RETAINED EARNINGS OF A FAMILY BUSINESS: INCOME, ASSET OR BOTH?

BY

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The treatment of retained earnings in a family business owned in whole or in part by a party to divorce litigation is a topic practitioners have been struggling with since the advent of the Illinois Marriage and Dissolution Act in October of 1977 and for the decades preceding the advent of the Act. However, it was not until 2007 that an Illinois Appellate Court either had, or took the opportunity to, consider the treatment of retained earnings in a family business context, and establish some guidelines for their treatment by the trial courts of this state. In the 2007 decision In Re: The Marriage of Joynt,[1] the Third District acknowledged that the classification of retained earnings was an issue of first impression in Illinois and relied heavily upon precedent from other states in reaching its conclusion. Recently the Second District weighed in on the issue in In Re: The Marriage of Schmitt.[2] Of even more interest to the family practitioner is the fact that the Second District relied on the Third District's opinion in Joynt to reach a completely different result. In order to understand the developing law regarding the treatment of retained earnings, a brief review is in order.

The concept of retained earnings is just one of many brought to us by our friends in the accounting profession, who seem to take particular glee in the fact that they were better at math and formulas than those of us who could think fast and talk pretty and, therefore, ended up pursuing a career in the law. The world of accounting, and its "Generally Accepted Accounting Principles," often brings a chill to the spine of the family lawyer, and there are not a few of us who confess bewilderment at these concepts in general, and discomfort when confronted with the financial statements, audited, compiled and otherwise, which are *de rigeur* in the case where small, family business interests are among the assets. The lawyer's apprehension about business valuation issues is not limited to this side of the bench. I have had at least one judge tell me that he would much prefer to try a custody case than a business valuation case, because custody cases "are easier."

Having said that, all of us either have, or will have to deal with the thorny issues raised in a case involving the family business, either run solely by one of the parties, or in which a party has an interest. These cases necessarily require the family lawyer to learn not only the lay of the land, but the theory and jargon that come with the territory. In order to best present your client's position to the judge, who just might wish he was trying a custody case instead, you must be sure that your accountant/expert can explain what are often somewhat arcane concepts. In much the same fashion as we do with psychological experts in custody cases, we must, like Toto, pull the curtain away from the wizard, and insist that our friends in the accounting community give us an explanation, in English, of the terms and concepts they rely upon in reaching the conclusions for which our clients pay so handsomely. "Retained earnings" is actually one of the more easy concepts to grasp.

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[1] IRMO: Joynt, 375 Ill.App.3d 817; 874 N.E.2d 916 (3rd Dist., 2007).
[2] IRMO: Schmitt, 244 2009 Ill.App. Lexis 237 (2nd Dist., 2009).

Simply put, retained earnings are that part of a corporation's net income which is retained by the corporation rather than being distributed to its owners as dividends. Frequently, a family business will be organized as a "Subchapter S" corporation, a pass through entity for federal income tax purposes, which generates retained earnings by paying taxes on income which it then retains, as opposed to distributes, to its shareholders. The purposes for the retention by the corporation of retained earnings are many and varied, and can range from an operating expense fall back fund to asset acquisition and beyond. The distribution part of the definition figured prominently in the Schmitt decision, as will be seen later. Given the ubiquitous nature of the Sub-chapter S corporation format for family held businesses, the characterization of retained earnings is an issue that needs to be addressed by the family practitioner in nearly every case involving a family business. The first question, of course, is are retained earnings income (as it appears from the definition) or are they assets? The answer found in Joynt and in Schmitt, is "Yes."

Both the Third District and the Second District came to the conclusion that retained earnings, although they constitute previously taxed (to the shareholder-a Subchapter S corporation pays no corporate tax) and undistributed income of the corporation, remain an asset of the corporation "until severed from the other corporate assets and distributed as dividends."[3] This previously taxed but undistributed income then becomes the shareholder's retained earnings account, usually in proportion to the shareholder's interest in the corporation. The Joynt court relied on decisions from courts in Idaho to North Carolina to reach this conclusion, and also noted the testimony of husband's accountant that although the retained earnings were not reported as an asset of the business, they were "in essence" the major component used to value the corporation's book value. The main issue which the Joynt court wrestled with, however, and the finding it made which propelled the Schmitt court to its decision was not the characterization of retained earnings as asset or income, but rather, the characterization of retained earnings as marital or non-marital, which was, in part, based upon the court's acknowledgment of the somewhat schizophrenic nature of retained earnings as income and asset.

In Joynt the husband was a 33% shareholder in a family business, the balance of which was owned by his father and sister. The parties stipulated that husband's stock was non-marital, but wife maintained that the retained earnings[4] were not corporate assets, but rather income available to the husband, and therefore, available to her. After noting that, because they had not been "severed" and distributed as dividends, the retained earnings remained a corporate asset, the Third District determined that the retained earnings were husband's non-marital property, but not because of wife's stipulation that husband's interest in the business was non-marital. Rather, the retained earnings were non-marital because husband, as a minority shareholder lacked control over corporate distributions and was unable to unilaterally authorize a distribution of the retained earnings. Thus, the table was set for the Second District in Schmitt.

Schmitt involved somewhat divergent facts from the Joynt case. At the time of trial husband was the president and sole shareholder of Bricks, Inc., a Subchapter S corporation which was the ultimate successor to a number of business ventures in which husband had been involved since 1970, four years prior to the parties' 1974 marriage.[5] The husband testified that all of his

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[3] IRMO: Joynt, 375 Ill.App.3d 817, 821.

[4] At the time of trial, husband's retained earnings were $1,250,309, so wife had plenty of incentive to take a stab at convincing the court she was right, precedent from other states being to the contrary.

[5] The factual background is quite complicated and set forth in detail in the opinion. In the author's opinion, the complicated factual background is somewhat of a sideshow to the Second District's decision which is based upon the husband's complete control over Bricks, not the complex series of transactions involved in his businesses.

acquisitions since 1970 had sprung from his interest in an entity known as Colonial, and its progeny, which according to a trial exhibit, had a February, 1974 value of $5,661.82. These acquisitions included literally millions of dollars in land acquisitions, including both Schmitt houses, the Bricks, Inc. corporate home, a 160 acre farm in Sublette, Illinois, and approximately two hundred acres of vacant land at an interchange located at and near the junction of Interstate 88 and Orchard Road, a very active commercial corridor on the northwest side of Aurora, Illinois.

Husband's business evaluator testified that Bricks, Inc. had a net fair market value of $2,654,000, and addressed the husband's practice of paying his expenses from the corporate bank accounts, including expenses related to the real estate holdings and about $895,000 in payments made for the benefit of wife and the parties' children. In his opinion, if a check is paid out of a business (as was done here) for the benefit of a sole shareholder, and that check is not booked as an income expense, then it would have to be booked as a distribution of previously taxed but undistributed income (retained earnings) or as a repayment of a loan from shareholder. He further went on to testify that the only way to track distributions to the shareholder (of retained earnings) is by calculating the differences in the corporate retained earnings account. In Bricks, Inc., case, this calculation involved calculating retained earnings carried forward year to year less the amount distributed to husband over 27 years. The witness concluded that anything husband had purchased through the use of his corporate account, and specifically the Bricks' account, was husband's "own property."

The husband testified similarly, identifying asset after asset that was purchased through the use of Bricks, Inc.'s corporate account established in 1978. Husband could not, however, recall whether these withdrawals were ever booked as being charged against husband's retained earnings account, and therefore accounted for on the corporate books as distributions of retained earnings to him. This failure of memory would prove to be very costly to husband in the appellate court's analysis and decision. The trial court, however, found that because the original Colonial funds were non-marital, that husband had met his burden of proving that Bricks and all of the real estate assets non-marital, and found husband's non-marital estate to have a net value of $6,091,000, and the marital estate to have a value of $350,722. After some adjustments and credits,[6] the trial court awarded 100% of the marital estate to wife, and ordered husband to pay $1million in "gross maintenance and arrearage." Husband retained the rest.

The Second District relied upon <u>Joynt</u> to reverse the trial court on its finding that the majority of the real estate,[7] and Bricks, Inc., were non-marital. Relying upon <u>Joynt's</u> holding that retained earnings remain a corporate asset until "severed" when distributed as dividends, and husband's failure to identify which funds withdrawn from Bricks, Inc. were actually charged against husband's retained earnings account, the appellate court found husband had not met his burden of proving the real estate and business interests non marital, and therefore, the entire House of Schmitt, bricks and all, were marital assets. They did not, however, stop there. The Second District went on to address husband's status as the sole owner of Bricks, Inc., and the impact of his sole ownership on the characterization of retained earnings.

In keeping with <u>Joynt</u>, the appellate court noted that although retained earnings in a Subchapter S corporation are generally considered nonmarital, they are considered marital if the spouse has control over the decision to disburse the retained earnings. Husband, as sole shareholder of Bricks, Inc., had complete control of and access to the retained earnings, and thus, the *inference*

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[6] Wife was tagged with $150,000 of dissipation which the trial court awarded to her.
[7] Two parcels on South Kedzie in Chicago were found to be purchased with income husband received from Colonial and titled in his name as an individual. The appellate court therefore found them to be marital.

to be drawn from this evidence was that the funds used by husband to make the purchases described were attributable to his personal efforts, and therefore to be characterized as marital property. Husband, therefore, lost on both counts: he failed to rebut the presumption of marital property in connection with his acquisition of the real estate and business interests, *and* his retained earnings were marital due to his complete and sole control over their distribution. "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 (husband) 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."[8]

What are the lessons to be learned from Schmitt? First of all, it seems clear that in order 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. Obviously, the Achilles Heel of Mr. Schmitt's case was the inability to tie up distributions to him to charges against his retained earnings account.

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 shareholders 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. One thing is for certain, more law is going to be made on this issue in the not too distant future.

In short, all is not lost for the small business owner, and the Schmitt case is not the death knell for retained earnings of a sole shareholder being characterized as non-marital property. When that small business owner appears in your office and asks, I have this retained earnings account does my wife/husband get any of it, you can pretty confidently and comfortably reassure them when their interest is a minority, non-controlling one. Even when sole shareholders present, there are options, and no doubt some which remain to be discovered by the clever and creative club that is our family law bar. The point to be made is that we now have two fairly definitive cases addressing the treatment of retained earnings in the all and none cases. I am speaking, of course,

[8] IRMO: Schmitt, 237 Ill.App. Lexis 237 at page 6.

of C-O-N-T-R-O-L. But what happens if that fantasy client, with money and a willingness to spend it, presents with not a minority interest, or a controlling interest, but something in between.? If I own 51% of my family business' stock, am I treated as Mr. Schmitt because I have a controlling interest, or as Mr. Joynt because I cannot unilaterally declare distributions? We will all have to stay tuned for the answer to that question.