



Divorce Planning Is Critical for Your Business-Owner Clients

By Leon Finkel and Andrew Eichner

Legal professionals should watch for numerous potential issues that may arise with “nonmarital” assets.

Death and taxes are a certainty. Divorce is 50/50. Accordingly, business advisors must be prepared to protect their clients’ premarital businesses. Awareness of potential issues and careful planning can help minimize risk to your client’s business in the event of divorce.

Marital Property vs. Nonmarital Property

The law presumes that all property acquired by either spouse during the marriage is “marital property,” regardless of how title to that property is held. At the time of divorce, all marital property is divided “equitably.”

Property acquired before marriage is “nonmarital property.” Property acquired during the marriage can also be nonmarital property if one can prove by clear and convincing evidence (a heightened standard of proof to overcome the presumption of marital property) that it was a gift, an inheritance, acquired after a legal separation, or acquired in exchange for other nonmarital property.

Increase in the value of nonmarital property, such as a nonmarital business, during the marriage is also a nonmarital asset unless “significant” personal efforts of a spouse during the marriage results in the “substantial” appreciation of that nonmarital business and the marital estate has not been reasonably compensated.

Similarly, income from nonmarital property (including dividends, profit distributions and retained earnings) is nonmarital only if that income is not attributable to the personal efforts of a spouse.

Potential Issues Facing Nonmarital Business Owners

Those owning a nonmarital business may face many different issues, and have to prove the following:

- the nonmarital character of the business
- that the increase in value of the nonmarital business was not due to the significant personal efforts of a spouse during the marriage
- that income from the nonmarital business was not attributable to a spouse's personal efforts during the marriage

Proving the Nonmarital Character of the Business

One can prove that a business is nonmarital property by showing that it was:

- acquired before the marriage
- inherited
- gifted
- obtained through a stock redemption or as nonmarital collateral
- acquired in exchange for other nonmarital property

These exceptions to the presumption of marital property must be proven by clear and convincing evidence.

Types of evidence that may prove useful in documenting the nonmarital character of a business include:

- stock certificates
- corporate minute books
- tax returns (including gift tax returns)
- partnership agreements
- wills/trust documents
- transfer records
- title documents
- personal records (letters, emails, etc.)
- testimony, especially testimony of the donor, if available

BUSINESS ACQUIRED IN EXCHANGE FOR OTHER NONMARITAL PROPERTY

One can also prove that a business is nonmarital property by showing that it was acquired in exchange for other nonmarital property. A typical example is when proceeds from the sale of a nonmarital asset are used to start or purchase the business, or when a business is purchased using a loan secured by nonmarital property. Potential issues include the necessity of carefully tracing proceeds from sale to purchase, the risk of commingling (mixing together) nonmarital and marital funds, and the need to avoid using marital accounts as a conduit for nonmarital funds.

BUSINESS ACQUIRED THROUGH A STOCK REDEMPTION

When a corporation redeems stock, theoretically that should not change the value of the remaining shares, as the shareholder simply owns a greater percentage of a smaller net value. Under Illinois case law, redemption does not change the nonmarital character of the owner's interest. Potential issues arise not in the redemption itself, but in how the company pays for the redemption. If funds used in the redemption are deemed marital (for the same reasons that retained earnings or profits might be deemed marital, as discussed below), the marital estate might be entitled to reimbursement.

ONCE BUSINESS IS PROVEN TO BE NONMARITAL PROPERTY

Even after a business is proven to be nonmarital property, the owner is not necessarily in the clear, as the owner still must prove the nonmarital character of: the increase in value of the business during the marriage, the income earned by/received from the business during the marriage, and any retained earnings.

ESTABLISHING REASONABLE COMPENSATION

Reasonable compensation can be established in several ways. The shareholder/operating agreement or employment contract can: delineate compensation and any bonus formula; specifically identify "efforts" to be compensated; and identify employment-related benefits/perks. One can also elect to set compensation based on the advice of a compensation expert, who will consult market benchmarks in helping to identify reasonable compensation. If it comes down to later establishing reasonable compensation in an eventual divorce case, expert testimony can be used to establish market rates for compensation of similarly situated business owners, including all benefits to the marital estate as a result of the business ownership, and other employees' compensation for the sake of comparison.

Proving Nonmarital Character of Profits or Increase in Business Value

When trying to prove the nonmarital character of the increase in value of the business during the marriage, the factual analysis includes whether the value of the business increased substantially during the marriage and, if yes, whether the increase was a result of a spouse's personal efforts.

Illinois law provides that the marital estate is entitled to reimbursement where the business-owner spouse's personal efforts are expended to increase the value of the nonmarital business, unless the marital estate has already been reasonably compensated for the spouse's efforts.

One's "income" from a nonmarital business includes salary/bonus, distributions/dividends, and retained earnings/AAA accounts. The presumption is that income earned by a

spouse during the marriage is attributable to the personal efforts of the spouse. This presumption can only be overcome with clear and convincing evidence that: the income was not compensation for personal efforts; that any personal efforts were reasonably compensated; and/or that nonmarital income was not commingled with income attributable to personal efforts.

Potential pitfalls in this area include:

- the existence of bad case law finding that 100% ownership/control means all income/distributions/retained earnings during the marriage are presumed to be marital property
- the issue of profit distributions/retained earnings
- the question of what is reasonable compensation

Another potential pitfall is the issue of business expansion, which can present the risk of commingling. When marital and nonmarital assets are commingled, or mixed, the asset becomes part of the “receiving” estate, and the “contributing” estate is entitled to reimbursement. When marital and nonmarital assets are combined into a new entity, the new entity is deemed marital.

Regarding mergers and acquisitions, one question to consider is whether the new entity is a continuation/expansion of the old business, or whether it is a new and distinguishable entity. Another question to consider is whether marital capital or credit was used in the acquisition of a new entity by one’s premarital company.

Unintentional missteps can cause big headaches. For example, a “bargain sale” is a situation when a parent transfers their business to their married child during the marriage for a bargain price to avoid gift taxes. The married child makes a small down payment with marital funds and pays the remainder of the purchase price from the company profits. In this situation, the business would be marital, as it was purchased with marital funds.

Solutions

There are several good solutions to protect nonmarital businesses in the event of divorce, including premarital agreements and post-marital agreements.

Premarital agreements can:

- establish that the business is separate, nonmarital property
- explicitly provide that income from an increase in the value of the business be nonmarital regardless of personal efforts/reasonable compensation
- provide for succession planning in the event of death or divorce

- establish the value of the business or its stock in the event of divorce

Post-marital agreements are the best alternative to premarital agreements. They can do everything a premarital agreement can do except provide that a spouse waives a statutory share of the marital estate. The law requires that they not be “unconscionable.”

Diligently avoiding commingling (mixing of marital and nonmarital assets) is of the utmost importance in protecting a nonmarital business. Take the example of a business-owner spouse who receives reasonable compensation through salary and also takes profit distributions. It is essential that the business-owner spouse:

- segregates any profit distributions and/or sales proceeds if the business is sold
- does not title her/his spouse on any accounts or newly acquired assets associated with the nonmarital business
- keeps excellent records tracing nonmarital funds and proving they were never commingled

These steps are especially important if there were no premarital agreement.

Best Practices

To protect a nonmarital business in case of later divorce, legal professionals should consider several best practices, including:

- shareholder/operating agreements that establish terms of control and distributions
- excellent recordkeeping, with every transaction papered and every payment/bonus/gift/loan characterized
- strictly segregated accounts, with no commingling of business and personal funds

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