

NO. A11-1225

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State of Minnesota  
**In Court of Appeals**

Kathy Lynn Haefele,

*Appellant,*

vs.

Douglas Alan Haefele,

*Respondent.*

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**APPELLANT'S REPLY BRIEF AND APPENDIX**

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The appendix to this brief is not available for online viewing as specified in the *Minnesota Rules of Public Access to the Records of the Judicial Branch*, Rule 8, Subd. 2(e)(2).

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## ARGUMENT

### **I. THE PURPOSE BEHIND THE TAX DISTRIBUTIONS AND TRANSFERRED EARNINGS MUST BE CONSIDERED BY THE COURT IN ANALYZING THE ISSUE OF WHETHER THESE DISTRIBUTIONS QUALIFY AS GROSS INCOME FOR CHILD SUPPORT PURPOSES.**

The two issues before the Court relate to the calculation of gross income of a parent (Mother in this case), who is a minority shareholder of an S Corporation, for child support purposes. The first issue is whether tax distributions made to Mother for the sole purpose of paying her pro-rata share of the corporate pass-through income not received by her (tax distributions), should be included as Mother's gross income. The second issue is whether the transfer of Dura-Supreme's retained earnings to another entity, TK Investments, which were transferred for a legitimate business purpose and not done in an attempt to avoid Mother's child support obligation (transferred earnings), should be included as income for child support. Father argues that this Court need not look beyond the statutory definition of gross income when analyzing these issues and that both the tax distributions and transferred earnings are gross income. Father is wrong.

Father claims that his argument is supported by the fact that the Minnesota child support guidelines were revised, as of January 1, 2007, and child support is now calculated on a parent's gross income versus net income. Although child support was calculated based on a parent's net income prior to 2007, the courts still had to determine a parent's gross income before net income could be calculated. In addition, as Father fails to acknowledge, the statutory definitions of gross income, both pre- and post-2007,

almost mirror one another. The current statutory definition of “gross income” is:

...any form of periodic payment to an individual, including, but not limited to, salaries, wages, commissions, self-employment income under section 518A.30, workers’ compensation, unemployment benefits, annuity payments, military and naval retirement, pension and disability payments...

See Minn. Stat. § 518A.29 (a) (2010).

Similarly, the former statutory definition of “income” was:

...any form of periodic payment to an individual, including, but not limited to, wages, salaries, payments to an independent contractor, workers’ compensation, unemployment benefits, annuity, military and naval retirement, pension and disability payments...

See Minn. Stat. § 518.54, subd. 6 (2005).

This Court made numerous decisions determining whether a source of funds should be included as income for child support purposes prior to the change of law in 2007. See Hubbard County Health and Human Services v. Zacher, 742 N.W.2d 223 (Minn. Ct. App. 2007) (analyzing whether retained earnings from an S-Corporation allocated to a minority shareholder should be considered a source for child support); Sherburne County Social Services v. Riedle, 481 N.W.2d 111 (Minn. Ct. App. 1992) (analyzing whether annuity payments from structured settlement of a personal injury action is a source for child support); Roth v. Roth, 406 N.W.2d 77 (Minn. Ct. App. 1987) (analyzing whether retained earnings from an S-Corporation allocated to a sole shareholder should be considered a source for child support). These cases addressed specific sources of funds for purposes of establishing a parent’s gross income for child

support purposes. Once a parent's gross income was determined, net income could be calculated, which was then used to determine the guidelines child support obligation.

It is clear from these cases that courts need to look beyond the literal language of the definition of income and that the purpose behind the payments also needs to be considered. Under the current statutory definition of gross income (just as under the former definition), additional analysis is required by this Court in determining whether certain sources of income should be included as income for purposes of calculating child support.

Father claims that because Hubbard was decided prior to the change in the child support law, Hubbard does not apply to this appeal. Father's argument is meritless. The analysis set forth in Hubbard is still required under the current statutory scheme (ie. whether retained earnings have been retained for a legitimate business purpose, whether the shareholder has control over the distributions, and whether the retention of the earnings is being done in an attempt to avoid the parent's child support obligation) and must be applied by the courts in making a decision whether an S-Corporation minority shareholder's portion of retained earnings should be included as income. Although in this case, the transferred earnings have been "distributed" to Mother, instead of being retained by the corporation, as was the case in Hubbard, the intent and purpose behind both payments must be analyzed under the same light.

Father's analysis of both issues focuses solely on the fact that distributions were made to Mother. Without any consideration of the purpose, intent, or common sense

reasoning and logic for the distributions, he argues that all distributions are gross income, thus, end of discussion.

Father completely disregards the undisputed evidence that prior to any distributions being made for the transferred earnings, Mother had to agree that those amounts would immediately be transferred to TK Investments for the legitimate business purpose of building Dura-Supreme's cash reserves for future expansion. Father also ignores the undisputed evidence that, but for Mother's agreement to transfer those distributions to TK Investments, the distributions would not have been made. Certainly, if Mother had reneged on her agreement with the majority shareholder and President of Dura-Supreme (Keith Stotts), no further distributions would have been made and instead, those earnings would have been retained by Dura-Supreme. It is uncontroverted that had that happened, those earnings would not have been included as Mother's income for child support purposes.

Father does agree that the transfer of earnings to TK Investments was for a legitimate business purpose and that Mother was not trying to shirk her financial obligations to her children. Nonetheless, he maintains that those facts are irrelevant and should be disregarded by this Court. As will be explained below, Father's analysis is short-sighted and mechanistic.

Father takes the same approach with regard to the tax distributions and suggests that Mother is attempting to "carve out" an exception from the statutory definition of gross income for S-Corporation shareholder parents. (See Father's Brief, p. 19). Mother

is not seeking an exception. She is seeking a determination that the payment of taxes on corporate retained earnings is an ordinary and necessary expense of the business, regardless of the corporation's corporate structure as a C or an S corporation.<sup>1</sup> To include the tax distributions received by Mother, which were made for the sole purpose of paying taxes on her share of the corporate retained earnings as income for child support purposes, would be inequitable because Mother would have no net funds remaining after payment of the income taxes<sup>2</sup>

Father agrees that the purpose of the new statutory scheme was primarily to make a system that would be perceived as fair, but refuses to look at the intent, purpose, and substance behind the tax distributions and transferred distributions, nor does he even address the fairness issue. (See Father's Brief, p. 21). This mechanistic approach of looking at form over substance is generally disfavored by Minnesota courts. See Grigsby

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<sup>1</sup> This is not a new argument, rather an extension of the argument made by Mother to the district court. Mother argued to the district court that the tax distributions should fall under the definition of an ordinary and necessary expenses required for business operation under Minn. Stat. § 518A.30, as payment of a business' taxes is certainly an ordinary and necessary expense. (See Appellant's Confidential Appendix ("CA") 20-21). Mother further argued that simply because the corporate structure of an S Corporation requires the shareholder (Mother here) to pay her pro-rata share of the company's taxes versus Dura-Supreme paying the taxes itself, should make no difference when calculating income from a business under Minn. Stat. § 518A.30. (See CA 21).

<sup>2</sup> For example, assume that a person has a 25% ownership interest in a subchapter S Corporation and that corporation has \$1,000,000 in income. The corporation, however, only distributes to its shareholder an amount sufficient to pay the shareholder's tax liability relating to that shareholder's proportionate share of the retained earnings (25% of \$1,000,000, or \$250,000). After payment of the tax liability (for purposes of this example, assume a tax rate of 30%, or \$75,000 on the \$250,000 proportionate share), there would be no funds left after payment of the taxes. The shareholder would have received only \$75,000, which amount was earmarked and used to pay that shareholder's \$75,000 tax liability due to retained earnings, and the net result would be \$0.

v. Grigsby, 648 N.W.2d 716 (Minn. Ct. App. 2002); see also Sweere v. Gilbert-Sweere, 534 N.W.2d 294 (Minn. Ct. App. 1995); Ward v. Ward, 453 N.W.2d . 729 (Minn. Ct. App. 1990); Van de Loo v. Van de Loo, 346 N.W.2d 173 (Minn. Ct. App. 1984).

Although these cases address the form over substance argument when determining whether property is marital or nonmarital, this same analysis has been extended to cases involving the calculation of income for support purposes. See Huntsman v. Huntsman, 2004 WL 2710044 (Minn. Ct. App. Nov. 30, 2004) (rev. denied Feb. 23, 2005) (Appellant’s Reply Appendix “ARA” 5-11). Although Huntsman is an unpublished decision<sup>3</sup> it is helpful in analyzing the issue of a mechanical approach versus an analytical approach when calculating income for support purposes. In Huntsman, this Court analyzed whether a lump-sum severance package should be considered as income for purposes of determining child support. This Court agreed that it was importance to focus on the *purpose* of each component of the settlement agreement in determining whether it should be considered in modifying child support. (See ARA 9).

The analytic approach focuses on the purpose behind a payments or settlement structure. (Id.) The reality here, is that there are no net funds left after payment of the income taxes, nor are there transferred earnings available to Mother for purposes of paying support. The payment of income taxes is a necessary and proper business expense. Likewise, the transferred earnings were relocated to TK Investments for the

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<sup>3</sup> Pursuant to Minn. Stat. § 480A.08 (3), a copy of this unpublished case and other unpublished cases cited herein are attached. Unpublished opinions of the Court of Appeals are not precedential, but may provide guidance regarding different factual scenarios. Id.

proper business reason of Dura-Supreme's expansion, with no intent on Mother's part to avoid paying support. These are undisputed facts. To calculate child support on "income" when the net effect is \$0, would be unreasonable and unfair, with no consideration of the substance of the transactions.

**II. THE FOREIGN AUTHORITY CITED BY FATHER IS INAPPLICABLE TO THE ISSUES BEFORE THE COURT AND SHOULD BE DISREGARDED.**

Father cites four cases, claiming that they support his position that the tax distributions made to Mother should be included as gross income. All of these cases are distinguishable and should be disregarded by this Court. Father cites a Missouri case, Kiem v. Kiem, but Kiem has *no* relation to this case and sets forth a completely different rule than Hubbard regarding retained earnings. 945 S.W.2d 603 (Mo. Ct. App. 1997). In Kiem, the shareholder parent's full share of retained earnings was included as income for child support purposes. Id. at 605. There was no analysis of whether there had been a legitimate business purpose behind the retention, whether the shareholder parent had any control over the distribution, or whether the shareholder parent was attempting to shirk his child support obligation. This case reaches the complete opposite conclusion than this Court in Hubbard and it is totally inapplicable to this case.

Father maintains that the Arkansas case, Anderson v. Anderson, also supports his position that tax distributions should be included as income for child support purposes, but this case is also contrary to the decision made by this Court in Hubbard. See 963 S.W.2d 604 (Ark. Ct. App. 1998). In Anderson, the chancery court included the tax distributions as income for purposes of calculating child support and this decision was

affirmed by the Arkansas Court of Appeals. The chancery court also stated, however, that it “is convinced that [father’s] share of retained earnings he receives each year from his company, of which he is a 24% shareholder, is income for child support purposes.” Anderson at 608.

Although the chancery court found the retained earnings to be income, it excluded those amounts in calculating child support because father rebutted the presumption that child support based on the retained earnings would be a just amount. Mother did not appeal the chancery court’s decision on the retained earnings issue, but it seems clear from the discussion in Anderson that had this issue been appealed, the Arkansas court would have included the retained earnings as income for child support purposes. For example, the Arkansas court found that if tax distributions were not included as income, a subchapter S shareholder would have incentive to keep most or all of the shareholder income as retained earnings by the corporation. This analysis is inconsistent with that of Hubbard, as it does not consider the shareholder’s control over the distribution of retained earnings, whether the retained earnings are being held for a legitimate business purpose, or whether the child support obligor is attempting to shield income for child support purposes. This Court should not rely on Anderson in deciding the tax distribution issue.

Father claims that the South Dakota case, Nace v. Nace, supports his position that tax distributions are gross income for child support purposes. 754 N.W.2d 820 (S.D. 2008). After review of the complete decision on the tax distribution issue, however, it is clear that Nace does not support Father’s claim and instead, support’s Mother’s position. The South Dakota court in Nace relied on its 2003 decision, Roberts v. Roberts, in

making its determination that tax distributions to a parent shareholder made for the purpose of meeting the parent's tax liability on pass-through income from the S-Corporation, should be included as gross income. See Nace v. Nace, 754 N.W.2d at 824 (citing Roberts v. Roberts, 666 N.W.2d 477 (S.D. 2003)).

Although the South Dakota court found that tax distributions fall under the definition of gross income for child support purposes, what Father neglects to include in his argument, is that in both of those cases, the matters were reversed and remanded back to the circuit court with instructions to decide whether the tax distributions would provide the basis for a deviation.<sup>4</sup> Nace at 824; Roberts at 484. In both cases, because a distribution was made to the shareholder parent, it fell under the broad definition of gross income. The South Dakota court recognized, however, that it may be inequitable to include those amounts when calculating child support and held that a deviation may be warranted. It was clear that the shareholder parent had received the tax distributions, so it fell under the broad definition of income, but the court acknowledged that those funds may not be available for payment of child support and, as a result, it may be inequitable to base child support on this unavailable income.

Father also cites a Nebraska case, Coffey v. Coffey, in support of his position that tax distributions should be included as gross income for child support purposes. 661 N.W.2d 327 (Neb. Ct. App. 2003). In Coffey, the court found that retained earnings allocated to an S corporation minority shareholder should not be included as income for

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<sup>4</sup> Under South Dakota law, a court may deviate from guidelines child support if there is any "financial condition of either parent which would make application of the schedule inequitable." See S.D.C.L. § 25-7-6.10 (2).

purposes of calculating child support, but that tax distributions should be included as income for child support calculation. Id. at 348. In reaching its decision on the retained earnings issue, the court looked to other jurisdictions for guidance, including cases such as Brand and Fennell, which held that the both retained earnings *and* tax distributions should not be included as income, and also looked at cases from other jurisdictions where retained earnings were included as gross income. Id. at 345-347.

Even though the court in Coffey cited Brand and Fennell regarding the retained earnings issue, it provided no analysis whatsoever regarding the tax distributions issue and did not refer to any other jurisdictions in making its ultimate decision to include those amounts as income. The court in Coffey found that because the tax distributions had been received by the parent, those amounts fell under the definition of income and should be included for purposes of calculating child support. There was no analysis of the purpose behind the distributions or whether those funds were available for purposes of paying child support. The court in Coffey took a mechanistic approach to the tax distribution issue, which is generally disfavored by this Court.

Here, Mother received the tax distributions, but that cannot be the end of the Court's analysis. The ultimate determination of a child support obligation is based on the obligor's ability to pay. See Strandberg v. Strandberg, 664 N.W.2d 887, 889 (Minn. Ct. App. 2001). This Court needs to determine whether tax distributions should be included as income for child support purposes given that none of those amounts is available for purposes of paying child support. Because this Court relied on other jurisdictions (Kansas, Pennsylvania, Indiana, and Florida) in making its decision in Hubbard, it is only

logical to extend the law of those same jurisdictions on the tax distribution issue. If the Court determines, however, that the tax distributions fall under the definition of gross income, a downward deviation in child support should be made so that support is calculated based on income *available* to Mother.

**III. IF THE COURT DETERMINES THAT THE TAX DISTRIBUTIONS AND/OR TRANSFERRED EARNINGS FALL WITHIN THE STATUTORY DEFINITION OF GROSS INCOME, A DOWNWARD DEVIATION FROM THE GUIDELINES CHILD SUPPORT IS REQUIRED TO ACCOMPLISH A FAIR AND REASONABLE RESULT.**

Father argues that even if this Court finds that the tax distributions and transferred earnings are not income for child support purposes, the district court's child support order should remain in place because Mother can afford to pay for 90% of the children's expenses. Father implicitly acknowledges that the tax distributions and transferred earnings are not available to Mother for purposes of paying child support, but maintains that Mother can pay an inflated amount of child support because she earns more money than Father. If this Court were to affirm the district court's decision, it would be a significant upward deviation to guidelines child support amount. Again, under the district court's order, Mother (who cares for the children 79% of the time) owes Father \$114 each month and she is responsible for 90% of the children's uninsured medical expenses.

If this Court extends the Hubbard analysis to the transferred earnings issue and agrees with the other jurisdictions relied upon by this Court in making its decision in Hubbard and finds that the tax distributions and transferred earnings are not income for

child support purposes, Mother's gross annual income would be \$323,268 and Father would owe Mother \$791 each month in combined support and Mother would be responsible for 64% and Father would be responsible for 36% of the children's uninsured medical expenses.<sup>5</sup> This is a \$905 monthly difference<sup>6</sup> to Mother and the district court made *no* findings to justify an upward deviation to child support. If a court deviates from the guidelines child support obligation, the court *must* make written findings that state the reasons for the deviation and how the deviation serves the best interests of the children. See Minn. Stat. § 518A.37, subd. 2.

Although it is true that a court may deviate above the child support guidelines, provided that the requisite findings are made and the deviation is appropriate under Minnesota law, it may also deviate below the guidelines. Minn. Stat. § 518A.43, subd. 1, provides that the court *must* consider, among other factors, the parties' earnings, income, circumstances, and resources and the standard of living that the children would have enjoyed if the parents were still living together, in setting or modifying child support and determining whether to deviate upward or downward from the guidelines. "To blindly apply the guidelines in nonpublic assistance cases would be improper because difference factors are necessarily involved." Moylan v. Moylan, 384 N.W.2d 859, 863 (Minn. 1986). Courts should utilize the amounts set forth in the guidelines as starting points for the determination of child support awards. Id. Further, the statutory guidelines are not to be applied mechanically and to avoid this potential error, the courts should give

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<sup>5</sup> \$1,009 (Father's basic support obligation) - \$218 (Mother's medical support obligation) = \$791. (ARA 12-13).

<sup>6</sup> \$791 owed to Mother + \$114 paid by Mother = \$905 per month difference.

“thoughtful consideration of departure” from the guidelines. Linderman v. Linderman, 364 N.W.2d 872, 875 (Minn. Ct. App. 1985).

The Court of Appeals unpublished decision in Lynch v. Lynch provides guidance on this issue. 2008 WL 2246068 (Minn. Ct. App. June 3, 2008) (ARA 1-4). In Lynch, the district court included a territorial cost-of-living allowance, which was equal to 24% of the father’s base pay and paid to the father due to the higher cost of living attributed to living in the State of Alaska, as income for purposes of calculating child support. This Court agreed that this payment to the father fell within the definition of income for child support purposes, but held that the district court erred by not deviating downward from the statutory guidelines and reversed and remanded the matter.

In holding that the district court should have deviated downward, this Court analyzed the factor relating to the standard of living that the child would have enjoyed had the marriage not been dissolved and found that if the parents had remained living together, their standard of living would have merely been preserved instead of increased given that it was substantially more expensive to live in Alaska. In addition, the Court looked at the earnings, income, and resources of both parents and found that the territorial cost-of-living did not increase the father’s real income available for purposes of paying child support. As a result, this Court agreed that the cost-of-living amount should not be included for purposes of calculating child support. This Court held that to include such income when calculating child support would be illogical and an error.

The same factors apply to this case. The tax distributions do not enhance Mother’s or the children’s standard of living, nor would they have enhanced the standard

of living if the parties were still living together. The full amount distributed is used to pay income taxes on the retained earnings allocated to her. For this same reason, the tax distributions are not a resource or income available for payment of child support.

Likewise, if the parties were currently living together, the transferred earnings are not be an available resource to pay for the Mother's and the children's living expenses and the family's standard of living would have remained the same even if they were still together because those funds are being held within a separate entity and unavailable to Mother.

If the tax distributions and/or transferred earnings are deemed gross income for child support purposes, a downward deviation of the guidelines amount is required. To award child support based on this non-existent income, which was either fully used to pay income taxed or transferred for a legitimate business purpose and was not transferred in an attempt to avoid child support, would be illogical and result in an error.

### CONCLUSION

The tax distributions and transferred earnings are not available to Mother for payment of child support and the purpose behind both payments should be looked at in determining whether to base child support on those amounts. To look no further than the statutory definition of gross income results in a pure mechanistic approach to the issues, with no consideration for the totality of circumstances. This matter must be reversed and remanded to the district court, with instructions to calculate child support based on Mother's *available* income for purposes of paying child support. Alternatively, if this Court finds that the tax distributions and/or transferred earnings fall under the definition

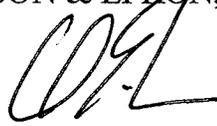
of gross income, the matter should be reversed and remanded to the district court, with instructions to consider the deviation factors set forth in Minn. Stat. § 518A.43.

Dated: January 9, 2012

Respectfully submitted,

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By



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