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

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I. **Introduction**: The 2016 amendments to Illinois law provide welcome clarity to a line of Illinois cases involving reimbursement claims for a non-marital business. These cases had essentially overlooked the reasonableness or the adequacy of the compensation. The line of cases that will be discussed brings up the issue involving non-marital corporations and whether retained earnings are marital or non-marital in character. The Second District 2009 case and the 2011 First District case had provided the bookends for the court's treatment of retained earnings—prior to the 2016 rewrite. But in light of the 2016 amendments, whether or not a non-marital business accrued substantial retained earnings during the marriage should no irrelevant—so long as the marital estate has reasonably. The critical language now provides "**if the marital estate reasonably has been compensated for his or her efforts, it shall not be deemed a contribution to the marital estate and there shall be no reimbursement to the marital estate**."

Before the Illinois 2016 statutory rewrite to the divorce laws, Illinois case law developed along new lines with four cases—two taking a radical departure in the treatment of retained earnings.

Since 2007 Illinois case law had taken a radical departure regarding what has been referred to as the "marital energies" issue and the classification of retained earnings from a non-marital corporation. The case representing this development were: *Marriage of Joynt*, 375 Ill.App.3d 817 (Third Dist., 2007); *Marriage of Lundahl*, 396 Ill. App. 3d 495 (1st Dist., 2009); *Marriage of Steel*, 2011 IL App (2d) 080974; and *Marriage of Dann*, 2012 IL App (2d) 100343. The *Steel* case—which is no longer good law—had provided parameters of when the courts would and would not treat retained earnings of a premarital corporation as marital in character.

II. **The Statute**: Before addressing this line of cases, consider §503(a) of the statute that defines marital and non-marital property. Marital property is defined as all property acquired after the marriage. Then non-marital property is defined as eight exceptions to what is marital including what we generally consider to be premarital property and gifted property as well as:

(6.5) all property acquired by a spouse by the sole use of non-marital property as collateral for a loan that then is used to acquire property during the marriage; to the extent that the marital estate repays any portion of the loan, it shall be considered a contribution from the marital estate to the non-marital estate subject to reimbursement;

(7) *the increase in value of non-marital 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:

* * *

2015 Law Re Marital Energies:

(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. provided, that no such reimbursement shall be made *** in the case of a contribution of personal effort of a spouse to non-marital property, unless the effort is significant and results in substantial appreciation of the non-marital property. * * * Personal effort of a spouse shall be deemed a contribution by the marital estate." 750 ILCS 5/503 [*prior to* the January 1, 2016 amendments.]

2016 Amendment re Marital Energies:

(2)(B) When a spouse contributes personal effort to non-marital property, it shall be deemed a contribution from the marital estate, which shall receive reimbursement for the efforts if the efforts are significant and result in substantial appreciation to the non-marital *property <u>except that if the marital estate reasonably has been compensated for his or her efforts, it shall not be deemed a contribution to the marital estate and there shall be no reimbursement to the marital estate</u>*. 750 ILCS 5/503(c)(2)(B**) [***following the January 1, 2016 amendments***.]**

A. So What is Income and What is Property?

To put earlier case law in context, first understand the critical language of the 2016 Amendments. The 2016 amendments mirror what had been the crux of earlier Illinois case law (reflecting the *status quo ante*). The 2016 critical language states: "<u>except that if the marital estate *reasonably has been compensated for his or her efforts*, it shall not be deemed a contribution to the marital estate and *there shall be no reimbursement to the marital estate*</u>."

Looking at the statute, as it existed in 2015, the question had been whether retained earnings of a non-marital business was property under (a)(7) or income under (a)(8). If retained earnings is property, then the property should remain non-marital subject to potential reimbursement rights. If retained earnings constitutes income rather than property, then there would not necessarily be a right to reimbursement. So, this brings us to consider what exactly is "retained earnings" and what is property as compared to income. The Illinois Supreme Court somewhat recently addressed the issue of what is the definition of property – but in that case in the contest of whether vacation pay constituted property. In *Abrell*, (236 Ill. 2d 249 (2010), the Court stated:

Black's Law Dictionary defines "property" as:

> "1. The right to possess, use, and enjoy a determinate thing (either a tract of land or a chattel); the right of ownership ***. 2. Any external thing over which the rights of possession, use, and enjoyment are exercised ***." *Black's Law Dictionary,* 1335-36 (9th ed. 2009).

The seminal Supreme Court *Rogers,* 213 Ill.2d 129 (2004) decision defines income – although under a difference circumstance. And it used the dictionary definition of income. The Court stated income represents a gain or profit generally understood to be a return on investment increasing the recipient's wealth. So to answer our question about whether we should focus on (a)(7) or (a)(8), we address whether retained earnings is more akin to property or more akin to income. Our problem is that retained earnings is neither one nor the other—it is an accounting convention and rarely constitutes a "bucket of cash" that can be distributed to the controlling owner.

B. **What Are Retained Earnings?**

So what is meant by the statement that retained earnings is an accounting convention? We will see that the recent Illinois' cases relied upon out-of-state case law. But none of the out-of-state cases relied on statutory law 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 statement misleads. The "other proper corporate purposes" can include necessary reinvestment for a business.

Consider retained earnings as an accounting convention for what appears near the bottom of the shareholder's equity section of the balance sheet. Viewed this way, retained earnings is far more like property than income. While retained "earnings" has something to do with income, understand that the problem is that many cases use the mistaken assumption that there is some sort of "account" or "fund" that is maintained. While it is possible that retained earnings could go hand in hand with an increase in working capital, often it does not. Instead, the funds that represent this accounting convention are often reinvested into the business so that a business can continue to compete 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.

One author discussing the nature of retained earnings and finding them more akin to property than income gave the following example:

> [A]ssume 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. Brett Turner, "Division of Third-Party Property in Divorce Cases," AAML Journal, Vol. 18, 2003, pp. 410-11.

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

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. Assuming that there is not adequate compensation, these four cases had appeared 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 on §503(a)(8).

III. **The Legislative History Leading to the Marital Energies Cases:**

Understanding the nature of retained earnings, a reading of the statute even prior to the 2016 Amendments seemed to lead to the conclusion that the retained earnings of a non-marital business generally remain non-marital. As will be seen based upon the appellate courts' interpretation in this line of cases, the recent focus was almost exclusively on subsection (8) and somewhat disregards subsection (7)—when dealing with a control owner. They did this despite the focus 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. Finally, as of January 1, 2016 the statutory law explicitly adopted what had been Illinois case law before the more recent line of cases, that earlier case law providing that if the marital estate "reasonably has been compensated" there is no reimbursement.

When we consider the Illinois statute, keep in mind that states with essentially the same original statutory scheme of the IMDMA 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 history of Illinois divorce law will recall the case law that developed under the original §503 under the IMDMA. The seminal case addressing the extreme treatment by the Illinois courts was *IRMO Smith*, where a couple spent $3,500 to remodel a non-marital office/apartment building. 86 Ill.2d 518 (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 (l984). See: www.sdflaw.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, http://www.sdflaw.com/RA322S10/assets/files/lawarticles/Revisiting%20Transmutation.pdf

***Van Camp* versus *Pereira* Approaches**: As stated, other States have generally relied on two traditional approaches: the *Pereira* approach and the *Van Camp* approach. See GITLIN ON DIVORCE: A GUIDE TO ILLINOIS MATRIMONIAL LAW (GITLIN), § 8-12[b] "Reimbursement to Marital Estate for Contribution of Personal Effort of One Spouse to Nonmarital Property." The *Van Camp* approach focuses on the value of a spouse's efforts expended to improve nonmarital property. In *Van Camp v. Van Camp*, 53 Cal.App. 17, 199 P. 885, 890 – 891 (1921), the court heard evidence as to the value of services rendered by the spouse to the business and determined whether the value of these services had already been paid to the spouse in the form of salary (or otherwise) or whether such services had been unpaid. The value of the unpaid services would be deemed marital property and subtracted from the earnings and increased value of the business. The remainder would be deemed the owner spouse's separate property. The holding in *Van Camp* emphasized the fact that the husband had been *adequately paid* by the corporation for his services and that the remaining profits derived from the business were accredited to the use of the capital previously invested (his premarital property). Thus, under *Van Camp* as under the 2016 Amendments, the focus is on the reasonableness or adequacy of the compensation. On the other hand, the *Pereira* approach relied on the assumption that the nonmarital property owner is entitled to a reasonable rate of return on his or her separate property. The *Pereira* approach provides:

> [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).

The focus under *Pereira* is the *reasonable rate of return*. 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. See *Pereira v. Pereira*, 156 Cal, 103 P. 488 (1909).

There is now no question that Illinois has adopted an approach that follows a reasonable compensation inquiry. It is even clearer that the previous line of cases is good law. In *In re Marriage of Werries*, 247 Ill.App.3d 639 (4th Dist. 1993), *In re Marriage of Morse*, 143 Ill.App.3d 849 (5th Dist. 1986), and *In re Marriage of Thornton*, 138 Ill.App.3d 906 (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 ON DIVORCE: §17-1(j)(2).[1]

The series of four Illinois cases involving what we refer to as the marital energies applied to a non-marital business will be reviewed. All prior Illinois cases had not focused on a potential increase in the retained earnings of the business. Instead, each focused on whether the marital was adequately compensated by the marital energies. But effective January 1, 2016 Illinois law provides the critical language that there is no reimbursement <u>if the marital estate **reasonably has been compensated for his or her efforts."**</u>

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

IRMO Joynt, 375 Ill.App.3d 817 (Third Dist., 2007).

A. **Opening the Door to Later Cases There are No Longer Good Law**:

Joynt had begun to open the door to making this departure in Illinois case law. This case introduced the issue as being one of first impression in Illinois. This had been an overstatement. The question that it presented was whether retained earnings of a non-marital corporation should be classified as marital property. It stated:

[1] Gitlin on Divorce: A Guide to Illinois Family Law, 4th Ed., § 17-1[j][2] "Support Reduction Denied Because of Reduction or Loss of Employment Income."

> 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 dictum in *Joynt*) likely led to the later 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."

As indicated in light of the 2016 amendments to the IMDMA, this no longer remains good law.

B. **Reliance on previous edition of *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 had pointed 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.
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> * * *
>
> 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.[2]

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 the husband lacked 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 – *Lundahl* – urging that corporate retained earnings are income rather than an asset when we are dealing with a control / majority owner.

It was left to the November 2009 *Lundahl* decision to take a quantum leap in Illinois case law—applying some of 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 was whether the corporate earnings, themselves, of

[2] This is a reference to the 3rd Edition of Gitlin on Divorce. Currently, see: § 8-14[l] "Subchapter S Retained Earnings."

a premarital business constitute marital property.

V. *Lundahl* - Retained Earnings [prior to change in statutory law] Constituted Marital Property from Non-Marital Corporation but Amount was in Error

IRMO Lundahl, 396 Ill. App. 3d 495 (Second Dist., 2009): *Lundahl* involved a 100% owner with clear control of the business. In this situation the Second District reasoned that the retained earnings of the 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.

The trial court's original decision was well reasoned, and it was in keeping with the 2016 amendments to the reimbursement provisions:

> 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.

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 noted 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. A quote from one of these cases, *IRMO Perlmutter*, typifies the post-Feldman/Fleck amendment line of case law that was finally incorporated into the Illinois statutory law effective January 1, 2016. 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 an accounting convention instead of reflecting an actual account.

The problem with *Lundahl* is that it is based on 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."
By focusing exclusively on subsection (8), our appellate court has sidestepped the 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.

IRMO Steel, 2011 IL App (2d) 080974 now shows the sort of cases where a *Lundahl* analysis will not result in a premarital corporation's retained earnings being treated as marital. In *Steel*, the appellate court contrasted *Joynt* and *Lundahl*:

> On the retained earnings issue, the overarching principle, as noted in *Joynt*, is that the retained earnings and profits of a subchapter S corporation in which the spouse has an ownership interest remain the corporation's property, and are not considered income to a spouse, until severed from the other corporate assets and distributed as dividends. *Joynt*, 375 Ill. App. 3d at 821. Under certain circumstances, however, retained earnings may be considered marital property. Id. at 819. There are two primary factors. The first is the extent of the spouse's ability to distribute the retained earnings to himself. *Joynt*, 375 Ill. App. 3d at 819; *Lundahl*, 396 Ill. App. 3d at 503-04. *** The second is the extent to which retained earnings are considered in the value of the corporation and utilized to fund the corporation's business. *Joynt*, 375 Ill. App. 3d at 819-21; *Lundahl*, 396 Ill. App. 3d at 503-04. *Joynt* and *Lundahl* portray contrasting pictures of a corporation's treatment of its retained earnings.

The appellate court then discussed *Joynt* and *Lundahl* at length and

> [DFO Distributions] Petitioner claims that respondent's liberal use of the DFO shows a manner of control more similar to Lundahl than to Joynt. In truth, the DFO advances do not implicate the concerns of Lundahl and Joynt at all. The issue in those cases was the spouse's ability to actually receive the retained earnings of the S corporation. While KASC's shareholder distributions, like those in Lundahl and Joynt, are an actual disbursement of retained earnings, DFO advances are not. Rather, they are secured by the retained earnings.

As we understand the process, KASC's lender records the DFO advances as shareholder distributions in order to determine the level of security for the advances, but the advances are not a true disbursement of retained earnings. There was no question at trial that DFO advances are loans, and petitioner does not dispute that characterization. (Though there was no definite repayment term for any of the DFO advances, pressure to repay flowed naturally from the accrual of interest and the enforcement of the net-worth cap.)

[KASC Distributions]¶ 68 Petitioner does also cite respondent's taking of "distributions" of the retained earnings, which she claims were "at [respondent's] sole discretion." The evidence is unclear as to KASC's policy on distributions, though Ludwig testified that distributions must be disbursed equally among shareholders. External restrictions on distributions, however, existed in the form of the bank covenants, which required KASC to maintain a certain level of tangible net worth—retained earnings being one component of net worth. See *INOVA Diagnostics, Inc. v. Strayhorn*, 166 S.W.3d 394, 400 (Tex. Ct. App. 2005) ("One component of net worth or stockholder's book equity value is a corporation's retained earnings."). The bank covenants are evidence that KASC, like the corporation in *Joynt* and unlike the corporation in Lundahl, relied on its retained earnings for its business operations and hence for its survival. In 2000, the bank required KASC to issue distributions to pay down the DFO balance. Thus, even if the DFO advances were akin to shareholder distributions that actually disbursed the retained earnings, we would not conclude that respondent had unrestricted access to funds from KASC. In any event, the level of shareholder discretion is just one factor in determining whether retained earnings are income to the spouse. The remaining factors favor respondent.

First, as in *Joynt*, KASC reimbursed respondent for the taxes he paid on its retained earnings.

Second, as petitioner does not dispute, the salary that respondent received from KASC, which ranged in the last several years from $400,000 to $600,000 yearly, **was adequate compensation** for his work at KASC. See *Joynt*, 375 Ill. App. 3d at 821. [Emphasis added consistent with the 2016 amendments.]

¶ 69 Thus, the relevant factors set forth in *Joynt* and *Lundahl* weigh in favor of holding that KASC's retained earnings are not income to respondent. There are restrictions on respondent's ability to disburse the retained earnings, KASC relies on the retained earnings to operate its business, KASC reimburses respondent for his tax payments on his share of the retained earnings, and respondent is adequately compensated at KASC through salary.

VI. **2012 *Dann* Case and the 2015 Moorthy Case**:

2012 Dann Decision:
In 2012, the court again weighed in on this issue, but in the context of a non-majority owner who was in a control position of the company. The *Dann* focused on the fact that minority interest only was not sufficient for the husband to demonstrate:

Applying the foregoing principles, we hold that the record before the trial court when it entered summary judgment contained no evidence to rebut the presumption that the payments

> from DBI for the purchase of the 550 shares were attributable to Russell's personal effort. Essentially, the only evidence before the trial court was Russell's and Barsella's averments that DBI made payments so that the trust could purchase 550 additional shares of DBI, and Russell's deposition testimony that the payments were "distributions" from DBI. Citing *Joynt*, *Schmitt*, and *Lundahl*, Russell notes that he did not have a *controlling* interest in DBI. This fact alone did not overcome the presumption. **The thrust of the analyses in Joynt and Lundahl is that "distributions" or "dividends" disbursed during the marriage may be considered nonmarital property if proven not to be compensation to the spouse, that is, if proven not to be due to "the personal effort of a spouse.**" Here, the record at the summary judgment stage was silent on whether DBI even deemed the transfers to be distributions or dividends rather than salary, which is typically compensation for personal effort. See *In re Marriage of Phillips*, 229 Ill. App. 3d 809, 818 (1992) ("remuneration to a spouse, in whatever form, during the marriage is considered marital property"). Moreover, Russell's deposition testimony that the transfers were "distributions" is not determinative, for he did not indicate what he meant by the term, nor does the context reveal it. As material fact questions remained, summary judgment for Russell was improper. (emphasis added).

The question according to *Dann* was not majority versus minority shareholder but influence of disbursement of funds, i.e., what I have referred to in the business valuation context of indicia of control that might apply even with a non-majority shareholder.

> Russell's status as a minority shareholder of DBI also is not determinative. Russell would have us conclude from this fact alone that he lacked influence over the disbursement of funds from DBI, but we decline the invitation. "[W]hen 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, courts have held that retained earnings are marital property." (Emphasis supplied.) Id. at 820. Russell adduced no evidence of DBI's policies on distributions and so did not foreclose the possibility that, despite his minority interest, he had substantial influence over the decision to retain or disburse earnings. Thus, even if we could consider Barsella's January 6, 2008, deposition, we would not conclude that Russell proved his entitlement to summary judgment.

A critical aspect of this case is that it is merely a summary judgment. The case is quite limited in that the deposition testimony and fact of minority position alone did not entitle him to summary judgment. There still was the potential for a genuine issue of material fact.

2015 Moorthy Decision:
Finally, we address a 2015 case that addresses a somewhat complimentary issue – i.e., what constitutes income from a Subchapter S corporation and retained earnings. In the recent *Moorthy* case the appellate court ruled that the trial court did not abuse its discretion in excluding retained earnings as income for support purposes. *IRMO Moorthy*, 2015 IL App (1st) 132077.

The players in this case were:
Mother: Moorthy
Father: Arjuna
Corporation: Mahantech.

A key factor was that the mother had the burden of proof due to the fact that she brought the modification of support proceedings. The key quotations in the case stated:

> We note that there is no prior history of the subchapter S corporation's retained earnings because Arjuna did not acquire Mahantech until after the divorce was finalized. While we recognize that heightened scrutiny may be warranted where an individual has the ability to control distributions (*In re Marriage of Brand*, 44 P.3d at 330), there was no evidence presented that Arjuna was actually manipulating his income or refusing to declare distributions of Mahantech's income in order to avoid an increase in his child support obligation. Rather, the evidence indicated that Arjuna obtained majority ownership of the corporation at a time when it was not financially successful and he was able to make it more profitable over the years. He testified that the retained earnings must be reinvested in the company to ensure its continued growth and to cover overhead expenses in the event of a business downturn. *** In addition, Arjuna testified that although he was the majority shareholder, he owed a duty to the minority shareholder and could not declare a distribution without considering the other shareholder
>
> Significantly, [former wife] failed to offer any evidence or testimony to rebut Arjuna's evidence that the retained earnings were necessary and appropriate business actions and were not excessive. Notably, Moorthy did not present the testimony of an accountant or other expert regarding whether the level of retained earnings was in line with the corporation's needs. As noted in *Taylor*, 158 S.W.3d at 358, expert testimony may be helpful and relevant in establishing "the level of retained earnings that are appropriate for the corporation to carry on its intended purpose, and the court should consider post-divorce corporation activities, particularly any unexplained increases or reductions of capitalization or retained earnings." See, e.g., *In re Marriage of Joynt*, 375 Ill. App. 3d at 818 (accountant testified about the retained earnings and other financial information concerning the obligor's closely held subchapter S corporation). Moorthy did not call an expert witness to present any evidence that Arjuna was manipulating his income or that the retained earnings were excessive, and she did not otherwise provide evidence through the examination of Arjuna or any other witness to rebut his testimony regarding Mahantech's financial situation. Despite Moorthy's argument to the contrary, our case law dictates that "[t]he party seeking relief has the burden of showing a change in circumstances substantial enough to warrant a change in support." *In re Marriage of Eberhardt*, 387 Ill. App. 3d at 231.
>
> Although Arjuna's individual tax returns showed that he paid taxes on the portion of Mahantech's earnings that were attributable to him through the schedule K-1, his testimony indicated that the money to pay these taxes came from Mahantech's account, it was sent directly to the taxing agency, and the amount was not distributed to Arjuna first. An equivalent situation occurred in *In re Marriage of Brand*, 44 P.3d at 328, where the father received a distribution from the corporation only for purposes of paying his share of the corporation's taxes, and the court held that this amount was not available to pay child support. We similarly conclude that the amounts used to pay Arjuna's proportionate share of the taxes on Mahantech's earnings did not constitute disbursements to him that should have been included in the child support calculation.

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. There is no issue about the characterization of nature of retained earnings when dealing with a minority non-control owner. 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 unlike Joynt, the appellate court sidestepped the adequacy of compensation issue. 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. In a case such as this there are adequate protections within the IMDMA if we are dealing with an owner in a control position regarding retained earnings. Under §503(a)(7) we would determine whether reimbursement were appropriate considering the adequacy of compensation.

View, then, the approach taken by the *Lundahl* decision as one of three states that had taken this position. L*undahl* had stood 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. Finally, as of January 1, 2016 we have amendments to the reimbursement provisions especially focusing on the reasonable compensation issue and accordingly the *Lundahl* decision is no longer good law.

Consider the 2016 *Moorthy* case as reflecting where case law will now concentrate following the 2016 amendments to the marital energies provisions, i.e., what constitutes income from a subchapter S corporation for the purpose of child support in light of overall indications of control.

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