

## Family Law

### Retained Earnings: Prudent Business Practice or Support Dodge?

It depends, and in the context of a divorce it can make a big difference

By Jonathan W. Wolfe

There are many legitimate reasons for a business to retain earnings. However, for a spouse in a divorce — or contemplating divorce — leaving money in the business may be viewed as a tool to shield income to avoid support. For shareholders of an S corporation, even though earnings have not been distributed, they will appear as “phantom income” on the owner’s personal tax returns. Given how frequently these issues arise in our practice, there is surprisingly little New Jersey precedent addressing the treatment of retained earnings in the context of divorce.

This article examines whether, and under what circumstances, retained earnings can be considered as income for the purpose of determining support.

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#### Income Must Be “Available” To Be Considered for Support

A support obligation should not be based on income that is not available. This fundamental principle is codified in the Child Support Guidelines, which define gross income as “all earned and unearned income that is recurring or will increase the income *available* to the recipient over an extended period of time.” See Appendix IX-B (emphasis added). The appendix to the guidelines further explains that to determine whether income should be considered, “the court should consider if it would have been *available* to pay expenses related to the child if the family would have remained intact.” (Emphasis added.)

Albeit in a different context, the requirement that income must be available to be considered was addressed by the Appellate Division in *Forestall v. Forestall*, 389 N.J. Super. 1, 6-7 (App. Div. 2006). In *Forestall*, the court rejected the contention that an employer’s contribution to an employee’s 401(k) plan should be considered as income for the purpose of calculating support. While recognizing that an employer’s contributions would technically fall within the broad definition of gross income, the court concluded that contributions should not be considered because an intact family would not have

utilized the funds to pay expenses.

The court explained that support is not “intended to allow children of separated parents a greater share of the combined parental income than would have been utilized for them had there been no separation.” However, this ruling does not extend to an employee’s *voluntary* contributions, because a “defendant’s *choice* to place money into a retirement fund does not absolve him of the obligation to utilize that income for his children.” (Emphasis added.)

#### Heightened Scrutiny for the Self-Employed

For the self-employed, the guidelines define gross income as “gross receipts minus ordinary and necessary expenses.” While the definition is straightforward, determining actual gross income can be tricky, given that business owners can underreport receipts or inflate “necessary expenses.”

This problem is reflected in the guidelines, which caution that “[i]ncome and expenses from self-employment or operation of a business should be *carefully reviewed* to determine gross income that is *available* to the parent to pay a child support obligation.” Appendix IX-B of the Child Support Guidelines (emphasis added). Our courts similarly stress that a business owner is in “a better position to

present an *unrealistic picture* of his or her actual income than a W-2 earner.” *Larbig v. Larbig*, 384 N.J. Super. 17, 23 (App. Div. 2006) (emphasis added).

### Should Retained Earnings Be Considered Income for Determining Support?

There are no published New Jersey decisions addressing the treatment of retained earnings or phantom income in divorce. In *Frustieri v. Rawlings*, 2008 WL 850194, at \*7 (App. Div. Apr. 1, 2008), the plaintiff-wife argued that the husband’s company had retained excessive earnings, which she argued should have been distributed and would have enabled him to pay more support.

The defendant argued that his income should not even be subject to the heightened scrutiny for the self-employed. Why? Notwithstanding that he owned two-thirds of the company, he argued he was “merely a corporate employee.” The court rejected his argument, finding that he “admittedly controlled this *two-person* corporation and was *in a position to manipulate* its finances and his own.” (Emphasis added.) Accordingly, the court ruled that the “considerations underlying self-employed litigants apply.”

Although the defendant’s position made it possible for him to manipulate income, the court determined there was no evidence of any manipulation. The defendant had provided a “cogent explanation for the need to have the corporation retain income,” together with a certification from his company’s accountant “attesting to the legitimate need to retain earnings.” The plaintiff had presented no “contrary certification from an accountant or other corporate financial expert contradicting [the] certification that retaining earnings is a legitimate financial step for a corporation to take and specifically a legitimate action for [defendant’s company] to take.” The court concluded the “undisputed evidence” therefore showed “nothing nefarious” in the retained earnings. It is worth noting that the Appellate Division affirmed even though the plaintiff had not been afforded discovery.

• *Practice Tip:* When representing the nonbusiness owner before discovery, consider presenting an expert certification detailing the circumstances

under which retained earnings can be used to shield income, together with an explanation of the type of discovery needed to analyze the issue in your case.

The *Frustieri* court’s substantive analysis of retained earnings is well reasoned. If earnings are legitimately retained, they should not be considered for support because they would not have been available to the intact family to pay expenses. Of course, the difficulty will be the determination of whether the retention is a legitimate business practice, or an attempt to evade paying support.

### Support Your Case with Precedent From Other Jurisdictions

The treatment of your client’s retained earnings (or their spouse’s retained earnings) may have a dramatic impact on the outcome of your case. Because little New Jersey precedent exists on the topic, practitioners should look to the wealth of precedent on the subject from across the country.

For example, in *Tuckman v. Tuckman*, 308 Conn. 194 (2013), the Connecticut Supreme Court analyzed the issue as a matter of first impression. In *Tuckman*, the trial court ruled the defendant had “substantial income available to her” based on the income reflected in her tax returns. While it was accurate that her tax returns reflected income as high as \$945,000, the defendant had only received her \$85,000 salary. The Supreme Court reversed and concluded that the trial court erred by failing to “make any finding as to what portion of the income reported on her tax returns was *actually available to the defendant*....” (Emphasis added.)

*Tuckman* closely followed the Massachusetts Supreme Court decision of *J.S. v. C.C.*, 454 Mass. 652 (2009), which stressed that the treatment of retained earnings requires a “case specific, factual inquiry and determination.” In recognizing that there can be no one-size-fits-all approach, the court explained “[s]uch a fact-based inquiry is necessary to balance, inter alia, the considerations that a well-managed corporation may be required to retain a portion of its earnings to maintain corporate operations and survive fluctuations in income, but corporate structures should not be used to shield available income that

could and should serve as available sources of child support funds.”

### Do the Retained Earnings in Your Case Pass the Test?

The first question is whether the spouse has the legal or effective ability to control the decision to retain earnings. If not, the income is not available and should not be considered. However, a lack of legal control does not necessarily mean a lack of *effective* control, and courts must pay particular attention to family-owned businesses.

That being said, control alone does not render retention improper, and courts recognize that a legitimate corporate purpose can be shown even when the owner spouse has complete control over whether funds are distributed. See, e.g., *Zold v. Zold*, 911 So. 2d 1222 (Fla. 2005).

Assuming that a spouse has control *and* a legitimate explanation for the decision for the retention, does that end the inquiry? Not necessarily.

Courts can, and should, still test the purported justification for the retention by examining, among other things, (i) the company’s prior practice and (ii) the industry standards for similar corporations. While there could be circumstances that cause a company to deviate from its prior practice, or the practice of comparable companies, such deviations — particularly at the time of divorce — can be evidence of improper conduct.

• *Practice Tip:* When representing a business owner, demonstrate the retention is consistent with past practice and/or industry standards. If not, be prepared to defend the basis for the deviation. When representing the supported spouse, seek targeted discovery of: (i) the spouse’s involvement, if any, in the decision to retain earnings; (ii) the basis for the retention; (iii) the company’s prior practice; and (iv) industry standards.

### Who Has the Burden of Proof?

Courts are divided on the question. Some states place the burden of proof on the business owner regardless of his or her level of ownership. Others presume that minority owners have no ability to

control distributions, and therefore only place the burden of proof on majority owners. In *Tuckman*, the Connecticut Supreme Court followed the Massachusetts Supreme Court, which had concluded “the second approach is more appropriate, because ...

regardless of the percentage of ... ownership interest, the shareholder is likely to have greater access to relevant information about the corporation than a party who is not connected to it.” *M.S.*, 454 Mass. at 665.

#### **Stay Tuned**

All of these issues — and more — will need to be explored by our courts as they seek to ensure that the interests of supporting and supported spouses are equally protected. ■