

Retained Earnings of a Non-Marital Corporation for the Purpose Property Classification in Illinois Divorce Cases:

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I. Introduction:

A. Triad of New Cases - 1st through Third District – with Two Taking Radical Departure:

Since 2007 Illinois law has taken a radical departure regarding what we might call the “marital energies” issue and the classification of retained earnings from a non-marital corporation. The triad of cases that represent this development are:

1. *Marriage of Joynt* - 375 Ill.App. 3d 817 (Third Dist., 2007)
2. *Marriage of Schmitt*, 391 Ill.App.3d 1010, 909 N.E.2d 221, 330 Ill.Dec. 508 (2nd Dist., April 2009)
3. *Marriage of Lundahl* - (1st Dist. 5th Div., November 2009)

This issue is important because it also impacts case law regarding potential consideration of retained earnings for the purpose of determining support or maintenance.

II. §503: Before addressing this line of cases from the First through Third Districts, we should address §503(a) of the statute which defines marital and non-marital property. Marital property, of course, is defined as all property acquired after the marriage.

A. §503 Verbatim:

Non-marital property is defined by the following exceptions:

- (2) property acquired in exchange for property acquired before the marriage or in exchange for property acquired by gift, legacy or descent;
* * *
- (6) property acquired before the marriage;
- (7) **the increase in value of property** acquired by a method listed in paragraphs (1) through (6) of this subsection, **irrespective of whether the increase results from** a contribution of marital property, non-marital property, **the personal effort of a spouse**, or otherwise, subject to the right of reimbursement provided in subsection (c) of this Section; and
- (8) **income from property** acquired by a method listed in paragraphs (1) through (7) of this subsection **if the income is not attributable to the personal effort of a spouse.**

(c) Commingled marital and non-marital property shall be treated in the following manner, unless otherwise agreed by the spouses:

* * *

(2) * * * when a spouse contributes personal effort to nonmarital property, the contributing estate shall be reimbursed from the estate receiving the contribution notwithstanding any transmutation. * * * Personal effort of a spouse shall be deemed a contribution by the marital estate.” 750 ILCS 5/503

B. §503(a)(7) and (8) Paraphrased as Applied:

The problem, therefore, is that subsections (7) and (8) are contradictory because paraphrased as applying to businesses with fact patterns similar to these cases the statute provides:

- (7) Non-marital property includes the **increase in value** of the non-marital business **even if** this increase was the result of **personal efforts of the business owning spouse** – although there may be the right to reimbursement.
- (8) Non-marital property also includes income from any non-marital business if the **income** is not attributable to the personal efforts of the business owning spouse.

III. Discussion of Statute and Nature of Retained Earnings

A. The Statute and Its History:

Understanding the nature of retained earnings, a reading of the statute seems to lead to the conclusion that the retained earnings remain non-marital. As will be seen, based upon the appellate court’s interpretation in this line of cases, the appellate court focuses almost exclusively on subsection (8) and somewhat disregards subsection (7). They do this despite the reliance of many more cases addressing the marital energies issue on whether the cash flow from the non-marital business was adequate compensation to the business owning spouse for his (or her) personal efforts. In arguing in favor of this recent trend, you might argue that the inverse of (8), as paraphrased, should also be true: Marital property would include income from any non-marital business if the income was attributable to the personal efforts of business owning spouse. In terms of logical reasoning, though, the inverse is not always true.

When we consider the Illinois statute, keep in mind that the states with essentially the same original statutory scheme are limited. Illinois adopted the Illinois Marriage and Dissolution of Marriage Act (1977) from the Uniform Marriage and Divorce Act (1970 and approved by the ABA in 1974). See: www.law.cornell.edu/uniform/vol9.html#mardv Those who know the relatively recent history of Illinois divorce law will recall the case law that developed following §503 under the IMDMA. The seminal case addressing the extreme treatment by the Illinois courts was *IRMO Smith*, where a couple spent \$3,500 of funds to remodel a non-marital office/apartment building. 86 Ill.2d 518, 427 N.E.2d 1239 (1981). Even though there were no provisions for reimbursement in §503, the trial court had tried to do just that and the Illinois Supreme Court reversed both the trial and the appellate courts, finding the property to be marital. The Illinois Supreme Court reasoned in 1981 that the statutory preference for

marital property was so strong that any intentional commingling of property from any two different estates resulted in the creation of marital property.

The legislative response was PA 83-129 – an amendment to §503 drafted by Jim Feldman and Charlie Fleck and explained in their frequently cited article “[Taming Transmutation](#).” James H. Feldman and Charles J. Fleck, Taming Transmutation: A Guide to Illinois’ New Rules of Property Classification and Distribution Upon Dissolution of Marriage, 72 Ill. B. J. 336 (1984). See:

www.sdfllaw.com/RA322S10/assets/files/lawarticles/Taming%20Transmutation.pdf

As that article states:

Under the *Van Camp* rule, if the salary is reasonable consideration for the wife's efforts, the non-marital business need not further reimburse the marital estate, since the wife's salary during [the] marriage is marital property and the marital estate has already been compensated.

See also, “Revisiting Transmutation 20 Years Later: Still Untamed?” by Timothy M. Daw and Sarane C. Siewerth, DCBA Brief, www.dcba.org/brief/aprissue/2003/art10403.htm

The point of this history is that when adding (c) addressing the reimbursement issue, we also added the following language (with emphasis added) to 503(a)(7):

the increase in value of property acquired by a method listed in paragraphs (1) through (6) of this subsection, **irrespective of whether the increase results from a contribution of marital property, non-marital property, the personal effort of a spouse, or otherwise, subject to the right of reimbursement provided in subsection (c) of this Section.**

We believe that this legislative history is critical when considering these two subsections; that is, the legislature amended the Illinois statute previously in order to avoid the harm taken by Illinois case law in classifying marital property too broadly.

[Note to GJG: Pull original taming transmutation article. Next, can we confirm change to a7 above?]

Following these amendments there were a series of Illinois cases involving what we refer to as the marital energies issue involving a non-marital business. None of these cases focused on a potential increase in the retained earnings of the business. Instead, they focused on whether the marital estate was adequately compensated by the marital energies. In terms of rules of construction, if a statute was amended and the amendment was intended to address a certain issue, then the amended portion of the statute should essentially stand on greater footing than the portion that was not amended. But putting this issue aside, the question, then, is whether the retained earnings constitutes income or property.

B. **What Are Retained Earnings?:**

We urge that this trio of cases got it wrong – retained earnings for a non-marital company is neither property nor income. It is an accounting convention. We will see that the Illinois cases rely upon out of state case law. But none of the out of state cases have law that is the same as Illinois law. Nevertheless, an example of a quote from an out of state case cited by the most recent Illinois case states, “Retained

earnings are ‘corporate net income which would be available for distribution as dividends, for payment of wages, salaries and bonuses, and other proper corporate purposes’.” While somewhat true, this is a misleading statement. The “other proper corporate purposes” can include necessary reinvestment for a business.

Keep in mind that retained earnings is simply an accounting convention for what will appear near the bottom of the shareholder’s equity section of the balance sheet. Viewed in this way, retained earnings are far more like property than they are income. While retained “earnings” have something to do with income, understand that the problem is that a number of cases that we reviewed use the mistaken assumption that there is some sort of “account” or “fund” which is maintained. While it is possible that retained earnings could go hand in hand with an increase in working capital, generally it does not. Instead, the funds that represent this accounting convention are often reinvested into the business so that a business can continue to thrive and potentially grow. When reading the following cases also consider the relationship of dividends to retained earnings. In accounting terms retained earnings are essentially the cumulative earnings of a business minus the dividends that it has paid since its inception.

As investor’s glossary states:

Retained earnings may be appropriated for specific purposes (like bond payments) or unappropriated; only unappropriated retained earnings are available to be distributed as dividends. An appropriation of retained earnings may be disclosed on the balance sheet or in the footnotes to the financial statements. Note, however, that an appropriation of retained earnings does not imply that the amount is held and segregated as cash. See: www.investorglossary.com/retained-earnings.htm

A somewhat disjointed explanation of the nature of retained earnings was contained in the husband’s expert’s testimony in *Joynt* when he tried to explain that retained earnings are simply a figure on the books of the business and they would be appropriate to look at if you were valuing a business based on its book value (which of course is not proper):

[Husband’s Expert, Carey] explained that the corporation’s stock would be an asset and "then the stock has to be valued." If you wanted to value the company’s stock at book value, "in essence you’re valuing the retained earnings." Carey stated that a company’s book value is the assets minus the debts, which equals the stockholders’ equity.

For the lawyer handling a case involving a nonmarital business, consider these cases in light of potential burdens of going forward and of proof when there is a closely held business where the spouse is in a control position. The point is that this trio of cases appears to place the burden of proof on the business owning spouse to show that the income of the business was not attributable to his personal efforts – with the emphasis 503(a)(8).

C. **The Need for Prenups:**

A secondary point is that unless and until this line of cases is overturned, the conventional advice that had been given regarding premarital agreements is simply no longer true when there is a premarital business. For example, in a Q&A by one well known Illinois divorce lawyer states:

Q: Do I need a premarital ("prenuptial") agreement? This is my second marriage.

A: No. To protect against a divorce, you do not necessarily need a premarital agreement. You will not need a premarital agreement if, during your second marriage, you are careful how you structure the ownership of your assets.

The answer on this Q&A now needs to be qualified – because it simply is not a true statement at this time – at least when dealing with a control position in a closely held nonmarital corporation. See, AAML Illinois website article Gunnar J. Gitlin regarding premarital agreements: aamlillinois.org/pre-post-marital-agreements.cfm

IV. ***Joynt* - Property: Retained Earnings for Shareholder in Minority Interest Without Control are Not Marital Property:**

[*IRMO Joynt*](#), 375 Ill.App. 3d 817, 874 N.E.2d 916, 314 Ill. Dec. 551 (Third Dist., 2007).

A. **Opening the Door to Later Cases:**

Joynt is the first Illinois case to begin to open the door to making this radical departure in Illinois case law. This case introduces the issue as being one of first impression in Illinois. This is an overstatement. The question that it presents is whether retained earnings of a non-marital corporation should be classified as marital property. It states:

Whether retained earnings should be classified as marital property *is an issue of first impression in Illinois*. As noted by both parties, however, other states have generally held that retained earnings are nonmarital. Those jurisdictions have reached that conclusion based on the evaluation of two primary factors: (1) 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 the retained earnings; and (2) to what extent are retained earnings considered in the value of the corporation. See 1 H. Gitlin, *Gitlin on Divorce* §8-13(j), at 8-172.2 (3rd ed. 2007). * * *

On the other hand, when a shareholder spouse has a majority of stock or otherwise has substantial influence over the decision to retain the net earnings or to disburse them in the form of cash dividends, [a minority of / some] courts have held that retained earnings are marital property. In [*Metz-Keener v. Keener*](#), 573 N.W.2d 865 (Wis. 1997), the court determined that the retained earnings fund of a corporation inherited by the wife was income separate from the corporation and should be included in the marital estate. The court reached that conclusion because the wife had "full ownership and possession of all the corporate shares and that she [was] the sole managing force behind the corporation." *Metz-Keener*, 573 N.W.2d at 869; see also *Heineman v. Heineman*, 768 S.W.2d 130 (Mo. App. W.D. 1989) (retained earnings account in wife's previously unincorporated art studio corporation was marital property because wife was sole shareholder and earnings were retained in lieu of salary). Thus, if the shareholder spouse controls the corporate distribution, the retained earnings are marital property. (Bracketed portion added by

author).

This last statement (which was clear dictum in *Joynt*) likely led to the later two cases. But keep in mind that this statement was merely a statement consistent with this minority approach of case law. And note that the appellate court also quoted from the majority view in dictum that would favor the opposite position: "However, retained earnings and profits of a subchapter S corporation are a corporate asset and remain the corporation's property until severed from the other corporate assets and distributed as dividends."

B. Reliance on *Gitlin on Divorce* and Its Discussion of Wisconsin Case:

The appellate court based its reasoning on an out of state case (which was reported in *Gitlin in Divorce Reports* and reviewed in *Gitlin on Divorce: A Guide to Illinois Matrimonial Law*) as well as one other case. The book did not take the position that based upon Illinois statutory law, Illinois should adopt the approach taken by Wisconsin – that retained earnings of a non-marital corporation may be marital where the shareholder is in a control position. Instead, *Gitlin on Divorce* had reviewed the Wisconsin appellate court case of *Metz v. Keener*, 215 Wis. 2d 626 (1997) at some length. H. Joseph Gitlin in his book points out:

At §503(a)(8) there is included as nonmarital property income from non-marital property if the income is not attributable to the “personal efforts” of a spouse. * * * This ruling was made under Wisconsin's case law holding that income generated by an exempt asset (non-marital) as separate and distinct from the asset itself.

* * *

The significance of this Wisconsin case, *Metz*, for divorce proceedings in Illinois, is that the Wisconsin court considered the retained earnings of the corporation as belonging to the shareholder. *Gitlin on Divorce*, 8-13(j) Subchapter S Retained Earnings, pp. 8-172.7 to .8.

The appellate court in *Joynt* ruled that the trial court did not err when it characterized the retained earnings in the husband's premarital closely held S corporation as non-marital property where he owned only 33% of shares of the corporation and did not control distribution of dividends. The court also based its finding on the totality of the husband's control, including significant distributions to officers in recent years and a buyout agreement between the husband and his father.

C. Remaining Reasoning of *Joynt*:

Regarding the key facts of the case, *Joynt* commented:

In this case, the retained earnings were part of the corporate assets. The expert witness testified that the earnings were held by the corporation to pay expenses. Although, under the passthrough provisions for subchapter S corporations, these undistributed earnings were taxed to Michael and Teresa as "income" on their individual income tax return,

MVS paid the tax through year-end designated payments made to Michael. Further, as the president of the company, Michael received a salary, plus biannual bonuses, as compensation for managing the daily operations. The only expert testimony found in the record indicates that Michael's compensation during the marriage was reasonable and fair for the services he provided.

The basis of the *Joynt* decision was therefore three-fold: because of the husband's lack of control to authorize payment of these earnings, "because the earnings were a corporate asset," and because the husband had reasonable compensation for his efforts regarding his interest in the non-marital corporation.

Joynt suggests in dictum that if a shareholder controls corporate distributions, retained earnings might be marital. Keep in mind that the actual holding provides simply a double negative – that is, that although the retained earnings were non-marital in this case, "this is not to suggest that under no circumstances would retained earnings of a nonmarital interest in a subchapter S corporation be classified as marital."

The language of *Joynt* that is difficult to reconcile with the recent *Lundahl* decision (discussed below) states:

However, retained earnings and profits of a subchapter S corporation are a corporate asset and remain the corporation's property until severed from the other corporate assets and distributed as dividends. See *Robert*, 652 N.W.2d at 543; *Hoffmann*, 676 S.W.2d at 827.

So, we have tension with this language and the language in the newest decision urging that corporate retained earnings are income rather than an asset when we are dealing with a majority owner.

V. ***Schmitt* - Classification of Property: Use of Retained Earnings to Acquire or Purchase Other Corporations or Assets – Income from Non-Marital Corporation and Marital Energies Issue / Reimbursement**

[*IRMO Schmitt*](#), 391 Ill.App.3d 1010 (2nd Dist., April 2009). At the time of the divorce, the husband was the sole owner of a closely held corporation, Bricks, that was the successor corporation to a number of business ventures in which the husband had been involved since before the marriage. All of the husband's business entities since 1970 came from an entity known as Colonial. The acquisitions included significant real estate holdings. The danger for the husband in *Schmitt* was that if the trial and appellate court were to follow some of the language in *Joynt* (because these corporations were separate from the original corporation), it could lead to the conclusion that the new corporations were in essence marital – if acquired through retained earnings.

Regarding the original premarital corporation, Colonial, the husband was given distributions to make the down payments and mortgage payments for certain real estate. The payments for the real estate were paid via what was reflected as end of the year distributions. The trial court had found that the husband's non-marital estate had a value of \$6 million and the marital estate had a value of \$350,000. The trial court awarded the wife what it found to be the marital estate and required the husband to pay \$1M in gross maintenance and arrearage. The appellate court reversed.

The appellate court stated:

Thus, the distributions were income to Kim. **Kim also testified that he purchased the Kedzie properties as an individual.** We find nothing in the record sufficient to **rebut the presumption** that the distributions were attributable to Kim's personal efforts. Therefore, the trial court's finding that the Kedzie properties were purchased with nonmarital funds, and were thus nonmarital, is against the manifest weight of the evidence.

Regarding other real properties and businesses acquired during the marriage, funds from Colonial were used to purchase them. In this regard, the appellate court stated:

Accordingly, Kim failed to establish by clear and convincing evidence that the funds used to purchase these assets were not distributions ("dividends," see *Joynt*, 375 Ill.App. 3d at 821) and, thus, income attributable to his personal efforts. Therefore, the trial court's finding that they were purchased with nonmarital funds is against the manifest weight of the evidence.

Double negatives are difficult to follow. The above statement suggests that the husband would have maintained his burden of proof if he showed that the funds used to purchase the assets were something other than distributions or dividends – with the implication that distributions or dividends were income related to his personal efforts.

It is noteworthy that there was testimony that the funds used to purchase these assets came from the operating account. The appellate court stated:

However, this does not negate the fact that Kim could not recall whether these withdrawals were later charged against Kim's retained earnings account, thus constituting a distribution to Kim.

In an interesting quote, the appellate court stated:

Further, although retained earnings in subchapter S corporations are generally considered nonmarital, they are considered marital if the spouse has control over the decision to disburse the retained earnings. See *Joynt*, 375 Ill.App. 3d at 819.

But, again, this was not the holding in *Joynt*. It was dictum taken from an out of state case that does not have Illinois' unique statutory property classification scheme. It is also contradicted by other language of *Joynt*.

Regarding the purchase of another corporation during the marriage, Bricks, the appellate court stated:

Kim testified that he did not know whether the money from Bricks was credited to his retained earnings account. Kim, as sole shareholder of Bricks, had complete control of and access to the retained earnings. Thus, the inference to be drawn from the evidence is that the funds were attributed to his personal efforts. Accordingly, the retained earnings of

Bricks, and all assets Kim purchased with them, are presumed to be marital, and the record does not show that Kim rebutted with sufficient evidence either the inference or the presumption. Thus, the trial court's finding that Bricks and the assets purchased by Bricks were nonmarital is against the manifest weight of the evidence.

The key reasoning is that if we have a controlling owner, we presume that retained earnings are attributed to the personal efforts of the business owning spouse. But keep in mind the language of §503(a)(7). It provides that non-marital property includes, “**the increase in value of [non-marital property]** irrespective of whether the increase results from a contribution of * * * **the personal effort of a spouse** * * * subject to the right of reimbursement provided in subsection (c) of this Section.”

The next issue regarding the reimbursement issue was one of the most compelling. Recall that a party is not entitled to reimbursement due to marital energies if the marital estate has already been compensated due to salary or income from the non-marital efforts. The trial court found that the yearly salary of \$20,000 from 2000 to 2006 as well as expenses paid for the wife and the children [of \$895,000] was sufficient to adequately compensate the marital estate. The appellate court noted that:

Kim did not present evidence of his contributions for expenses for Sandra and the children for 1974 through 1999, which constituted most of the parties' marriage. The trial court's finding that \$895,000 was sufficient to reimburse the marital estate, from Bricks' gross value along with its purchases of approximately \$10,761,000 in real estate, is against the manifest weight of the evidence.

Does this mean that if it were shown that there were adequate compensation to the marital estate due to the marital energies, then there would be no right to reimbursement and the newly acquired assets would be non-marital (as being acquired in exchange for other non-marital assets)? You cannot determine this by reading the decision.

Read the line of cases discussed and distinguished in this case. We will focus on it because it reflects how previous cases handled premarital businesses interests and assets that arise from these businesses:

Non-marital, closely held corporations, partnerships, or individually owned businesses, including farm operations, can accumulate income and assets in a variety of ways resulting in a substantial increase to the non-marital estate which should continue to be treated as non-marital property. If this fact can be demonstrated by competent evidence, such as accurate book keeping and a segregation of business funds, a court is justified in finding that some or all of the increased value of the business is non-marital. The issue is not the businesses' form. Rather, it is whether there has been an actual segregation of the non-marital estate from the marital and whether adequate proof of the separation of business from personal assets is offered. (*IRMO Werries*, 247 Ill.App.3d 639 at 646 (4th Dist., 1993)).

When considering whether the Illinois Supreme Court might backtrack from the position in *Schmitt* consider that *Schmitt* may not have been the perfect vehicle for the appellate courts to reject some of the expansive dictum from *Joynt*. The focus on *Schmitt* was due to the fact that there is a presumption that if you acquire assets during the marriage, they are presumed to be marital. So, important to the *Schmitt*

case is the issue of burdens of proof. It was left to our November 2009 *Lundahl* decision to take a quantum leap in Illinois case law - applying the reasoning of the two previous cases to a case where we do not have assets acquired in exchange for other non-marital property. The issue in this new case is whether the corporate earnings, themselves, of a premarital business constitute marital property.

VI. *Lundahl* - Retained Earnings Constituted Marital Property from Non-Marital Corporation but Amount was in Error

IRMO Lundahl, (Second Dist. November 25, 2009): Justice Samuel Betar, III, wrote the opinion in *Lundahl* making the leap that when dealing with a 100% owner with clear control of the business, that the retained earnings of a non-marital corporation constituted marital property.

Lundahl involves one of the rare instances where a trial court reverses field when faced with a motion to reconsider. Originally, the trial court had determined the retained earnings remained non-marital property and reasoned that:

“‘marital property’ means all property acquired by either spouse.” The trial court found that this definition focused on which spouse, if any received the retained earnings. The trial court noted that in the instant case, neither party acquired the retained earnings because the earnings were the property of AIS and were located in AIS’s corporate account. Because the parties agreed that AIS was *Lundahl*’s nonmarital asset, the trial court found that the retained earnings constituted nonmarital property.

Because we believe that the trial court’s original decision was correct, we quote from it at length:

Additionally, the [trial] court found that Hopper had completely ignored sections 503(a)(7) and 503(c)(2) of the Act, which provide for the possible reimbursement to the marital estate for a spouse’s personal efforts that increase the value and retained earnings of property. The trial court noted that Hopper’s argument would render sections 503(a)(7) and 503(c)(2) meaningless because she defined AIS’s retained earnings as marital property simply because *Lundahl*’s personal efforts increased the value of the retained earnings. **The trial court stated, “[i]f this were the correct definition of marital property, ‘reimbursement’ of the marital estate under 503(a)(7) and 503(c)(2) would be unnecessary in every case and there would be no need for the inclusion of 503(a)(7) and 503(c)(2) in the 503 statute.”** The trial court found that looking at the Act as a whole, and recognizing the common rule of law that it is not appropriate to construe a statute in such a way as to render some of its parts meaningless, AIS’s retained earnings constituted *Lundahl*’s nonmarital property.

To this we say – yes. But based upon the *Joynt* decision the trial court then reconsidered its decision and determined that the retained earnings of the non-marital business were marital.

Lundahl argued that a long line of Illinois cases have addressed the marital energies argument regarding closely held premarital corporations. These cases have ruled to the extent the marital estate has been reasonably compensated by these efforts, there is no right to reimbursement. *Lundahl*’s string citation of

those cases stated:

IRMO Kennedy, 94 Ill.App. 3d 537 (1981) (music stores owned by husband prior to marriage were his nonmarital property and increase in value of those nonmarital businesses was also his nonmarital property);

IRMO Kamp, 199 Ill.App. 3d 1080 (1990) (finding that the Act leaves no doubt but that a business property interest owned by one spouse prior to the parties' marriage is nonmarital property and retains its nonmarital classification despite a significant increase in its value during marriage);

IRMO Landfield, 209 Ill.App. 3d 678 (1991) (a business property interest owned by one spouse prior to the parties' marriage is nonmarital and retains its nonmarital classification despite a significant increase in its value during marriage, and if a contributing spouse's salary is found to be reasonable for the efforts contributed, the nonmarital business need not reimburse the marital estate because the contributing spouse's salary during marriage is marital property and thus the marital estate has already been compensated);

IRMO Perlmutter, 225 Ill.App. 3d 362 (1992) (if husband's salary is found to be a reasonable compensation for his efforts, the nonmarital business need not reimburse the marital estate because husband's salary during marriage is marital property);

IRMO Steinberg, 299 Ill.App. 3d 603 (1998) (marital estate not entitled to reimbursement from the accounts receivable of a nonmarital corporation because the annual income received by the husband during the course of the marriage adequately compensated the marital estate)

A quote from one of these cases, *IRMO Perlmutter*, typifies the post-Feldman/Fleck amendment line of case law. After finding that the non-marital business substantially increased in value, the appellate court stated:

Thus, initially at least, it would seem that reimbursement to the marital estate is warranted. However, it is also true that, in valuing the right to reimbursement, if Norman's Heitman salary is found to be reasonable compensation for his efforts, the nonmarital business need not reimburse the marital estate because Norman's salary during the marriage is marital property, and thus, the marital estate has already been compensated. (Citations omitted.) In addition, the fact that Norman could have received a higher salary, as implied by Kathryn, does not mean that he was not adequately compensated. (Citation omitted.)

The *Lundahl* appellate court affirmed and based its reasoning in part on the language of §503(a)(8) that provides that income from property acquired prior to marriage is nonmarital property if it is not attributable to the personal effort of a spouse. The appellate court concluded:

Lundahl was the sole owner and shareholder of AIS, and thus the income of AIS during the marriage was attributable to Lundahl, making such income marital property. Accordingly, pursuant to both *Joynt* and the statute, the retained earnings of AIS were properly classified as marital property by the trial court.

Key language regarding *Lundahl's* reasoning states:

[O]ther states have generally held that retained earnings are nonmarital by evaluating two primary factors: “(1) 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 the retained earnings; and (2) to what extent are retained earnings considered in the value of the corporation.” *Joynt*, 375 Ill.App. 3d at 819. Contrary to the parties’ interpretation of the case, **we do not believe that the *Joynt* court has set forth a “two-part” test.** Rather, the Third District acknowledged that these *were two primary factors that other jurisdictions relied upon*. Some jurisdictions, as *Lundahl* noted, relied on *only* one of those two factors. Nonetheless, we will evaluate both factors in light of the facts of the case at bar. (Emphasis added.)

The appellate court noted:

Lundahl wholly owned AIS, was the sole shareholder of AIS, and could have unilaterally declared or withheld dividends. In fact, Lundahl unilaterally took disbursements from AIS’s retained earnings in the amount of \$147,000 in 2004, \$218,000 in 2005, and \$411,500 in 2006 without requiring approval from anyone else.

[T]he retained earnings of AIS were not held by the corporation to pay expenses. They were not used to pay dividends, nor were they used in connection with the corporation. Additionally, they were taxed to Lundahl who paid the income tax on the earnings. Accordingly, we find that the retained earnings constituted Lundahl’s income, rather than an asset of AIS.

Factually, then, one difference between *Schmitt* and *Lundahl* is that in *Schmitt* the corporation paid the taxes attributable to the retained earnings while in *Lundahl* the owner paid the taxes individually. The point that retained earnings were not held by the corporation to pay expenses is more in the nature of retained earnings being more of an accounting convention instead of reflecting an actual account.

The problem with the *Lundahl* decision is that it is based on a discussion of the minority approach to the issue as discussed in the *Joynt* decision. But the actual holding of *Joynt* was quite limited: it ruled that the non-marital retained earnings remained non-marital based upon the facts of the case. The appellate court relied on two out of state cases for the proposition that retained earnings of a non-marital corporation should be marital if the shareholder is in a control position. It relied in significant part on a Delaware decision, *Ramon v. Ramon*, 963 A.2d 128, 133 (Del. 2008). The problem with relying on this opinion is reflected by the differences in our statutory schemes. They are similar because they are both loosely based upon what was the Uniform Marriage and Divorce Act. But Delaware has a much broader definition of what is marital property – with only four exceptions and the fourth stating simply, “The increase in value of property acquired prior to the marriage.” [See: §513\(b\) of the Delaware Divorce and Annulment Act](#). Delaware did not add onto its statutory language provisions for reimbursement.

Thus, Delaware law is not the same as our subsection (7) that adds, “...irrespective of whether the

increase results from a contribution of marital property, non-marital property, **the personal effort of a spouse**, or otherwise, subject to the right of reimbursement provided in subsection (c) of this Section.”

Therefore, by focusing exclusively on subsection (8), our appellate court has sidestepped the entire issue of reimbursement. In doing this, they have essentially rendered worthless as surplusage a large portion of the Feldman-Fleck amendments. The appellate court should have gone into greater depth in analyzing the history of the statute, the reasons for the amendments to the Illinois statute regarding reimbursement, and rules of construction of statutes when there is an ambiguity. Had they done this, they would have come to the same decision the trial court originally came to in the *Lundahl* decision – that is before it chose to reconsider its own decision.

Comment by GJG: Curiously, the *Lundahl* case fails to cite *Schmitt*, also a Second District case. Why?

VII. **Case Law Summary:**

Viewing *Joynt* in context, we had a minority, non-control owner who was reasonably compensated for his marital energies by his income during the marriage. In a case such as this there are adequate protections within the statute if we are dealing with an owner in a control position regarding the issue of retained earnings. If we rely upon Section 503(a)(7) we would then determine whether reimbursement were appropriate considering the adequacy of compensation.

The bookend to the *Joynt* decision is *Lundahl* because it addressed an owner in a control position. The radical wrinkle in this decision is that there was no issue of the adequacy of compensation. The First District appellate court simply ruled that retained earnings constitute income rather than property when the owner is in a control position (and where the owner pays taxes on the additional corporate earnings passed through to the individual). They came to this conclusion without considering the overall statutory scheme in Illinois and its difference from the statutory scheme in Wisconsin, Delaware or Missouri. The Missouri case, discussed below, was one where Illinois law would have provided protection for the non-business owning spouse because the business owning spouse took no income from her non-marital business, whether by way of retained earnings or otherwise. View, then, the approach taken by the *Lundahl* decision as one of three states taking this position, and *Lundahl* stands alone as a maverick decision since Illinois has a statutory scheme providing for reimbursement in marital energies cases where the non-marital asset substantially increases in value without reasonable compensation to the marital estate.

Consider the importance of *Schmitt* in terms of burdens of proof when dealing with assets acquired from premarital corporations.

VIII. **Reviewing the Pass Through Income – the Basics:**

A. **The K-1:**

The IRS states:

The corporation uses Schedule K-1 to report your share of the corporation's income (reduced by any tax the corporation paid on the income), deductions, credits, etc.. You are liable for tax on your share of the corporation's income, whether or not distributed. Schedule K-1 does not show actual dividend distributions the corporation made to you. The corporation must report such amounts totaling \$10 or more for the calendar year on Form 1099-DIV, Dividends and Distributions. See: www.irs.gov/pub/irs-pdf/i120ssk.pdf

When you review K-1s go straight to the IRS information because it will provide detailed information on each portion of the applicable form.

First, review Line 1 of the Schedule K-1. It provides the figure for the "Ordinary Business Income (or Loss)" for the shareholder. See the sample attached. See also: www.irs.gov/pub/irs-pdf/fl120ssk.pdf

The key on this schedule is to review any property or cash actually distributed to the shareholder. This is reported on Line 16D (called "Property Distributions"). Keep in mind that even if funds or property are distributed, divorce lawyers are looking at the after-tax amounts shown for income or for support purposes to the extent that the line Property Distributions in Line 16(d) exceeds the shareholder's tax liability on the income in the left column of Part III. Thus, the shareholder can have pass-through taxable income and a property distribution which is equivalent, thus causing the shareholder to have what some refer to as "phantom income."

B. **Schedule L 1120 S:**

Next, go to page four of the [Corporate Subchapter S tax return](#). This is Schedule L – the balance sheet per the books of the business. It is the one with retained earnings of the corporation on line 24. Schedule L should tie in with the financial statements of the business – the balance sheet.

IX. **Articles:**

A. **Previous IICLE Chapter by Gunnar Gitlin and Bruce Richman Regarding Business Valuation:**

Section 5.3 addressed, "Marital and Nonmarital Businesses — Reimbursement Due to Personal Efforts of Spouse in Nonmarital Business." There, the authors point to the two approaches taken to determine whether the marital estate should be reimbursed for marital energies on a non-marital business– the so called *Pereira* approach and the *Van Camp* approach. See GITLIN ON DIVORCE: A GUIDE TO ILLINOIS MATRIMONIAL LAW (GITLIN), §8-11(a). As stated in the Gitlin/Richman chapter:

Thus, under *Van Camp* the focus is on the reasonableness or adequacy of the compensation. On the other hand, the *Pereira* approach relies on the assumption that the nonmarital property owner is entitled to a reasonable rate of return on his or her separate property:

[W]hen one spouse owns separate property at the time of the marriage and devotes significant time and effort to the care and management of that property over and above the minimum amount needed to preserve the assets, the community will be credited with any increase in value of the separate estate over and above an ordinary return on a long-term secured investment.

Donald C. Schiller, *Distribution of Property: Compensation for Marital Energies Applied to Non-Marital Property*, 76 Ill.B.J. 904, 906 (1987).

Using the *Pereira* approach may result in a more generous award to the nonbusiness-owning spouse because the burden is on the owner spouse to prove that an amount less than the reasonable rate of return should be applied. Thus, if the business is not profitable or actual capital return is less than the reasonable rate, the difference weighs in favor of the non-owning spouse if the owning spouse cannot carry his or burden to show otherwise

According to §503(c)(2) of the Illinois Marriage and Dissolution of Marriage Act (IMDMA), 750 ILCS 5/503(c)(2), the marital estate may be entitled to reimbursement for marital energies (personal efforts) to a nonmarital business if “the effort is significant and results in substantial appreciation of the non-marital property.” Illinois has adopted an approach that follows a reasonable compensation inquiry. In *In re Marriage of Werries*, 247 Ill.App.3d 639, 616 N.E.2d 1379, 1387, 186 Ill.Dec. 747 (4th Dist. 1993), *In re Marriage of Morse*, 143 Ill.App.3d 849, 493 N.E.2d 1088, 98 Ill.Dec. 67 (5th Dist. 1986), and *In re Marriage of Thornton*, 138 Ill.App.3d 906, 486 N.E.2d 1288, 93 Ill.Dec. 453 (1st Dist. 1985), the issue before the appellate courts was whether the marital estate was entitled to reimbursement from the nonmarital business because of the contribution of the personal efforts of the husband. Each of these cases held that the marital estate was not entitled to reimbursement if the salary was found to be reasonable compensation for services rendered.

The *Werries* court commented that the wife did not present any evidence from which the trial court could have determined that the compensation received by the husband from the nonmarital partnership during the marriage was unreasonably low, or that the compensation paid to the other partners was unreasonably high. The *Werries* court found that the husband had been reasonably compensated for his personal efforts. *Thornton* emphasized that the wife failed to show that the increases in value to the nonmarital business were extraordinary or that they resulted from the husband’s personal efforts. Accordingly, for there to be reimbursement for the marital estate due to the marital energies of a spouse with respect to a nonmarital business, it must be shown that (a) the compensation received during the marriage was not reasonable; (b) the efforts by the business owner spouse are significant; and (c) it is a result of these efforts that the business has substantially increased in value. Thus, in business valuation matters, an expert may be called to testify as to the elements necessary for a reimbursement claim to succeed, including an analysis of the reasonableness of the compensation. For further discussion see GITLIN §17-21.

B. **Rory Weiler's ISBA FLS Newsletter Article:**

Regarding *Joynt* and *Schmitt* a good discussion of this case and Illinois case law regarding retained earnings, see: [“Retained earnings of a family business: Income, asset, or both?” Rory T. Weiler](#), ISBA FLS Newsletter, July 2009. Regarding lessons to be learned, Rory states, as slightly paraphrased:

To establish retained earnings as a distinctly non-marital asset, several things must be present. A minority interest which is not controlling and cannot declare distributions is likely the best and easiest way to put these retained earnings into the non-marital category. There must also exist well-kept books, and clear distinctions between salary/compensation and distribution/dividends must be drawn and maintained.

Distributions or “draws” that cannot be specifically tied to dividends distributed from retained earnings will not likely pass muster as anything other than compensation for personal efforts, and therefore potentially be subject to classification as marital property. This means that the niceties of good bookkeeping and accounting need to be instituted and maintained.

Equally clear is the idea that for sole shareholders who completely control access to and distributions from retained earnings, establishing the non-marital character of retained earnings will be an uphill battle. Both *Joynt* and *Schmitt* seem unequivocal in their statements that retained earnings will be considered marital if the spouse has control over the decision to disburse the retained earnings. But all is not lost. The Second District seemed to leave the door open a little to the sole shareholder to rebut “the inference” that retained earnings controlled by a sole shareholder are marital.

How might that be done? Perhaps, as is often common, a financing and security arrangement with the business’ lender precludes, or severely restricts, the shareholder’s ability to draw distributions from the corporation. Perhaps the sole shareholder has yet to pay for the business purchase, and the seller, perhaps Dad or the Family Trust, has rights under the contract to limit distributions to the shareholder. In the very common family business situation, where the spouse inherits the controlling interest from a parent or parents, the payment of estate taxes could be another reason why distributions are limited to the sole shareholder. None of these arguments have been tested, but anything that would impede the shareholder’s access or control over retained earnings would appear to be worthy of arguing, given the *Schmitt* court’s commentary. ISBA FLS Newsletter, July 2009, Vol. 53, No. 1, p. 4

We agree with this comment.

C. **Michael Kalcheim's January 2007 Illinois Bar Journal Article:**

Michael's January 2007 Illinois Bar Journal article was written before the first of these cases was decided. In it he took the conventional approach that the issue involving the retained earnings of a premarital corporation was reimbursement consistent with prior case law and §508(a)(7). Kalcheim's emphasis was also the usual conventional focus, that is, the degree to which retained earnings of a marital or non-marital business may be considered for the purpose of child support and maintenance.

D. **“Marital Appreciation of Non-Marital Stock: Fish or Foul,”** By: Nicole Park, Stephanie Vanos, Rebecca Palmer & Terry Young (2008). See:

The cases so far have not been developed in terms of the issue of the burden of proof. This article discusses the burden of proof in Florida on this issue and states:

The non-shareholder spouse bears the burden of proof to establish enhancement in value or appreciation of a nonmarital asset so that it may be equitably distributed. Further, the nonshareholder spouse must establish not only that a nonmarital asset increased in value during the marriage, but that the increase in value was the result of marital funds or labor. The burden then shifts to the shareholder spouse to show that any or all of the enhanced value should be exempt from equitable distribution. (See their footnotes 3 to 5 for references).

But keep in mind that this analysis is more consistent with what we would refer to as a §503(a)(7) rather than (a)(8) approach. Our §503(a)(7) is far more limited than what would be similar in Florida. This article discusses the then existing case law out of state:

“Retained Earnings: Corporate or Shareholder Asset?”- Although Florida cases have not addressed the issue of whether retained earnings of an S corporation constitute marital property, many other jurisdictions have addressed the issue. For example, courts in Minnesota and Missouri have found that “[r]etained earnings and profits of a corporation are a corporate asset and remain the corporation’s property until severed from other corporate assets and distributed as dividends.”³⁰ Courts in North Carolina and Texas have held that “[A]s a general matter, retained earnings of a corporation are not marital property until distributed to the shareholders.” *Allen v. Allen*, 607 S.E.2d 331, 336 (N.C.Ct.App.2005) (citing *Thomas v. Thomas*, 738 S.W.2d 342, 344 (Tex.App.1987)). See also *Craig-Garner v. Garner*, 77 S.W.3d 34, 38 (Mo.Ct.App.2002).

In determining whether retained earnings are marital property in cases where one spouse is a shareholder in a closely held family S corporation, other jurisdictions have considered the extent the shareholder spouse controls the corporation, and whether the shareholder spouse has the authority to decide whether corporate earnings are distributed or retained. *Gottsacker v. Gottsacker*, 664 N.W.2d 848, 856 (Minn.2003). See also *Joynt v. Joynt*, 874 N.E.2d 916, 918 (Ill.App.Ct.2007); *Hoffman*, 676 S.W.2d at 827. In a case where the husband’s nonmarital shares of stock in a closely held corporation were at issue, an Illinois court concluded that the retained earnings of the corporation were nonmarital. *Joynt*, 874 N.E.2d at 919. The court noted that the corporation’s stock was held in unequal shares by three individuals, one of whom was the husband. The husband possessed only a minority percentage of the shares and was not a controlling shareholder, nor did he have the authority to declare or withhold dividends. Moreover, although the undistributed corporate income was included on the marital income tax return, the marital estate did not pay the taxes. The husband also received a salary and bonuses for managing the company and these payments were deemed to be reasonable and fair compensation for the husband’s services to the company. The court noted that only when the shareholder spouse controls the corporate distribution have courts in other jurisdictions found the retained earnings to be marital property.

A Missouri court has also considered this same issue. In *Hoffmann*, the husband owned a minority interest in a nonmarital closely held corporation, and the retained earnings of the corporation were at issue. *Hoffman*, 676 S.W.2d at 826. The wife contended that if the board of directors had voted to distribute the corporate profits to the stockholders and

officers rather than retain them within the corporation, the income which would have been distributed to the husband would have been marital property. The appellate court affirmed the trial court's holding that the retained earnings were nonmarital based on the fact that the husband was a minority shareholder, was one of only four board members, and could not unilaterally declare or withhold dividends. Moreover, there was no evidence of collusion with other board members to defraud the wife by minimizing dividends.

Sole or Controlling Shareholder - A Wisconsin court has considered the issue of retained earnings in a case where the shareholder spouse was the sole shareholder in a nonmarital closely held S corporation. *Metz v. Keener*, 573 N.W.2d 865 (Wis.Ct.App.1997). The court held that the retained earnings should be included in the marital estate when the shareholder spouse paid income taxes on the retained earnings and had "full access, control and right to the undisturbed income."

However, even if a shareholder spouse is the controlling shareholder in a closely held family S corporation, the owner spouse may still have an argument that the retained earnings should not be considered marital because the earnings were used for a corporate purpose and not retained merely to shield assets from equitable distribution."

- E. **"Division of Third-Party Property in Divorce Cases, Brett Turner,"** Vol., 18, 2003, p. 406- AAML Journal. See also: "Classifying the Retained Earnings of a Separate Property Business as Marital Property, Aug. 2003, p. 141." Brett is the senior research attorney at National Legal Research Group, [Equitable Distribution of Property](#), Third Ed., West., Last updated November 5, 2009.

This contains an excellent discussion of the then existing state of the law regarding this topic. See: www.aaml.org/tasks/sites/default/assets/File/docs/journal/Journal_vol_18-2-3_Div_of_Third_Party_Property.pdf

The AAML Journal's article on the topic of retained earnings as property states:

Nevertheless, the law recognizes two exceptions to the general rule against treating the assets of corporations and partnerships as marital property. This section considers the first exception: the retained earnings of a separate property business. The retained earnings of a business are owned by the business, and as such they are technically not marital property. **But some courts have been troubled by the fact that retained earnings are separately identified.** Sometimes they are even placed in a specific account which includes no other asset. If the retained earnings had been distributed, they would have been income and they probably would have been marital property. Because retained earnings seem so close to being marital property, some courts have been willing to hold that they are marital property. **The easiest cases are those in which the owner retains substantial earnings, while paying himself or herself an unreasonably low salary.** In *Heineman v. Heineman*, 768 S.W.2d 130 (Mo. Ct. App. 1989), the wife owned a separate property incorporated art studio. An antenuptial agreement provided that the

increase in value of separate property remained separate. But the agreement allowed the court to treat income from separate property as marital. During the marriage, the wife drew no salary from the studio. The trial court held that the studio's retained earnings were an increase in value, and therefore separate property under the agreement. The appellate court reversed, holding that the retained earnings were actually income from separate property:

We hold however that the retained earnings did not represent an increase in value of the premarital studio. The corporation did not exist at the time of the marriage, it came into being after the marriage. The retained earnings account was accumulated from money which otherwise would have been paid to wife as her salary. If the business had remained unincorporated all the profits thereof would have constituted earnings to the wife and would have constituted marital property. *Craig-Garner v. Garner*, 77 S.W.3d 34, 38 (Mo. Ct. App. 2002) (citations omitted). See also *Hoffmann v. Hoffmann*, 676 S.W.2d 817, 827 (Mo. 1984) ("the wife could not claim the retained earnings as marital property, because the earnings and profits of a corporation remain its property until severed from other corporate assets and distributed as dividends"); *Thomas v. Thomas*, 738 S.W.2d 342, 344 (Tex. Ct. App. 1987) ("in an ordinary corporation, retained earnings are a corporate asset. They are not marital property[.]").

The court elaborated:

Here it is clear that the wife, the sole stockholder of the corporation, for some period of time forewent all compensation for her services, which would have been marital property, and that the retained earnings account of the corporation is directly traceable to that forbearance. It is clear, too, that the earnings of the corporation were attributable in only a minor way to the capital of the corporation. Chiefly the earnings were from wife's valuable services. We hold, then, that the retained earnings account in the amount of \$128,063 is marital property.

Because the wife's salary was so low, the court held essentially that she was refusing in bad faith to draw from the corporation a fair value for her efforts. By treating the retained earnings as marital property, the court was essentially imputing to the wife the income that she should have drawn from the business. The result in *Heineman* obviously depended greatly upon the unquestioned fact that the wife had the power to distribute the retained earnings. Where the owning spouse is a minority shareholder with no ability to force distribution of retained earnings, the retained earnings are clearly no different from any other corporate asset. * * * Thus, they cannot be treated as distributed income:

Generally, retained earnings of a corporation do not constitute marital property. . . . Retained earnings and profits of a corporation are a corporate asset and remain the corporation's property until severed from other corporate assets and distributed as dividends. . . . As retained earnings are a corporate asset, title remains in the corporation; the shareholder does not have legal title. . . . Accordingly, the court's treatment of corporate assets as marital property is in

error.

A Minnesota court reached the same result:

We note first that the Siegel-Robert AAA [a retained earnings account] is not “income” under the plain meaning of Minn. Stat. § 518.54, subd. 6 (2000), which defines “income” as “any form of periodic payment to an individual.” Although the Internal Revenue Code treats AAA earnings as income attributable to individual shareholders for federal tax purposes, **there is no evidence in the record before us that an asset-bearing account was set aside by Siegel-Robert for respondent or that any amounts were, or will be, held in such an account or distributed to either party.** Retained earnings and profits of a corporation are a corporate asset and remain the corporation’s property until severed from other corporate assets and distributed as dividends. . . Respondent agrees that Siegel-Robert dividends actually paid to the parties were marital property. But because Siegel-Robert never distributed the retained earnings to respondent, the earnings never became respondent’s income under Minn. Stat. § 518.54. *Robert v. Zygmunt*, 652 N.W.2d 537, 543 (Minn. Ct. App. 2002) (citation omitted); accord *Gottsacker v. Gottsacker*, 664 N.W.2d 848 (Minn. 2003).”

Turner then once again describes that the hardest of the cases is when the salary and income of the business owning spouse was unreasonably low. But this result is avoided in Illinois based on the existing language of the reimbursement provisions of our statute. We agree with the following critique of a Minnesota case holding that retained earnings might be considered marital property.

Authority exists for treating retained earnings as distributed income whenever the owner has the power to distribute the earnings. One of the leading decisions is the opinion of the Minnesota Supreme Court in *Nardini v. Nardini*. 414 N.W.2d 184 (Minn. 1987):

[I]n addition to the corporate income distributed to Ralph and Marguerite as salary and [fringe benefits], the corporation had retained earnings of \$563,598 (all of which were, of course, earned during the marriage). It seems to us that the nature of income generated through the efforts of the marital partners is not directly changed by its retention as shareholder equity in a wholly owned corporation. Whether the business be carried on as a family corporation or a partnership or a sole proprietorship, income earned during the marriage, whether distributed or undistributed and reinvested in the business, is marital property.

Nardini was a wise decision on many issues, including particularly the classification of appreciation in separate property. But the passage emphasized above is fundamentally wrong. It is not accurate to speak of a corporation retaining income generated by a spouse. The owning spouse may generate value, but income does not exist until something is actually distributed to the shareholders. If the owner is refusing in bad faith to distribute income equal to the fair value of his or her efforts—the *Heineman* situation— then a fair salary should be treated as distributed income, so long as the owner had the power to

make the distribution. Short of bad-faith failure to distribute, however, value created by marital efforts does not come within the definition of “income” until it is actually distributed. By speaking of marital “income” which had never been distributed, *Nardini* put the cart before the horse.

It is important to understand, however, that *Nardini* erred only by suggesting that the retained earnings were distributable *as income*. They were not income; they were an asset of the corporation. The court should not have taken the unnecessary step of suggesting that they were independently divisible as income—a holding which presumably would have permitted division even if the overall value of the company had declined.

* * *

Second, assume that a husband is sole operator of a business which manufactures widgets. Every 40 years, the company must replace and upgrade its expensive widget factory to remain competitive, and indeed to be able to produce widgets at all. For years before the divorce, under both the husband’s management and the management of prior unrelated owners, the company has accumulated a portion of its earnings in 39 out of 40 years, so that it can more easily afford the large expense of replacing its factory in the 40th year.

In this situation, the business has a clear need, indeed really a compelling necessity, to retain earnings. The fact that the husband has the nominal power to distribute earnings is not relevant, for prudent business practice requires that a portion of the earnings be retained. Any other practice would injure long-term profitability of the business. Perhaps a court facing this situation could be convinced to hold that the husband did not really have the power to distribute the earnings, because his decision was really dominated by an outside economic factor—the expense of replacing the factory. The ability to choose to distribute earnings, and thereby choose to face difficulty or even bankruptcy in the 40th year, might not be a real choice. But the example nevertheless shows that some businesses retain their earnings for very sound reasons. It is wrong to assume that every owner who retains corporate earnings is short-changing the marital estate.

Because of these problems, the better rule is to treat all retained earnings as an asset of the company. Like any other corporate asset, they are part of the value of the company. If the value increases during the marriage because of marital efforts, the increase should be marital property [Note by authors: In Illinois following this approach the increase would be marital property if substantial and if the marital estate had not already been adequately compensated for the marital energies.] This should be true regardless of the size of the owner’s salary, for all increased corporate value produced by marital efforts, whether reasonable in size or not, should be marital. [There would be a different result in Illinois because of our unique statutory scheme.]

But it is wrong to choose one particular asset of the corporation, whether called “retained earnings” or anything else, and insist that it must be divided merely because the owner had the raw power to divide it. Regardless of the owner’s power, the fact is that the asset was not distributed. Retained earnings should be divided *as income* only in those rare

cases where the owner is clearly defrauding the marital estate by failing to pay himself a fair value for his efforts.

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Last Updated: January 19, 2010

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