

NO. A06-2228

State of Minnesota  
In Court of Appeals

Shane L. Zacher,

*Appellant,*

and

Beth A. Hadrava,

*Respondent.*

APPELLANT'S BRIEF AND APPENDIX

WALLING, BERG & DEBELE, P.A.  
Allison Maxim (#0353784)  
Gary A. Debele (#187458)  
121 South Eighth Street, #1100  
Minneapolis, MN 55402  
(612) 340-1150

*Attorneys for Appellant*

Beth A. Hadrava  
40459 Pincherry Trail  
LaPorte, MN 56461

*Respondent, Pro Se*

Hubbard County Attorney's Office  
Erika Randall  
Assistant Hubbard County Attorney  
Hubbard County Courthouse  
301 Court Street  
Park Rapids, MN 56470

*Respondent*

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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## LEGAL ISSUES

- I. DID THE CHILD SUPPORT MAGISTRATE AND THE DISTRICT COURT ERR AS A MATTER OF LAW AND ABUSE THEIR DISCRETION BY INCLUDING CORPORATE PROFITS REPORTED ON MR. ZACHER'S 2005 TAX RETURN IN MR. ZACHER'S INCOME FOR THE PURPOSES OF DETERMINING HIS ONGOING CHILD SUPPORT OBLIGATION?

The District Court ordered child support based on a net monthly income that included corporate profits reported on Mr. Zacher's 2005 Tax Return, but not actually paid out to Mr. Zacher.

- II. DID THE CHILD SUPPORT MAGISTRATE AND THE DISTRICT COURT ERR AS A MATTER OF LAW AND ABUSE THEIR DISCRETION BY INCLUDING CORPORATE PROFITS REPORTED ON MR. ZACHER'S 2005 INCOME TAX RETURN IN HIS INCOME FOR THE PURPOSES OF DETERMINING HIS PAST CHILD SUPPORT OBLIGATION?

The District Court ordered child support based on a net monthly income that included corporate profits reported on Mr. Zacher's 2005 Tax Return, but not actually paid out to Mr. Zacher.

## FACTS/PROCEDURAL HISTORY

Appellant Shane L. Zacher and Respondent Beth A. Hadrava are the parents of Holden J. Zacher, born August 18, 2002, Shae L. Zacher, born June 16, 2004, and Tatiana F. Hadrava, born March 12, 2006. The parties have never been married. T.<sup>1</sup> p. 16. Mr. Zacher is employed by Next Innovations, Ltd, which is one of several businesses operated by his father, John Zacher. T. p. 19, 25, and 26. Mr. Zacher is paid an hourly rate of \$14.00 and works forty (40) hours per week. T. p. 19. He is also a minority shareholder in Next Innovations with a 15% ownership interest in the company. T. p. 19 and 57. He became a shareholder in March, 2005. T. p. 56. Mr. Zacher's father and brother, Jason Zacher, are also shareholders. T. p. 27. Although the exact percentages were not specified at the hearing on this matter, John Zacher holds the majority interest in the company, while Jason Zacher holds a minority interest that is slightly greater than Mr. Zacher's 15% ownership interest. T. p. 27 and 57.

Greg Peltier, who is employed by John Zacher and oversees the accounting operations for all of John Zacher's businesses, testified as a witness at the June 15, 2006 hearing on this matter. T. p. 26. Mr. Peltier has worked for John Zacher for over seven years and has full access to, and is familiar with, the financial records of Next Innovations. T. p. 26, 30. During his testimony Mr. Peltier explained that originally, Next Innovations was organized and operated as a Subchapter C-corporation. T. p. 28. As of January 1, 2005, however, it was changed to a Subchapter S-corporation. T. p. 28,

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<sup>1</sup> "T" cites refer to the Transcript of the June 15, 2006 Expedited Child Support Hearing

29. He explained how changing from a C-corporation to an S-corporation has important tax consequences for the shareholders of the corporation. T. p. 29, 30. He also summarized the differences in the tax consequences for a shareholder of a C-corporation versus the tax consequences for a shareholder of an S-corporation. T. p. 29, 30. A C-corporation pays its own corporate income tax, and its shareholders would report their earnings as income on their tax return, but not the corporate profits. T. p. 29, 30. However, with an S-corporation, the shareholders are responsible for paying the corporate taxes based on their percentage of ownership interest in the company. T. p. 29, 30.

According to Form 1040 of Mr. Zacher's 2005 U.S. Income Tax Return, line 7 states that Mr. Zacher earned wages of \$31,030.00 from his employment at Next Innovations (A-1) and T. p. 41. This figure is based on his total hourly earnings for 2005. T. p. 41. Additionally, Next Innovations experienced a loss from the sale of an asset, which is also reported on Form 1040 of Mr. Zacher's 2005 tax return on line 14. (A-1) and T. p. 42.

Mr. Zacher also reported his proportionate share of corporate profits totaling \$53,098 on line 17 of his 2005 tax return. (A-1) and T. p. 42, 43. In his testimony, Mr. Pelltier explained in detail how the \$53,098 is not at all tied to income Mr. Zacher actually receives. T. p. 43. Rather, because Next Innovations is an S-corporation, the \$53,098 is merely Mr. Zacher's share of the corporate profits he is required to report for tax purposes. T. p. 43. Mr. Zacher does not have access to, or receive, any of the \$53,098. T. p. 43. This sum is reported as pass through income because Next

Innovations is a subchapter S-corporation in which Mr. Zacher was required to report his proportionate share of corporate profits, even when he did not receive a cash distribution. Mr. Pelltier established in his testimony that the \$53,098 is not money that has ever been “in [Mr. Zacher’s] hands,” but that it “merely represents a portion of the company’s profit” that the shareholder’s are required to report as income for tax purposes in order to cover their share of the company’s taxes. T. p. 52.

Mr. Zacher’s 2005 tax liability based on his W-2 earnings and the proportionate share of corporate profits attributable to his 15% ownership interest in Next Innovations was \$11,758. T. p. 46. As of the date of the hearing (June 15, 2006) the \$11,758 tax liability was due and owing and had not yet been paid. T. p. 47. Mr. Pelltier explained in his testimony how shareholders in an S-Corporation ordinarily pay their tax liability and that it may be that John Zacher, Jason Zacher, and Shane Zacher would receive a cash distribution in an amount that would cover the tax liability. T. p. 47, 48. At the time of the hearing, however, no cash disbursements had been made by Next Innovations to cover Mr. Zacher’s outstanding tax liability. T. p. 52. 56.

Mr. Pelltier further explained that if Next Innovations disbursed funds to the three shareholder’s in amounts proportionate to their share of the tax liability, the amount of the disbursed funds would be reported on line 16 Mr. Zacher’s Schedule K-1 showing that Mr. Zacher actually received a cash distribution. T. p. 48, 51.

Further, it was established through Mr. Pelltier’s testimony that as a minority shareholder, Mr. Zacher has no authority to compel a cash distribution to cover his portion of the taxes. T. p. 51. Only Mr. Zacher’s father, John Zacher, as the majority

shareholder, has the authority to make a decision to distribute corporate monies for tax liability of Next Innovations shareholders or otherwise. T. p. 51, 52. There were no cash distributions made from Next Innovations to its shareholders between January 1, 2005 and June 15, 2006, the time of the final child support hearing. T. p. 52.

During the proceeding Ms. Hadrava was given ample opportunity to question Mr. Zacher and his expert witness. One of the few questions she asked was directed to Mr. Pelltier when she inquired: "So, according to all this information you're telling me he paid taxes on money he doesn't receive?" T. p. 54. Mr. Pelltier responded: "Yes, that's correct." T. p. 54. There was no testimony or other evidence offered which in any way contradicted the information provided by Mr. Zacher or Mr. Pelltier.

Hubbard County started this proceeding when it personally served a Summons and Complaint on Defendant seeking ongoing child support for Holden Zacher and Shae Zacher on November 30, 2005. (A-22) A child support hearing was held on February 16, 2006, to determine the amount of ongoing child support, past and present, and to address the issues of reimbursement of public assistance and past child support. (A-22)

Mr. Zacher and Ms. Hadrava came to an agreement that the child support magistrate approved and ordered as follows:

1. Beginning December 1, 2005 and continuing each month thereafter:

- [Mr. Zacher] shall pay \$560.00 per month as ongoing current child support. The total monthly payment is \$560.00.

(A-24).

A review hearing was held on April 20, 2006, and the matter was continued until June 15, 2006. (A-27 ) The June 15, 2006 hearing was held pursuant to the expedited child support process. The child support magistrate issued an Order on July 6, 2006 in which he made the following findings of fact:

7. [Mr. Zacher] is employed by Next Innovations. [He] earned gross wages in 2005 of \$31,030.00.

8. [Mr. Zacher] is also a 15% owner of Next Innovations Based on his 2005 schedule K-1, his share of corporate profits for 2005 was \$53,098.00.

9. [Mr. Zacher] claims that the corporate profits reported on his return of \$53,098.00 should not be attributed to his income. Due to his status as a shareholder, this share of gross profits is a regular source of income and should be included in his gross monthly income.

10. [Mr. Zacher] had an adjusted gross income for 2005 including corporate profits and wages of \$81,766.00, or a gross monthly income of \$6,813.83.

14. [Mr. Zacher] receives an average net monthly income from wages of \$4,498.57, after the following deductions:

- \$2,248.26 for S-1 taxes and social security
- 167.00 for pension contribution

23. Based upon [Mr. Zacher's] 2005 tax return and his net monthly income as found above for 2005 and the present, [Mr. Zacher] should have paid \$1,400.00 per month child support effective January 1, 2005 and continuing through March 31, 2006. Effective April 1, 2006, [Mr. Zacher's] support obligation would be for three children at \$1,575.00 per month.

(A-29 & A-30 )

Based on these findings, the child support magistrate set monthly child support at \$1,575.00 per month beginning April 1, 2006. (A-31) A support obligation of \$1,400.00 per month was ordered for back child support from January 1, 2005 through March 31, 2006. (A-31)

Mr. Zacher properly filed a Motion for Review requesting that a district court judge review the July 6, 2006 Order. (A-33) In an Order dated September 26, 2006, the district court affirmed the Findings and Order of the child support magistrate. (A-36)

Mr. Zacher now appeals the Order of the Hubbard County Child Support Magistrate dated July 6, 2006, and the Order of the Hubbard County District Court dated September 26, 2006, affirming the same.

## ARGUMENT

### I. STANDARD OF REVIEW

If an appeal presents mixed questions of law and fact, the Court of Appeals must correct erroneous applications of the law while also according the district court discretion in its findings of fact and ultimate conclusions. Rehn v. Fischley, 557 N.W.2d 328, 333 (Minn. 1997). Whether distributions from a subchapter S-corporation are in fact received by a shareholder as income is generally treated as a question of fact. Williams v. Williams, 635 N.W.2d 99, 103 (Minn. App. 2001). Thus, the Court of Appeals must review the trial court's determination that corporate profits were actually received by Mr. Zacher under the abuse of discretion standard.

However, the designation of a particular source of funds as income for purposes of determining a person's child support obligation is a question of law. Watson v. Watson, 379 N.W.2d 588, 50 (Minn. Ct. App. 1985). Hence, the Court of Appeals must review de novo the trial court's error of law, namely, improperly treating profits attributed to Mr. Zacher on his 2005 tax return solely for the purpose of paying his 15% share of the corporate taxes as income for the purpose of calculating child support.

**II. THE CHILD SUPPORT MAGISTRATE AND TRIAL COURT ERRED AS A MATTER OF LAW AND ABUSED THEIR DISCRETION BY INCLUDING CORPORATE PROFITS REPORTED BUT NOT PAID OUT IN APPELLANT'S GROSS INCOME FOR THE PURPOSES OF DETERMINING APPELLANT'S ONGOING CHILD SUPPORT OBLIGATION**

Because S-corporation earnings pass directly to shareholders, the shareholders pay taxes on the earnings as if they were personal income. I.R.C. §§ 1363 and 1366 (2005). Moreover, shareholders pay income tax on S-corporation earnings regardless of whether they actually receive a distribution. Gottsacker v. Gottsacker, 664 N.W.2d 848, 850 (Minn. 2003). Thus, when an S-corporation retains its earnings, shareholders pay taxes on money they never receive. This point was made clear in the hearing on this particular matter when Ms. Hadrava inquired of Mr. Pelltier: "So, according to all this information you're telling me he paid taxes on money he doesn't receive?" And Mr. Pelltier responded: "Yes, that's correct."

This Court recently stated the following regarding the treatment of S-Corporation earnings in child support matters:

There is no definitive treatment of [subchapter S-corporation] (SSC) distributions for child-support purposes in Minnesota case law. While recognizing the potential for the employee-shareholder to manipulate SSC income to avoid or reduce child support obligations, our cases have essentially treated the question as one of fact. Compare Roth v. Roth, 406 N.W.2d 77, 79 (Minn. App. 1987) (finding error where the district court failed to include profits from SSC in which obligor was sole officer and shareholder), with Marx v. Marx, 409 N.W.2d 526, 529 (Minn. App. 1987) (affirming district court's decision to exclude losses from three SSCs in which obligor was involved).

Williams v. Williams, 635 N.W.2d 99, 103 (Minn. App. 2001).

While this Court has declared that there is no definitive treatment of subchapter S-corporation distributions, it has consistently ruled that corporate profits that are not necessary to retain in the corporation for business capital purposes should be imputed to a sole shareholder of a subchapter S-corporation. Hertz v. Hertz, 304 Minn. 144, 229 N.W.2d 42 (1975), see also, Roth v. Roth, 406 N.W.2d 77 (Minn. Ct. App. 1987) and Isanti County v. Formhal, 358 N.W.2d 703 (Minn. Ct. App. 1984) (holding that “income, less sums for business capital purposes” should be imputed to a sole officer and shareholder of a closely held subchapter S-corporation.)

Given the history of rulings that income from a subchapter S-corporation should be imputed to a sole officer and shareholder who has control over earnings received by an S-corporation, it is logical to conclude that income from a subchapter S-corporation should not be imputed to a minority shareholder who has no control over whether funds are distributed. In other jurisdictions, the less control an obligor has over retained earnings of an S-corporation, the more reluctant the courts are to impute corporate earnings to a shareholder obligor. See, M. Kyle Rominger, Note, Valuing S-Corporation Earnings in Child Support Calculations, 35 U. of Louisville J. of Fam. L. 145 (1996-97) (A-37).

It is the child support magistrate’s duty to ascertain a child support obligor’s ability to pay child support, whether that is best evaluated by taxable income, cash flow, or some combination of the two. Marx v. Marx, 409 N.W.2d 526 (Minn. App. 1987). Indeed, if the child support magistrate or trial court had any concerns about Mr. Zacher’s father manipulating payout of corporate profits, evidence should have been solicited and

appropriate findings made. Instead, the uncontroverted evidence was that no such manipulation occurred. The findings of the child support magistrate, as affirmed by the trial court, are conclusory, lack evidentiary support, are without any analytical support, and are erroneous. We ask that this Court issue a definitive ruling that income should not be imputed to a minority shareholder with no control over corporate earnings without compelling evidence of fraud or inappropriate manipulation and that child support magistrates and trial courts be required to make specific findings regarding their rationale for either including or excluding subchapter S-corporation profits in the income of a particular shareholder obligor.

The trial court in Worms v. Worms, 1999 WL1037997 (Minn. App. 1999) (A-51), which involves a similar situation as the one at hand, made sufficient findings for the court of appeals to affirm its decision not to include subchapter S-corporation distributions in the income of a shareholder obligor for the purposes of calculating child support. The court of appeals recited with affirmation the district court's findings that the obligor had not received any net cash from the subchapter S-corporation "other than a small amount attributable to the income tax differential," and that the S-corporation distributions were not income for the purposes of calculating child support. 1999 WL at 1037997. (A-51) The court of appeals went on to state:

In excluding from Timothy Worms' income the annual distribution of the amount equal to the highest tax liability, the district court relied on testimony from Timothy Worms and two of his brothers that they used the money to pay income taxes or signed it over to the WFP. The two brothers testified that the practice stems from an agreement among the shareholders that has been uniformly followed. The checks are written to the shareholders, rather than directly to the WFP, to avoid IRS characterization as loans. The parents' accountant substantiated

that the only money Timothy Worms receives is the difference between the income tax he owes and the tax owed by the shareholder with the highest marginal tax rate and that he has no right to pull money out of Cool Air or the WFP.

Whether a source of funds is income for purposes of determining a person's child support obligation is a question of law. *Sherburne County Soc. Servs. v. Riedle*, 481 N.W.2d 111, 112 (Minn. App. 1992). Although cash distributions from Cool Air are reported on Timothy Worms' income tax returns as unearned income, that designation is not determinative in calculating income for child support. See *Marx v. Marx*, 409 N.W.2d 526, 528-29 (Minn. App. 1987) (substantial losses reported on tax returns were due to large deductions, and cash flow was more reliable indicator of income). Timothy Worms' receipt of cash distributions from Cool Air to cover his increased income tax liability is consistent with the "pass-thru" nature of a subchapter S-corporation. See Denise Roy, *Taxation of Corporations and Their Shareholders* at 23, in *Business Law 101* (Minn. CLE 1999) ("Sub S income is taxed only once at the shareholder's applicable marginal rate. Income is taxed to the shareholders regardless of whether they receive any distributions from the corporation."). On this record, the district court did not err in excluding the Cool Air distributions from the calculation of Timothy Worms' income...

1999 WL at 1037997. (A-52)

In the case at hand, the child support magistrate and the trial court abused their discretion when they found that Mr. Zacher received as a regular source of income \$53,098.00 in corporate profits. It was undisputed at the hearing on this matter that the \$53,098.00 was reported on Mr. Zacher's tax return solely for the purpose of reporting his share of Next Innovations corporate profits. Greg Pelltier, an accountant for Next Innovations as well as the other companies operated by John Zacher, testified that the \$53,098.00 was included on Mr. Zacher's tax returns solely for the purpose of reporting Mr. Zacher's share of the subchapter S-corporate profits for which he owed taxes. Both Mr. Zacher and Greg Pelltier testified that (1) Mr. Zacher has a 15% minority ownership interest in Next Innovations, (2) Mr. Zacher has no control over the distribution of funds from Next Innovations for the purpose of paying taxes on corporate profits or otherwise,

and (3) at no time prior to the hearing on this matter were funds in fact distributed to Mr. Zacher.

There was no evidence presented at the hearing to contradict any of these assertions. Because Mr. Zacher never received a cash payment of \$53,098.00, the child support magistrate abused his discretion by making a finding that Mr. Zacher received \$53,098.00 as a regular source of income. After determining that Mr. Zacher received \$53,098.00 as income, the child support magistrate added this figure to Mr. Zacher's 2005 gross wages of \$31,030.00 and found his total gross income to be \$81,766.00. From this, the child support magistrate found a gross monthly income of \$6,813.83 and a net monthly income of \$4,498.57. These findings resulted in an income determination that contradicts the undisputed facts on record and goes against logic and rationality.

The child support magistrate and the trial court erred as a matter of law by including the \$53,098.00 in Mr. Zacher's income for the purposes of calculating child support. For purposes of determining child support obligations, income is defined as follows:

**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.**

Minn. Stat. § 518.54, subd. 6 (2000).

The child support magistrate concluded that because Mr. Zacher is a shareholder in Next Innovations, his share of gross profits is a regular source of income and thus should be included as income in the calculation of his child support obligation. However,

it was undisputed at the hearing that the \$53,098.00 reported on his tax return was not in fact a "periodic payment," but rather, unearned income included on his tax return solely for the purpose of reporting his share of corporate profits. These payments under these circumstances do not meet the legal definition of income for purposes of child support, and to hold as the child support magistrate and trial court did is erroneous as a matter of law.

Based on the child support guidelines set forth in Minn. Stat. § 518.551, subd. 5(b), Mr. Zacher's child support obligation should be \$765.19. This calculation is based on Mr. Zacher's gross wages of \$31,030.00 on line 7 of his 2005 U.S. Individual Tax Return, less \$3,350.00 in federal tax withheld and less \$1,445.00 in state tax withheld (See p. 5.15 of the tax return attached hereto as A-15 for federal and state tax withheld for a yearly net income of \$26,235.00 and a monthly net income of 2,186.25.) The guideline child support for three children for an obligor with a monthly net income of this amount is \$765.19.

**III. THE CHILD SUPPORT MAGISTRATE AND TRIAL COURT ERRED AS A MATTER OF LAW AND ABUSED THEIR DISCRETION BY INCLUDING CORPORATE PROFITS REPORTED BUT NOT PAID OUT IN MR. ZACHER'S GROSS INCOME FOR THE PURPOSES OF DETERMINING MR. ZACHER'S PAST SUPPORT OBLIGATION.**

For the same reasons it was an abuse of discretion to find that Mr. Zacher received \$53,098.00 as part of his income and that it was erroneous as a matter of law to include the \$53,098.00 in his income for the purposes of calculating his ongoing child support obligation, it is also an abuse of discretion and an error of law to include the \$53,098.00

in unearned corporate profits to calculate his past child support obligation. However, that is exactly what the child support magistrate did and the trial court affirmed.

### CONCLUSION

Mr. Zacher does not deny that he has a duty to support all three of his children. However, he disputes the child support magistrate's determination of his income as including corporate profits. He does not have control over receipt of corporate profits, nor did he in fact receive such profits as a cash payment. The Court of Appeals must reverse the child support magistrate's Order dated July 6, 2006, and the trial court's Order dated September 26, 2006, and order Mr. Zacher to pay \$765.19 per month in past and ongoing child support as set forth above.

The evidence submitted to the child support magistrate leads to only one logical conclusion – that Mr. Zacher did not actually receive \$53,098.00 or any other distribution from Next Innovations at any time prior to the child support hearing. Given that he did not receive corporate earnings as income, the child support magistrate abused his discretion by including the \$53,098.00 in corporate earnings in Mr. Zacher's income for the purpose of calculating child support. Not only is it an abuse of discretion, but it is also an error of law to include corporate profits in Mr. Zacher's income for the purpose of calculating child support. Because Mr. Zacher never received a distribution of corporate profits it is error to conclude that corporate earnings are a form of periodic payment under Minn. Stat. § 518.54, subd. 6 (2000).

In the alternative, Mr. Zacher requests this Court remand this matter with clear guidelines to the trial court to make findings on whether the corporate earnings were actually received as a cash payment to Mr. Zacher, and if not, to exclude the \$53,098.00 in corporate earnings from his income for the purposes of calculating child support.

Dated: 12-22-06

WALLING, BERG & DEBELE, P.A.

  
\_\_\_\_\_  
Allison Maxim (#0353784)  
Gary A. Debele (#187458)  
121 South Eighth Street  
Suite 1100  
Minneapolis, MN 55402  
(612) 340-1150  
Attorneys for Appellant Shane L. Zacher