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Feature Story

Issues Regarding Closely Held Business Interests And Divorce

By Jeffrey A. Baskies

A July decision by the Minnesota Supreme Court should interest estate planners advising clients with closely held business interests and/or family limited partnerships or limited liability companies.

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In the case, *In re Marriage of Gottsacker*, the court was asked to categorize the status of an "accumulated adjustment account" ("AAA") in a family controlled S corporation as well as certain dividends and disbursements from the company. (See "Wife's Income From S Corp Not Marital Property," Lawyers Weekly USA, Aug. 4, 2003. Search words for LWUSA Archives: Gottsacker and undistributed.)

This decision helps clarify for planners some of the important issues regarding divorce planning and family businesses. But it has also left open an interesting question: If distributions from a family business made to the shareholders of a pass-through entity for the sole purpose of paying the taxes on the shareholder's portion of the entity's undistributed income are marital property, then should the non-owner spouse be reimbursed for half the tax payments?

Facts

Janis Edwards Gottsacker ("Janis") married Gregory Gottsacker ("Greg") in October 1991. In May 1999, Janis filed for divorce.

Before and during the marriage, Janis acquired interests in three family owned businesses (owned by Janis, her parents, her brother and her sister). The primary entity was an S-corp called Edco Products, Inc. ("Edco"). Janis owned shares in this entity from before the marriage and acquired other shares by gift from her parents during the marriage. There was no dispute that the shares were non-marital assets.

However, during the marriage, Janis' Edco shares did recognize substantial income (from the pass-through entity) and she did receive regular distributions from Edco to pay her taxes thereon. Other than the amount needed to pay taxes, however, most of the additional income remained in Edco and was reflected in Janis' AAA account.

During the marriage, the family created a new structure - Edcoat, a limited partnership ("Edcoat") - and a corporate general partner, Edcoat General Partnership, Inc. ("Edcoat, Inc."). Edcoat, Inc. was a 1 percent owner of Edcoat. The rest of the interests in Edcoat as well as the shares in Edcoat, Inc. were owned by Janis and her family members (and a few select, key employees).

But Janis acquired part of her interests in these new entities in an interesting manner. While a small part of her interest in the limited partnership came from gifts from her parents (and Janis and Greg agreed that was non-marital), the rest were acquired with cash she received as a distribution from Edco. The family accountant testified in the trial that the design of the partnership/corporate structure of Edcoat was preferred for a variety of legal reasons as compared to other options - like making Edcoat a sub-entity of Edco. And he testified that the distributions from Edco were only made to facilitate creating Edcoat and Edcoat Inc in this design.

Key Elements Of The Holding

1. The AAA account was non-marital property. The trial court found, and the Minnesota Supreme Court affirmed, that the AAA account was not marital property. The court found that the "determining factor in these decisions from other jurisdictions tends to be the degree of control the shareholder-spouse can exercise over the corporation and, consequently, the degree of control that shareholder-spouse has in determining when to distribute the retained earnings as shareholder dividends." Thus the level of control and active involvement in the management of the corporation is keenly relevant.

In this case, as in many cases with our clients, the active management and control rested in the parents - not Janis. As a result, the court held that the AAA account was not marital.

This ruling should be comforting to many clients. We often encourage clients to involve their children, grandchildren and trusts for their benefit in the structure of their entities for a variety of important estate planning reasons - not the least of which being the tax-free passage of the wealth appreciation. We knew that the gifted shares would be treated as non-marital property in a divorce (assuming they were not commingled or somehow re-titled), but the status of the income has been (and will be) a question.

This decision is a reminder of the general rule that the non-controlling shareholder has no possessory right to the income, the AAA may never be paid out, and as such it should not be deemed marital property. The less control the divorcing spouse has over distribution decisions, the more likely the retained earnings (the AAA) will be treated as non-marital.

2. Active vs. passive appreciation. The decision also provides a lengthy discussion of the differences between active and passive appreciation of assets. In this case, Greg argued that the AAA account constituted appreciation in value and it should be deemed active. He asserted that the use of marital assets to pay the income taxes on the retained earnings constituted active involvement in the company's appreciation. He argued that Janis' "interest in the AAA can be attributed not to the efforts of Edco officers, but to the payment of taxes on Edco income directly allocated to [Janis], which taxes were paid with marital funds."

But the court disagreed. The opinion states: "It is not marital income when the shareholder spouse has little to no control over whether to retain or distribute the earnings, and it is not active appreciation when no marital effort was expended to increase the value of the stock interest."

Again, this is a comforting ruling to clients. While Greg's argument may have been clever, it was

not legally compelling. Instead, the decisions about paying out or retaining income - which so many of our clients make routinely - will not create a marital asset subject to division in their children's potential divorces.

3. Income from non-marital property is marital property. The court also addressed a claim by Janis that her income from Edco (at least the income that was used to invest in Edcoat) was not in fact marital property. She asserted that marital effort and control should be considered in determining if the dividends were marital. The family could have formed Edcoat as a subsidiary of Edco and Greg would have had no interest. So, she argued, she should not be penalized by a "form over substance" argument where the corporate structure/design was created requiring the dividend. She argued that, "in deeming the Edcoat interests marital property, she and her family are being penalized for choosing one corporate form over another."

But the court dismissed her claim. Based on a prior decision, *Nardini v. Nardini*, 414 N.W. 2d 184 (Minn. 1987), the court found that cash dividends are income and thus marital property. Next, the court reiterated the long-standing law that assets acquired with marital property are treated as marital property. Consequently, since the cash dividend from Edco was marital, the interests in the Edcoat entities - which were purchased with the cash dividends - were marital.

The court stated: "Though the Edwards family may regret the corporate structure it chose and while the family may not have fully considered all the consequences of that structure, the district court relied on well-established law in finding that the Edco distributions to [Janis] were marital income, the marital income was used to acquire Edcoat ownership interest, and that Edcoat interest is, therefore, marital property."

While this may not be a novel decision, the ruling succinctly explains what is probably black-letter law in most jurisdictions. Moreover, this should be a reminder to clients who may face corporate or partnership issues with their family businesses.

4. Equitable claim for reimbursement of taxes. This last issue remains unsettled. Greg argued that if he has no interest in the AAA (as it is non-marital), then he deserves to be reimbursed for his share of any marital funds distributed by Edco to pay the taxes on the AAA. In this case that total amount distributed to pay taxes during the marriage was nearly \$3 million. Unfortunately for Greg, he did not raise this argument until post-trial motions. The trial court and the Minnesota Supreme Court were able to avoid answering his question by dismissing the arguments. They found he made the arguments too late and he did not offer sufficient evidence to prove his claim.

However, by dismissing on legal grounds and not addressing the underlying equitable arguments, the court left open for debate the merits of Greg's argument. In a nutshell: If the dividends paid from Edco to Janis were marital assets, and if the marital assets were immediately used to pay for the taxes on Janis' non-marital property, should there be some compensation to Greg for his total loss of his share of the marital assets?

This case is a stark example - with nearly \$3 million at stake, and with "traceable assets" (there's a trail of a distribution check from Edco, going into Janis' account, and then a check from that account to the IRS in the same amount). But doesn't this issue come up rather frequently? Maybe the impact of the use of marital funds to pay taxes on non-marital property has usually been negligible enough that it hasn't been litigated. Or maybe there are decisions out there addressing this matter.

It is an interesting question and the legal consequences of this question were not squarely answered by this court. For anyone representing clients with similar circumstances, it might be worth investigation.

Conclusion

In the end, the Minnesota Supreme Court's decision provides a good summation of the legal

issues involved in representing closely held business owners who involve their families in the ownership structure and fear the impact of divorce. Most of the conclusions are reassuring to most clients - if the children are not actively involved then the decisions about management, the decisions about distributions, and the growth in value of the entity (the non-marital assets), then their interests in such entities should not be subject to division at divorce. But the court did leave open this rather large equitable argument that could have profound impact.

While this decision is helpful and a valuable reminder of general law, each state's laws may be unique and should be considered.

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