itself is characterized as marital property subject to division or a spouse's non-marital property. In certain instances, even when a spouse's ownership interest is characterized as his or her non-marital property, there are still circumstances where "assets" can be considered marital property. This can occur with the retained earnings of a business.

Retained earnings is defined as the accumulated portion of a business' profits that are not distributed as dividends to shareholders, but are instead retained for reinvestment in the company. Retained earnings are typically included on the company's balance sheet as part of the "shareholder's equity." The question then becomes for marital property purposes, who actually owns the retained earnings: the shareholder or the company?

Section 503(a) of the Illinois Marriage and Dissolution of Marriage Act states that "all property, including debts and other obligations, acquired by either spouse subsequent to the marriage" is "marital property." However, Section 503(a) carves out specific classes of

property that are to be characterized as "non-marital property." These exceptions include acquiring property "by gift, legacy or descent," acquiring property before the marriage, and acquiring property "in exchange for property acquired before the marriage," among other exceptions. In addition, Section 503(a)(8) of the Illinois Marriage and Dissolution of Marriage Act provides that income from non-marital property as specifically delineated in Section 503(a)(1) through (7) is non-marital "if the income is not attributable to the personal effort of a spouse."

Generally, a closely held company's retained earnings are non-marital property if the company is non-marital and just a part of the stockholder's equity. However, retained earnings in a closely held company can become marital property for purposes of a divorce.

To determine whether a portion of the retained earnings attributable to the spouse owner are marital or non-marital, divorce courts conduct a two-prong test. Under the first prong, the court must consider whether the retained earnings were really "income" rather than an asset of the business. To make this determination, courts must consider the nature and extent of the stock holdings, i.e. is a majority of the stock held by a single shareholder spouse with the power to distribute or not retain the earnings, and to what extent are retained



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earnings considered in the value of the company. This is not a bright-line test, and to make this determination, courts are directed to consider a variety of factors, including (1) whether the spouse was a controlling shareholder and hence could disburse or withhold a dividend (this does not mean that the shareholder spouse has to have a controlling interest, just that the shareholder

spouse had great influence over the distribution of funds); (2) whether the corporation held the retained earnings for a proper business purpose to pay expenses; (3) whether the corporation paid the tax, through designated tax payments, relative to the owner spouse's share of the retained earnings reported on their tax returns; and (4) whether the owner spouse received a salary from the corporation that was fair and reasonable.

Under the second prong of the analysis, once a court determines that any retained earnings should be treated as "income" of a spouse for divorce purposes rather than an asset, the court must determine if the "income" is due to the "personal efforts" of the spouse. The burden of proof is on the spouse owner who works in the business to show that retained earnings were not attributable to their personal effort which must be demonstrated by clear and convincing evidence, a higher burden than by a preponderance of the evidence. *In re Tiffany W.*, 2012 IL App (1st) 102492-B, Para. 12. The classic example of when income is not due to a spouse's "personal effort" is when a spouse is receiving income through a passive investment such as rental income. In other instances where the spouse is actively participating in an asset's daily operations (usually a company), the income is presumed a result of the

spouse's personal efforts and presumed marital.

For example, in *In re Marriage of Joynt*, 375 Ill.App.3d 817 (3d Dist. 2007), the husband had a minority, non-control ownership interest in a business that the parties stipulated was his non-marital property. The company had sizeable retained earnings that the court determined were a non-marital corporate asset. In so holding, the court reasoned that the husband only held a non-marital minority

interest and he could not unilaterally declare or withhold dividends, the retained earnings were a corporate asset that the company used to pay expenses, the corporation paid the tax on the husband's portion of the retained earnings, and the husband was fairly and adequately compensated through his salary.

Conversely, in *In re Marriage of Lundahl*, 396 Ill.App.3d 495 (1st Dist. 2009), the court determined that the retained earnings of two sub-

chapter S corporations that the husband had owned prior to the marriage and was the sole shareholder was marital property. The court reasoned that the husband as the sole shareholder could unilaterally take disbursements, the retained earnings were not held by the corporation to pay expenses, dividends, or used in connection with the corporation, and the husband paid the income tax on the earnings. As a result, the retained earnings were income from

property acquired prior to the marriage that was attributable to the husband's personal efforts and therefore marital.

The law surrounding the characterization of retained earnings of a business for divorce purposes is complex and can turn on any one fact. It is therefore imperative upon any spouse in such a predicament to consult with appropriate professionals and seek the appropriate information through the discovery process.