TAX TRENDS AND DEVELOPMENTS

# Food for Thought on Treatment of Appreciation in Value of a "Separate" Business During Marriage

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## Background

This article considers the treatment of appreciation in value during marriage of a business enterprise that was owned by one party at the time of marriage

Many seem to consider appreciation during marriage of value of a "separate" business as either 100% active – thereby marital – or 100% passive – thereby separate (assuming no commingling, etc.).

This "either/or" characterization seems overbroad and generally based on little or no analysis of the factors driving the increase in value. It is also out of sync with the equitable nature of divorce and the corresponding objective of addressing the unique circumstances of each case as they are versus a "one size fits all" basis.

In previously writing on this issue, I presented an example similar to the following;

- A and B own identical rental property management companies – with one exception – which they operate as LLCs.
- The exception - A manages his company and draws a $50,000 salary. B has always used a full-time manager who is paid $50,000 a year by the company. B works at a machine shop earning $50,000 annually.
- At the time of A's and B's respective marriages, their companies were each worth $100,000; and, at the time of their divorces each was valued at $250,000. The growth of both is attributable to (1) pay down of debt, (2) inflation, and (3) increase in market values exceeding inflation.
- Both companies have always been owned separately by A and B, respectively. Company income was always deposited in their separate accounts from which funds were drawn solely to pay taxes on company income.
- Though A and B had essentially the same earnings, business values, and appreciation during the marriage, arbitrary application of "either/or" active/passive characterization results in the $150,000 appreciation treated as marital in A's divorce but separate in B's divorce.
- Why this anomalous result? Because 100% of the appreciation of A's company is attributed to her activity as the rental property manager notwithstanding that she brings no particular "value-adding" skills to the job. As noted, the appreciation in value is due to other factors, which are "passive" (except arguably income used to pay down debt).

This example does not address whether the income from the separate property is separate or marital or, correspondingly, as noted, whether the reduction of debt by use of such income is separate or marital. Rather, the purpose is to illustrate the fiction that, if the owner is actively involved, 100% of the appreciation in value is attributable to his/her efforts and thereby marital.

## Michigan Case Law on the Issue

The following discussion focuses on pertinent decisions of Michigan Court of Appeals (Court) regarding the subject issue.

### *Hanaway*, 208 Mich App 278 (1995)

The principal issue regarding the family business (Company) was whether Ms. Hanaway (W) contributed to its "acquisition, improvement, or accumulation." The trial court ruled that she had not, apparently focusing on "direct" contribution. The Court ruled, essentially, that W, did in fact, contribute by tending to the household and the parties' four children thereby enabling Mr. Hanaway (H), "the company president," to devote "himself to the business, working long work weeks." This case established the principle that "contribution" could be indirect as well as direct in the family partnership.

The Court stated that although H received the business as a gift from his father, "… the increased value of that interest necessarily reflected defendant's investment of time and effort in maintaining and increasing the business, an investment that was facilitated by plaintiff's long-term commitment to remain home to run the household and care for the children."

The Court ruled that the appreciation was marital.

*Observations*

- The Court made no attempt to identify factors for the increase in value other than H's intensive efforts as the Company's CEO who worked long hours in this capacity.
- Also, the apparent demanding role served diligently by W - which was front and center as the prime issue of the case – likely had some effect on the ruling on appreciation in value.

### *Reeves*, 206 Mich. App. 490 (1997)

In this case, Mr. Reeves (H) owned a minority interest in a shopping center before his marriage to Ms. Reeves (W). H also owned a condominium that he and W lived in and two rental properties that he purchased in both parties' names while they co-habited before marriage.

The Court ruled that appreciation in value of the shopping center was separate because H's interest was "wholly passive." In so ruling, the Court noted – "[i]t cannot be stated, as was done in *Hanaway, supra* at 294, that the property appreciated because of defendant's efforts, facilitated by plaintiff's activities at home."

*Observations*

- In *Reeves,* the Court did not need to parse reasons for the increase in value because H had no involvement whatsoever. All appreciation was obviously due to passive factors.
- The Court's use of the term "wholly passive" described H's relationship to the shopping center investment which supported its ruling.
- Thus, because H had no involvement whatsoever in the asset at issue, this case sheds no light on a situation where there may be some involvement by the owner, however minimal.
- The Court included as marital the appreciation during marriage of the value of the jointly owned rental properties.

### *Dart*, 460 Mich. 573 (1999)

The principal issue in this Michigan Supreme Court case was jurisdiction involving enforceability of an English judgment.

The Court also addressed a claim by W that she was entitled to share in the appreciation in value during marriage of a large family company, Dart Container Corporation (Dart), at which H was employed. H also had a beneficial interest in a trust to which substantial gifts of Dart stock had been made.

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The English court had rejected W's claim.

The Court noted that it was possible "that plaintiff might have shown a nexus between defendant's work at the company and the underlying trust assets." ... "However, we conclude that the possibility of prevailing was remote."

The Court also noted that, apparently under general separate property principles, "[t]he trust income from the Dart Container Corporation was never marital property."

*Observations*

- Though the Court did not need to decide whether H's active involvement at Dart was sufficient to include appreciation during marriage, the fact that it stated that there needs to be a "nexus" between the two is significant. Though not an express statement to this effect, it indicates that it may take more than active involvement to result in active appreciation.
- The Court's statement regarding trust income from Dart is noteworthy since there is little definitive law on the status of separate property income that is not commingled.

**_Uygur_, Mich. App. No. 258207 (6/8/2006)**

H was an executive at Giffels, a large company. He owned Giffels stock before his marriage to W. The Court ruled that, despite H's active, high level involvement, appreciation in value during the marriage of his pre-marital Giffels stock was passive, hence, his separate property.

In supporting its decision, the Court stated:

"The value of defendant's stock rose and fell based on the net worth of Giffels. The success of the company, and thus its stock value, rested on all of the company's employees, of which defendant was only one. **Because defendant worked for the company, his performance necessarily affected the company's success to *some* degree.** However, we cannot conclude that defendant's employment caused the stock values to appreciate. Because the defendant's ability to affect the company's stock value was limited, the nexus between defendant's employment and the company's success was necessarily attenuated." (Emphasis added.)

*Observations*

- The Court ruled that the appreciation was passive notwithstanding that H actively worked at the Company at a high level and, further, that his work "necessarily affected the company's success to some degree."
- Also, the Court indicated that there must be a nexus between the owner's activity and the success – that is, increase in value – of the company.
- Thus, according to this court, simply being actively involved does not automatically result in "active" appreciation.
- This case is significant for the acknowledgement that factors other than the owner spouse's active involvement may be responsible for increase in value.

**_Henderson,_ Mich. App. No. 295765 (6/9/11).**

H was actively involved on a day-to-day basis in a management capacity at a family company founded by his father. In this regard the Court stated:

> "Plaintiff worked a regular schedule and maintained an office at the company. He oversaw multiple departments and performed necessary functions."

H's counsel relied on *Uygur* in support of his claim that the appreciation was passive. The Court did not consider *Uygur,* in large part, apparently, because it is an unpublished opinion.

The Court noted that, unlike with the shopping center in *Reeves,* H's position at the company was not "wholly passive at all times." And, further, that he "was not merely one of several employees at BNP. As co-CEO, the record demonstrates that plaintiff bore responsibility for many of the company's major functions."

Thus, the Court reversed the trial court decision saying that the "trial court clearly erred in finding that the appreciation was passive and could not be classified as marital property." The case was remanded for further proceedings.

*Observations*

- This appears to be an excellent case for allocating increase in value to various factors, one of which is H's active involvement. The Court did not expressly rule that all of the appreciation was marital.
- The Court's reference to "wholly passive" from *Reeves* is unfortunate since it is not at all clear that the court in *Reeves* intended anything more by that phrase than to describe the undisputed lack of any involvement of Mr. Reeves in the shopping center.

## About the Author

***Joe Cunningham*** *has over 25 years of experience specializing in financial and tax aspects of divorce, including business valuation, valuing and dividing retirement benefits, and developing settlement proposals. He has lectured extensively for ICLE, the Family Law Section, and the MACPA. Joe is also the author of numerous journal articles and chapters in family law treatises. His office is in Troy, though his practice is statewide.*

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