
State of Minnesota
In Court of Appeals

Kathy Lynn Haefele,

Appellant,

vs.

Douglas Alan Haefele,

Respondent.

APPELLANT'S BRIEF, ADDENDUM 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).

TABLE OF CONTENTS

TABLE OF AUTHORITIES ii

LEGAL ISSUES 1

STATEMENT OF THE CASE..... 2

STATEMENT OF FACTS 3

ARGUMENT 11

THE DISTRICT COURT ERRED AS A MATTER OF LAW WHEN
IT INCLUDED THE TAX DISTRIBUTIONS MADE TO MOTHER,
WHICH WERE MADE FOR THE SOLE PURPOSE OF PAYING
MOTHER’S PRO-RATA SHARE OF THE CORPORATE
PASS-THROUGH INCOME NOT RECEIVED BY HER, AS
MOTHER’S GROSS INCOME..... 13

THE DISTRICT COURT ERRED AS A MATTER OF LAW WHEN
IT FOUND THAT DURA-SUPREME’S RETAINED EARNINGS
THAT WERE TRANSFERRED TO TK INVESTMENTS AND NOT
AVAILABLE TO MOTHER WAS GROSS INCOME FOR PURPOSES
OF CALCULATING CHILD SUPPORT. 22

CONCLUSION..... 30

INDEX TO ADDENDUM..... 32

INDEX TO APPENDIX.....33

INDEX TO CONFIDENTIAL APPENDIX..... 34

TABLE OF AUTHORITIES

Brand v. Brand, 44 P.3d 321 (Kan. 2002)..... 1, 15, 16, 17

Davis v. Davis, 631 N.W.2d 822 (Minn. Ct. App. 2001).....11

Fennell v. Fennell, 753 A.2d 866 (Pa. Super. 2000).....1, 16, 17, 28

Gully v. Gully, 599 N.W.2d 814 (Minn. 1999).....11

Hubbard County Health and Human Services v. Zacher, 742 N.W.2d 223
(Minn. Ct. App. 2007).....1, 14, 15, 16, 17, 18, 22, 23

Ludwigson v. Ludwigson, 642 N.W.2d 441 (Minn. Ct. App. 2002)..... 11

Marx v. Marx, 409 N.W.2d 526 (Minn. Ct. App. 1987)..... 12

In re the Marriage of Matthews, 193 P.3d 466 (Kan. Ct. App. 2008) 16

McHugh v. McHugh, 702 So.2d 639 (Fla. Ct. App. 1997) 17, 18

Reuter v. Reuter, 2008 WL 2102598 (Minn. Ct. App. May 20, 2008) 20

Roth v. Roth, 406 N.W.2d 77 (Minn. Ct. App. 1987)..... 12

Rutten v. Rutten, 347 N.W.2d 47 (Minn. 1984)..... 11

Sherburne Cnty Soc. Servs ex rel. Schafer v. Riedle, 418 N.W.2d 111
(Minn. Ct. App. 1992)..... 11

Stevens County Social Services Department ex rel. Banken v. Banken,
403 N.W.2d 693 (Minn. Ct. App. 1987) 19

Strandberg v. Strandberg, 664 N.W.2d 887 (Minn. Ct. App. 2003) 21

Tebbe v. Tebbe, 815 N.E.2d 180 (Ind. Ct. App. 2004) 1, 18

In re the Marriage of Unruh, 88 P.3d 1241 (Kan. Ct. App. 2004) 16

Ver Kuilen v. Ver Kuilen, 578 N.W.2d 790 (Minn. Ct. App. 1998)..... 11

<u>Williams v. Williams</u> , 635 N.W.2d 99 (Minn. Ct. App. 2001)	12, 27
<u>Zold v. Zold</u> , 911 So.2d 1222 (Fla. 2005)	17

Statutes

Minn. Stat. §518A.29	1
Minn. Stat. §518A.30.....	1, 19, 20
Minn. Stat. §518A.43.....	1, 29

Minn. R. Civ. App. Pro. 128.02, subd 1(b)(1)	1
Minn. R. Civ. App. Pro. 128.02, subd 1(b)(3)	1

I.R.C. § 1363	13
I.R.C. § 1366	13
I.R.C. § 1367.....	13
I.R.C. § 1368	13

Article

“The New Income Shares Model for Calculating Child Support in Minnesota” by State Senator Tom Neuville	28
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LEGAL ISSUES

- I. Did the district court err as a matter of law when it included the tax distributions received by Appellant, solely for the purpose of paying her pro-rata share of the corporate pass-through income, as her gross income, instead of finding that the distributions were ordinary and necessary business expenses and as such, should not have been included as Appellant's gross income?

The ruling below: The district court included Appellant's tax distributions as income for child support purposes.

Apposite Authorities:

Minn. Stat. § 518A.29; Minn. Stat. § 518A.30

Hubbard County Health and Human Services v. Zacher, 742 N.W.2d 223 (Minn. Ct. App. 2007); Brand v. Brand, 44 P.3d 321 (Kan. 2002); Tebbe v. Tebbe, 815 N.E.2d 180 (Ind. Ct. App. 2004); Fennell v. Fennell, 753 A.2d 866 (Pa. Super. 2000).

- II. Did the Trial Court err as a matter of law when it included retained earnings transferred directly to TK Investments as Appellant's gross income for purposes of calculating child support?

The ruling below: The district court included distributions transferred on behalf of Appellant to TK Investments as income for child support purposes.

Apposite Authorities:

Minn. Stat. § 518A.29; Minn. Stat. § 518A.30; Minn. Stat. § 518A.43

Hubbard County Health and Human Services v. Zacher, 742 N.W.2d 223 (Minn. Ct. App. 2001); Fennell v. Fennell, 753 A.2d 866 (Pa. Super. 2000).

In accordance with Minn. R. Civ. App. Pro. 128.02, subd. 1 (b) (1) and 1 (b) (3), Appellant certifies that both of the issues appealed herein were raised in connection with the post decree motion hearing on January 26, 2011 and the resulting decision issued on May 6, 2011. Appellant's Notice of Appeal to the Court of Appeals was filed within 60 days after service of the Notice of Filing.

STATEMENT OF THE CASE

This appeal results from a post decree child support modification action pursuant to Minn. Stat. Chapter 518A. Appellant Kathy Lynn Haefele (hereinafter “Mother”) and Respondent Douglas Alan Haefele (hereinafter “Father”) have three children, [REDACTED], who is 15 years old, and twins, [REDACTED] and [REDACTED], who are 12 years old. The parties’ marriage was dissolved by stipulated Findings of Fact, Conclusions of Law, Order for Judgment, and Judgment and Decree, entered on December 15, 2000 (hereinafter “Judgment and Decree”). (Appendix (hereinafter “APP.”) 1-21). Mother was awarded sole physical custody of the children, subject to Father’s right to reasonable visitation, and Father was ordered to pay \$1,794 per month in guidelines child support. (APP. 9-11).

On September 29, 2010, Father served Mother with a motion to modify his basic child support and medical support obligations. (APP. 24-25). The Honorable Anne K. McKeig, Judge of Hennepin County, Fourth Judicial District, was assigned as the judicial officer. After a hearing on the matter, a decision was issued on May 6, 2011. (Addendum (hereinafter “ADD.”) 1-27). Father’s counsel served Notice of Filing on Mother’s counsel on May 10, 2011. (APP. 29).

This appeal followed, by Mother filing a Notice of Appeal and Statement of the Case on July 8, 2011. (APP. 29).

STATEMENT OF FACTS

The parties' marriage was dissolved by stipulated Judgment and Decree entered on December 15, 2000. (APP. 1-21). The parties have three minor children. (ADD. 1). Mother has primary physical custody of the children (79% parenting time), subject to Father's parenting time (21% parenting time). (ADD. 1; Confidential Appendix (hereinafter "CA." 2)). When the Judgment and Decree was entered, Father had a gross annual salary of \$108,000, plus the potential for bonus income. (APP. 4). Based on the fact that Mother had primary physical custody, Father was ordered to pay \$1,794 per month pursuant to the then-existing child support guidelines, plus a portion of any bonus received, which was further defined in the Judgment and Decree. (APP. 9-11).

On September 29, 2010, Father filed a motion to modify his basic child support and medical support obligations. (ADD. 2; APP. 24-25). Minnesota child support guidelines were changed as of January 1, 2007, while Father's initial child support obligation in the Judgment and Decree was calculated pursuant to the law in effect prior to 2007. (APP. 10-11). Under the pre-2007 law, only Father's income was taken into consideration for calculating support because Mother had sole physical custody. (ADD. 3). Under the new child support law, regardless of the label of physical custody, both parties' incomes are taken into consideration, as well as the percentage of parenting time exercised by the non-custodial parent. (Id.).

The parties agreed that Father's current gross annual income is \$178,056, or \$14,838 per month, which represents a base salary of \$166,389 and a three-year average

bonus income of \$11,667. (Id.). The parties further agreed that Father has parenting time with the children between 10% and 45% of the time. (ADD. 20). Both parties acknowledged that Father's child support obligation should be reduced, but they did not agree on the amount of the reduction because they did not agree on Mother's gross annual income. (ADD. 3-5).

The parties' disagreement regarding Mother's income was significant. (ADD. 3). Father claimed that Mother's annual gross income was \$1,759,252, or \$146,604 per month (based on a 3-year (2007 through 2009) average), whereas Mother maintained that her annual gross income was \$146,947, or \$12,246 per month (based on a 3-year (2007, 2009, and 2010) average).¹ (ADD. 5). The district court agreed that an average income should be used, calculating Mother's income between 2007 and 2009. (ADD. 16; 20). Mother has not appealed the inclusion of her 2008 income, and as a result, Mother's proposed gross annual income for years 2007 through 2009 is \$323,265, or \$26,939 per month. ($\$214,986 + \$662,199 + \$92,612 = \$969,797 / 3 \text{ years} = \$323,265 / 12 \text{ months} = \$26,938.75$). (CA. 15).

As will be explained further below, there are no factual disputes regarding the amounts distributed to or for Mother from her business interests. Rather, there are two legal disputes regarding whether two different types of S Corporation distributions should

¹ The parties agreed that the district court should use a three-year average for calculating Mother's gross income. (ADD. 15-16). Father claimed that 2010 income information should not be included because he did not have complete 2010 information. (ADD. 15). Mother argued that the district court should average 2007, 2009, and 2010 information, and exclude 2008 information because the distributions made to Mother in 2008 were an aberration due to the high gross sales of Dura-Supreme and they were not consistent with the distributions made prior to or following 2008. (ADD. 15; CA. 7; 21-22).

be included as income for child support purposes. When the Judgment and Decree was entered, Mother was not employed outside the home but she was receiving income and distributions from two non-marital, family-owned businesses, Dura-Supreme, Inc., (“Dura-Supreme”) and Howard Lake Properties, LLC (“Howard Lake”). (APP. 3-4). The parties agreed that Mother’s income and distributions from her ownership interests, in excess of applicable income taxes, totaled \$48,000 per year. (Id.).

Mother still has ownership interests in the family-owned businesses of Dura-Supreme and Howard Lake Properties and since the Judgment and Decree was entered, another family-owned entity, TK Investments, LLC, (“TK Investments”) has been formed. (CA. 2-3). The district court found that the distributions from Howard Lake Properties for years 2007 through 2009 averaged \$21,966 per year. ($\$53,628 + \$9,996 + \$2,275 = \$65,899 / 3 \text{ years} = \$21,966$). (ADD. 20). The district court further found that there had been no distributions from TK Investments. (Id.). The parties agreed on the amount of Mother’s interest and dividend income received in those years. (ADD. 20; CA. 15;35).

The parties’ positions regarding Mother’s income from Dura-Supreme are vastly disparate, with their respective numbers resulting in a difference of approximately \$1,400,000 as Mother’s annual three-year average income (\$323,265 claimed by Mother versus \$1,759,252 claimed by Father). Two primary reasons explain the large difference between Mother’s and Father’s suggested income figures: (1) Between \$1,000,000 and \$1,600,000 each year (2008 and 2009) was transferred directly from Dura-Supreme to

TK Investments (or from Dura-Supreme to a trust, which thereafter transferred the funds directly to TK Investments) and as a result, Mother claims it is not gross income for child support purposes, whereas Father claims that these amounts were distributions, regardless of whether the funds were available to Mother, and they should be included as her income; and, (2) Father argues that the tax distributions received by Mother, solely for the purpose of paying her pro-rata share of Dura-Supreme's pass-through income, should be included as gross income for purposes of calculating child support and Mother argues that the tax distributions are not gross income because they are proper business expenses required for the necessary operation of the business. (CA. 2-3; 15; 17-21; 34). The district court agreed with Father and included both types of distributions as income for child support purposes. (ADD. 10; 12).

Mother is a minority shareholder of Dura-Supreme, which she owns with her two brothers, Keith and Kevin. (CA. 2; 11). Keith is the majority shareholder and President of the company. (Id.). He is in control of the day-to-day operations at Dura-Supreme and has full authority to make (or not make) distributions to all of the shareholders. (CA. 11-12). (If distributions are made to its shareholders, the company is required by law to make those distributions to each shareholder pro-rata based on their ownership interest.) Mother has never been involved with the business operations and it is undisputed that she is merely a passive investor with no control or authority to make distributions. (CA. 2).

Regarding the distributions transferred to TK Investments, Dura-Supreme's Chief Financial Officer explained that the company's business goal is to reach sales in excess of

\$150,000,000 and he and other members of the Dura-Supreme operation team believe that the current facilities' capacity is approximately \$125,000,000. (CA. 7-10). As a result, they intend to expand into additional facilities. (Id.). The company began this expansion plan in 2008. (CA. 8). In order to fund the future growth, the company reached out to several lending institutions for borrowing. (Id.). The company ultimately obtained a line of credit with Wells Fargo, which is capped at \$3,000,000. (Id.). In order to obtain this line of credit, without requiring the shareholders to sign a personal guaranty, Dura-Supreme's negotiating leverage was longevity, stability, and cash reserves. (Id.). The company "tightened" its belt and also made significant improvement in its receivable collections. (CA. 9). These funds will be used for the purchase of future equipment and facility expansions. (Id.). The district court found that these are all proper business reasons to support the retention of the company's earnings, had they been retained by the Dura-Supreme. (ADD. 9). Father did not submit anything to refute this evidence.

Dura-Supreme's corporate earnings were not retained in the company. Instead, they were transferred to a new corporate entity. Keith Stotts, Dura-Supreme's President, its corporate legal counsel and its audit firm recommended that the "excess" cash reserves, which were being retained for the future expansion of Dura-Supreme, be moved to another entity as a means of lowering its exposure to risk of unknown corporate liabilities. (CA. 2-3). As a result, TK Investments was formed, with Mother, Keith, and Kevin each owning one-third of the entity. (CA. 3; 11-12). Although Mother and Kevin

are each one-third owners of TK Investments, Keith has 100% of the voting rights. (CA. 12).

Before making the distributions from Dura-Supreme and transferring them to TK Investments (with the first distribution occurring in 2008), Keith Stotts told Mother that Dura-Supreme's corporate earnings needed to be transferred from Dura-Supreme for the company's success and protection. (CA. 2-3). Mother agreed that she would not use any of these funds and that they would be transferred to TK Investments. (CA. 3). Keith Stotts affirmed that but for the TK Investments structure in place, the "excess" distributions to Mother in 2008 and 2009 would not have been made and instead, they would have been retained within Dura-Supreme for the future expansion. (CA. 12). There was no dispute regarding these facts.

The district court agreed that transferring these funds to TK Investments was not an attempt by Mother to avoid her child support obligation. (ADD. 9). Despite these clear and undisputed facts, the district court found that Mother had a choice whether to transfer the funds to TK Investments. (ADD. 10). As a result, the distributions transferred to TK Investments (\$1,600,000 in 2008 and \$1,090,000 in 2009) were included as Mother's gross income. (ADD. 4; 10).

The other issue on appeal relates to tax distributions made to Mother in order to pay the tax liability relating to her share of Dura-Supreme's pass-through income. As a subchapter S Corporation, Dura-Supreme does not pay corporate-level taxes on its

income and, instead, taxes on the corporation's income are passed through to its shareholders based on their pro-rata ownership of the corporate stock. (ADD. 10-11). To pay the income taxes, Dura-Supreme makes tax distributions to its shareholders. (ADD. 10; CA. 15). Mother (and the other shareholders) receives distributions so that she can pay the taxes on her pro-rata share of Dura-Supreme's pass-through income not available to her. (CA. 15).

Mother argued that the payment of a business' taxes is an ordinary and necessary expense required for business operation, and as a result, it must be deducted from Mother's total distributions in order to calculate her gross income for child support purposes. (ADD. 10; CA. 20-21). Father followed the same logic as he suggested regarding the TK Investments transfers and claimed that because the funds were distributed to Mother, regardless of whether the distributions related to funds that were never distributed to or available to Mother, those amounts should be included as her gross income. (ADD. 11).

Although payment of income taxes is an ordinary and necessary business expense and as a result, tax distributions made for the sole purpose of paying taxes on Dura-Supreme's pass-through income should not be included as gross income, the district court found that the tax distributions were Mother's gross income for calculation of child support. (ADD. 12).

The district court found that Mother's three-year average (2007 through 2009) gross income is \$1,679,380.60 and calculated guidelines child support based on that

amount and Father's gross income of \$178,056. (ADD. 3; 20). In addition, the district court computed Mother's medical support obligation based on the amounts paid by Father for the children's medical and dental insurance coverage. (ADD. 20). As a result, Father's basic child support obligation is \$281 per month and Mother's medical support obligation is \$395 per month. (ADD. 20-22). Offsetting these two obligations results in Mother, the primary custodian of three children, who cares for them 79% of the time, owing Father \$114 per month. (ADD. 22).

ARGUMENT

Standard of Review

The two issues appealed by Mother relate to specific sources of funds and whether those sources should be considered as gross income for purposes of calculating child support. The Supreme Court decision in Gully holds that the standard of review in child support cases is whether the district court abused its discretion. Gully v. Gully, 599 N.W.2d 814, 820 (Minn. 1999); Rutten v. Rutten, 347 N.W.2d 47, 50 (Minn. 1984). Before a court will find that the district court abused its discretion, there must be a clearly erroneous conclusion that is against logic and the facts on record. Id.; Davis v. Davis, 631 N.W.2d 822, 826 (Minn. Ct. App. 2001). Discretion is also abused if the district court misapplies the law. Ver Kuilen v. Ver Kuilen, 578 N.W.2d 790, 792 (Minn. Ct. App. 1998).

When an issue on appeal involves the determination of the amount of an obligor's income for child-support purposes, which is a finding of fact, it will not be altered unless it is clearly erroneous. Ludwigson v. Ludwigson, 642 N.W.2d 441, 446 (Minn. Ct. App. 2002). Whether a source of funds is considered to be income for child-support purposes is a legal question reviewed *de novo*. Sherburne Cnty. Soc. Servs. ex rel. Schafer v. Riedle, 418 N.W.2d 111, 112 (Minn. Ct. App. 1992). Whether a distribution from a subchapter-S Corporation should be treated as income for child support purposes is

generally treated as a question of fact. Williams v. Williams, 635 N.W.2d 99, 103 (Minn. Ct. App. 2001).

The issues appealed by Mother pose legal questions versus fact questions. In fact, both issues appealed by Mother are matters of first impression in Minnesota. In cases where the Court is making the determination whether S Corporation distributions should be included as income for child support, the Court has looked at the degree of control held by the obligor. (Compare Roth v. Roth, 406 N.W.2d 77, 79 (Minn. Ct. App. 1987) (finding error where the district court failed to include profits from an S Corporation in which the obligor was the sole officer and shareholder), with Marx v. Marx, 409 N.W.2d 526, 529 (Minn. Ct. App. 1987) (affirming district court's decision to exclude losses from three S Corporations in which the obligor was involved).

There is no question of fact regarding Mother's control, or lack thereof, over Dura-Supreme or TK Investments. She is a minority shareholder and does not control if or when distributions are made. (CA. 2; 11-12). In addition, there are no questions of fact pertaining to the reasons why the Dura-Supreme earnings have been transferred to TK Investments. (ADD. 9). The district court found that these transfers occurred for legitimate business purposes. (Id.). Further, not even Father claims that Mother is attempting to avoid a child support obligation and, in fact, the district court found that she was not trying to avoid any obligation. (Id.). As there are no disputed facts in this matter, this Court must determine as a matter of law, whether either type of distribution described below should be included as a source of income for purposes of calculating child support.

I. THE DISTRICT COURT ERRED AS A MATTER OF LAW WHEN IT INCLUDED THE TAX DISTRIBUTIONS MADE TO MOTHER, WHICH WERE MADE FOR THE SOLE PURPOSE OF PAYING MOTHER'S PRO-RATA SHARE OF THE CORPORATE PASS-THROUGH INCOME NOT RECEIVED BY HER, AS MOTHER'S GROSS INCOME.

Case law from other jurisdictions already relied upon by this Court in making similar decisions, indicates that tax distributions made for the payment of S Corporation pass-through income tax liability should not be included as income for purposes of calculating child support.

Dura-Supreme does not pay corporate-level taxes on its income because it is an S Corporation and, as a result, taxes on the corporate pass-through income are taxed individually to its shareholders (Keith, Kevin, and Mother) based on their pro-rata ownership of the corporate stock. See I.R.C. §§ 1363; 1366 - 1368. The shareholders are taxed on their pro-rata share of the company's income regardless of whether the shareholders actually receive the distributions. Id. Dura-Supreme makes tax distributions to its shareholders so that the shareholders are able to pay taxes on their pro-rata share of Dura-Supreme's retained earnings (earnings not distributed to the shareholders and thus, not available for child support purposes).² (CA. 13-15).

As set forth in Exhibit A of Garry McCreary's (the corporate tax planner and accountant for Dura-Supreme and TK Investments and Mother's personal accountant) Affidavit, Mother received the following tax distributions in years 2007 through 2009,

² For example, if a Subchapter S corporation, in which a person has a 25% ownership interest, has \$1,000,000 in income, yet the shareholder receives only \$50,000 in distributions, the shareholder will still be responsible for paying taxes on \$250,000 (25% of the total \$1,000,000 income). In situations such as these, the company will make a further distribution to the shareholder, in addition to the \$50,000 already received, so that they can pay the taxes on the \$200,000 that they did not receive.

which relate to funds not received or available to Mother versus taxes on the distributions received by Mother and available for child support:

	<u>2007</u>	<u>2008</u>	<u>2009</u>
Total tax distributions	\$777,800	\$567,500	\$254,650
Less tax distributions on cash actually received by Mother	<u>(\$45,559)</u>	<u>(\$166,877)</u>	<u>(\$9,169)</u>
Tax distributions relating to pass-through income only	\$732,241	\$400,623	\$245,481

Tax distributions average for years 2007 - 2009: \$459,448 per year (\$1,378,345 / 3 years)

(CA. 13-15).

These tax distributions should not be included as Mother's gross income. This issue is one of first impression in Minnesota. Although this Court has not addressed the specific issue, other jurisdictions, jurisdictions which this Court looked to in deciding a different matter of first impression but are related to this issue, have decided this issue. In fact, specific decisions this Court relied upon in making prior decisions have addressed this exact issue. Analysis of these decisions leads to the conclusion that tax distributions are not income for child support purposes and to include those distributions as income, is an error of law.

When this Court first determined whether a minority shareholder's pro-rata portion of an S Corporation's retained earnings should be included as income for purposes of calculating child support, it looked to other jurisdictions for guidance. The seminal Court of Appeals case, Hubbard County Health and Human Services v. Zacher,

addressed that specific issue for the first time in Minnesota. 742 N.W.2d 223 (Minn. Ct. App. 2007). The Court in Hubbard analyzed and relied upon cases from Kansas, Florida, and Indiana in determining the factors to be considered in deciding whether retained earnings should be included as income for child support purposes. Those same jurisdictions (and even some of the same cases) also decided whether tax distributions are a source of income for child support purposes. This Court should again rely on these decisions in determining this issue in Minnesota.

The Kansas Supreme Court, in Brand v. Brand, specifically addressed this issue. 44 P.3d 321 (Kan. 2002). In Brand, distributions of approximately \$40,000 per year were made for payment of the taxes due on the shareholder spouse's pass-through income. Id. at 324. The tax distribution amount was based upon an accountant's recommendations to the shareholders. The company retained all of its income and the only distributions made were to reimburse the shareholders for their tax liabilities from their pass-through income. Id.

The Kansas district court determined that the shareholder spouse's tax distributions were not income for child support purposes because those funds were not received (since they were used to pay taxes on pass-through income not received by the shareholder) and that these funds would not have been available to the parties for support if the parties' marriage was still intact. Id. at 324-25. The Kansas Supreme Court agreed and affirmed the district court's decision, finding that where complicated business and tax status applies, S Corporation income reflected on the individual's tax return may not represent the true amount of cash or benefit that may be available to the parent for

support. Id. at 327. In addition, the Supreme Court noted that the child support obligor was not abusing the S Corporation status and trying to use it as a shield to avoid child support. Id. If a shareholder spouse receives tax distributions relating to distributions actually received and paid out to the shareholder, plus tax distributions for pass-through income, only the tax distributions on distributions actually received should be considered as income to the shareholder spouse for purposes of calculating child support. See In re Marriage of Matthews, 193 P.3d 466, 471 (Kan. Ct. App. 2008); In re the Marriage of Unruh, 88 P.3d 1241, 1246 (Kan. Ct. App. 2004).

In Hubbard, this Court looked at Brand for guidance on the issue of whether retained earnings should be considered as income of a minority shareholder for child support purposes, and it should follow Brand here on this question, which is an extension of the first issue

Other courts have found similarly, noting that if there is not an issue of a shareholder using the S Corporation status as a shield against child support, then the court should look to policy concerns, such as the parent's ability to pay child support based on these distributions. In Fennell v. Fennell, the Superior Court of Pennsylvania (one of two intermediate appellate courts in Pennsylvania) analyzed a business owned by husband, his brother, his father, and an unrelated individual. 753 A.2d 866, 868-69 (Pa. Super. 2000). In Fennell, the husband's distributions were made only to pay taxes on pass-through income and that had been the practice of the corporation prior to the parties' separation. In addition, there was no finding that the father was attempting to shield his income in order to avoid his child support obligation. Id.

The Pennsylvania Superior Court stated that when considering income in a divorce situation, “income must reflect actual available financial resources and not the oft-time fictional financial picture” created by the application of the federal tax laws. Id. at 868. The Pennsylvania Court noted that deductions or losses on corporate books are irrelevant to the calculation of available cash unless they reflect an actual decrease of available cash and that “all benefits flowing from the corporate ownership must be considered in determining income available to calculate a support obligation,” including perks, entertainment and automobile expenses, and cash. A person cannot manipulate their income by receiving perks or corporate expenditures, but “by the same token, however, [the Court] cannot attribute as income funds not actually available to or received by the party.” Id. In Fennell, the Pennsylvania Court found that because there was no inference of a manipulation of S Corporation income as a shield against child support, it was error to include these tax distributions when determining child support. Id. at 869.

Fennell was analyzed by the Kansas Court in making its decision in Brand regarding retained earnings (pass-through income) and tax distributions, which, again, was relied upon by this Court in Hubbard in making its decision. Florida applies the same rationale when it comes to tax distributions. In Hubbard, this Court relied on Florida law in making its decision and analyzed Zold v. Zold, which cited McHugh v. McHugh. 911 So.2d 1222, 1231-33 (Fla. 2005); 702 So.2d 639 (Fla. Ct. App. 1997).

In McHugh v. McHugh, the husband was a 10% owner of an S Corporation and received \$124,000 to pay the S Corporation’s tax liability. 702 So.2d at 641. The wife sought to include the tax distributions when determining child support but the Florida

Court of Appeals upheld the district court's rejection of wife's request. This was a legitimate business expense, the funds were not received by the husband and available for support, and there was no issue of the husband using the S Corporation as a shield to avoid child support. Id. at 641-42.

Indiana courts have also addressed the issue and came to the same conclusion as Kansas, Pennsylvania, and Florida courts. See Tebbe v. Tebbe, 815 N.E.2d 180 (Ind. Ct. App. 2004). Tebbe was another case relied upon by this Court in making the Hubbard decision. The Court in Tebbe found that disbursements made to a shareholder which only compensate that shareholder for the tax liability associated with S Corporation pass-through income should be disregarded for purposes of calculating child support. Id. at 184. The court there reasoned that had the corporation not disbursed money to offset the shareholder's corporate tax liability, the shareholder spouse's actual income would have been less than represented by his salary or distributions. Id. 183-84.

This Court relied upon Kansas, Pennsylvania, Florida, and Indiana law in developing Minnesota law regarding retained earnings and whether retained earnings should be included as a minority shareholder's income for child support purposes. This Court should look to these same cases and jurisdictions in making its decision regarding tax distributions.

Taxes paid by an S Corporation shareholder toward their pro-rata share of the corporate retained earnings (pass-through income) are ordinary and necessary expenses required for business operation.

Subchapter S Corporation and Subchapter C Corporation shareholders should be treated the same, when calculating income for child support. The district's court decision

to include Mother's tax distributions for her pro-rata share of the retained earnings results in disparate treatments between Subchapter S and C shareholders. Pursuant to Minn. Stat. § 518A.30, income from the operation of a business is defined as gross receipts minus costs of goods sold minus ordinary and necessary expenses required for business operation. Clearly, the payment of a business' taxes is an ordinary and necessary expense required for business operation.

If Dura-Supreme were a C Corporation, Dura-Supreme (versus Mother and other Dura-Supreme shareholders) would have paid the taxes on the company's earnings. In order to determine Mother's income from Dura-Supreme (again, assuming that it was a C Corporation), the taxes would have been paid by Dura-Supreme at the corporate level as an ordinary and necessary expense and deducted from its gross receipts prior to any distribution to Mother. Simply because the corporate structure requires the shareholder (Mother here) to pay her pro-rata share of the company's taxes, as opposed to Dura-Supreme paying the taxes itself, should make no difference. Payment of income taxes is a legitimate and proper business expense and must be deducted from Mother's total distributions in order to calculate her gross income for child support purposes.

This Court has found that total disregard of a depreciation deduction when considering one's business or self-employment income is reversible error. See Stevens County Social Services Department ex rel. Banken v. Banken, 403 N.W.2d 693, 697

(Minn. Ct. App. 1987).³ If a tax deduction for depreciation is deemed an ordinary and necessary business expense to be deducted from gross receipts in calculating one's self-employment or business income, it is undeniable that the payment of income taxes on corporate income that is not distributed is an ordinary and necessary business expense.

Notwithstanding the language of Minn. Stat. § 518A.30, the district court erroneously found that the tax distributions should be included as Mother's gross income for child support purposes. (ADD. 12). The district court reasoned that to do otherwise, would result in child support being calculated based on Mother's net income. (*Id.*). The district court was flat wrong. Mother's tax distributions, used to pay taxes on corporate earnings not received by her (including funds directly transferred to TK Investments), are legitimate business expenses. As an ordinary and necessary expense required to be paid even on income not received, these tax distributions should not be included as income to Mother.

Whether a corporation's structure is an S or C Corporation should make no difference when calculating a shareholder's income for child support purposes. Regardless of whether the shareholder or the company pays taxes on earnings, taxes need to be paid even if distributions of other income are not made. Mother's receipt of tax distributions to pay taxes on her pro-rata share of the company's pass-through income, should not be included as income for purposes of calculating child support.

³ Although this case pre-dates the new child support guidelines, which became effective in 2007, this case has been cited for the same proposition in post-2007 cases where self-employment or business income must be determined. See Reuter v. Reuter, 2008 WL 2102598 (Minn. Ct. App. May 20, 2008). (APP. 30-32).

Mother's receipt of tax distributions to pay her taxes on her pro-rata share of Dura-Supreme's pass-through income should not be considered when determining child support, as they do not increase her ability to support the children, and she is not attempting to shield any child support obligation.

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. 2003). The tax distributions made to Mother are not a resource available to her for purposes of supporting the parties' children and she has no ability to pay support based on those distributions. The end result after paying taxes is zero dollars. It would be inequitable to require Mother to pay child support based on non-existent income.

Further, it is uncontroverted that Mother is not attempting to shield income for purposes of avoiding any child support obligation. (ADD. 9). Mother agrees that her 2007 through 2009 average annual gross income (not including tax distributions or the funds transferred to TK Investments, as detailed further herein) is \$323,265. (CA. 15). This income is more than two and one-half times that of Father. Clearly, she is not attempting to avoid any child support obligation. Rather, child support must be appropriately and equitably calculated, which can only be done if Mother's gross income is the correct amount.

The district court's inclusion of tax distributions made to Mother for her pro-rata share of Dura-Supreme's retained earning was an abuse of discretion and its decision must be reversed and remanded. Minnesota law and other jurisdictions upon which this Court has relied in making decisions regarding S Corporation distributions and retained

earnings, clearly show that tax distributions are not income for child support purposes.

Such distributions should be excluded as income or a resource for child support purposes.

II. THE DISTRICT COURT ERRED AS A MATTER OF LAW WHEN IT FOUND THAT DURA-SUPREME'S RETAINED EARNINGS THAT WERE TRANSFERRED TO TK INVESTMENTS AND NOT AVAILABLE TO MOTHER WAS GROSS INCOME FOR PURPOSES OF CALCULATING CHILD SUPPORT.

Retained earnings of an S Corporation, which are transferred to another entity for a proper business reason and thus, are unavailable to the minority shareholder, should not be included as income for purposes of calculating child support.

This Court also has not addressed this issue. The district court found that the distributions made on behalf of Mother directly to TK Investments (which were essentially retained earnings transferred from one entity to another for a proper business purpose), which were never available to Mother, were gross income to Mother. (ADD. 9). These distributions were considered as income, despite the fact that the district court found that the reasons for the funding of TK Investments with Dura-Supreme retained earnings was legitimate and not an attempt on Mother's part to avoid a child support obligation. (*Id.*). It is clear that if the retained earnings had remained within Dura-Supreme, the district court would not have included those amounts as Mother's income. The district court focused on form over substance and that focus has resulted in an unfair and inequitable result, requiring the primary custodian of three children, who cares for them 79% of the time, to pay the non-custodial parent child support each month.

The analysis adopted by this Court in Hubbard County Health and Human Services v. Zacher should be extended to this case. 742 N.W.2d 223 (Minn. Ct. App.

2001). This Court held that undistributed earnings of a Subchapter S corporation that have been retained for a business reason are not income to a minority shareholder for the purpose of establishing a child support obligation. Id. In Hubbard, the child support obligor was employed by a company that was owned by himself, his brother, and his father. Id. at 225-26. The obligor was a minority shareholder and had no authority to force a distribution of the company's earnings. Rather, the obligor's father as the majority shareholder had the authority to make distributions. Despite this evidence, the district court included the obligor's share of the company's earnings as "a regular source of income." This Court reversed. Id. at 229.

Hubbard is factually similar to this matter. Here, Mother is a minority shareholder of Dura-Supreme, which she owns with her two brothers, Keith and Kevin. (CA. 2-3). Keith is the majority shareholder and President of the company. (CA. 2). He is in control of the day-to-day operations at Dura-Supreme and has full authority to make (or not make) distributions to all of the shareholders. (CA. 2; 11-12). Mother has never been involved with the business operations and there is no question that Mother is merely a passive investor with no control or authority to make distributions. (Id.). If Dura-Supreme's retained earnings remained within Dura-Supreme, these amounts could not be included as Mother's income for the purpose of calculating child support, provided that there is a business reason for that retention.

The next inquiry surrounds the purpose behind the retention of Dura-Supreme's earnings in the company. Whether undistributed earnings of a Subchapter S corporation have been retained for a business reason is a fact question which must be decided on a

case-by-case basis. Id. Here, the district court found that the following reasons provided by Mother in explaining the transfer of Dura-Supreme's retained earnings to TK Investments, were legitimate. (ADD. 9). Father did not appeal these findings.

First, as explained by Gene Schweiss, Dura-Supreme's Chief Financial Officer, the company's business goal is to reach sales in excess of \$150,000,000. Its highest year was in 2007, when the company earned gross sales of \$89,000,000. Those gross sales decreased to \$52,800,000 in 2009 and slightly increased in 2010. (CA. 7-8).

Gene Schweiss and other members of the Dura-Supreme operation team believe that the current facilities capacity is approximately \$125,000,000. As a result, they intend to expand into additional facilities. The company began this expansion plan in 2008 by negotiating a three-year lease of vacant property in Pierz, Minnesota. Management has also toured a couple of other sites in Pierz and Little Falls and has been in contact with the Economic Development Team in Little Falls. (CA. 8).

Second, in order to fund the future growth, the company contacted several lending institutions and discussed borrowing. The company ultimately obtained a line of credit with Wells Fargo, which is capped at \$3,000,000. In order to obtain this line of credit, without requiring the shareholders to sign a personal guaranty, Dura-Supreme's negotiating leverage was longevity, stability, and cash reserves. (Id.).

Third, the company "tightened" its belt and also made significant improvement in its receivable collections. These funds will be used for the purchase of future equipment and facility expansions. (CA. 9).

The district court agreed that the transfer of the Dura-Supreme earnings to TK Investments was done for these proper business reasons. (ADD. 9). Without a doubt, had the retained earnings remained in Dura-Supreme, the district court would not have included these amounts as Mother's income.

Dura-Supreme's corporate legal counsel and its audit firm recommended that the "excess" cash reserves, which were being retained for the future expansion, be moved to another entity as a means of lowering Dura-Supreme's corporate retained earnings exposure to risk of unknown corporate liabilities. As a result, TK Investments was formed, with Mother, Keith, and Kevin each owning one-third of the entity. Although Mother and Kevin are one-third owners of TK Investments, Keith has 100% of the voting rights. (CA. 12). Mother has no control over the manner in which the funds within TK Investments are used or not used, just as she has no control over the Dura-Supreme distributions. (CA. 11-12).

Another reason for the formation of TK Investments was to provide Dura-Supreme with the ability to borrow funds from TK Investments at a more favorable interest rate than a financing company, while greatly decreasing the retained earnings risk. The company must first exhaust the funds within TK Investments before borrowing on the Wells Fargo line of credit. (CA. 9).

With 100% of the voting rights, Keith is able to fully authorize any necessary lending from TK Investments, which was anticipated from the beginning. But for the TK Investments structure in place, the "excess" distributions to Mother (and the other shareholders) in 2008 and 2009 would not have been made and instead, they would have

been retained within Dura-Supreme for the future expansion. (CA. 11-12). As a result, these transfers of corporate retained earnings to TK Investments should not be considered as Mother's income.

Mother had no control over the distributions made by Dura-Supreme and she was required to allow the direct transfer of those funds to TK Investments.

Despite the district court's findings regarding the proper business purpose behind the transfer of funds to TK Investments, it found because a distribution was made by Dura-Supreme to Mother, she had a "choice" as to whether to transfer those funds to TK Investments and, consequently, those amounts are income to her. (ADD. 8). The district court's analysis was not complete. The district court relied on the language of the TK Investments Member Control Agreement, which does not set forth any requirement that Mother (or the other members) contribute Dura-Supreme distributions into TK Investments. (Id.). Although the district court's recitation of this language is accurate, it ignored the undisputed evidence from Dura-Supreme's majority shareholder and President, Keith Stotts. But for Mother's agreement to allow Dura-Supreme to directly transfer her share of the retained earnings to TK Investments for the business expansion purposes, the distributions made in 2008 and 2009 would not have been made and the earnings would have been retained within Dura-Supreme. (CA. 12).

Although legally, Mother may have had the ability to demand that she be allowed to retain the 2008 distribution for her own personal use, it is clear beyond question that Dura-Supreme would not have made any additional distributions in future years and, instead, those amounts would have been retained by Dura-Supreme. (Id.). Mother was

required by her brother, the Dura-Supreme majority shareholder, to cooperate with direct transfer of the Dura-Supreme retained earnings to TK Investments. She had no control over these distributions and had she gone back on her agreement for the transfer to TK Investments, the distributions would not have been made.

Mother did not transfer her share of Dura-Supreme's retained earnings to TK Investments in an attempt to avoid a child support obligation.

Minnesota courts recognize the potential for a shareholder to manipulate income to avoid or reduce child-support obligations, but the formation of TK Investments was started and completed long before Father advised Mother that he wanted to modify his child support obligation. See Williams v. Williams, 635 N.W.2d 99, 103 (Minn. Ct. App. 2001). The creation of TK Investments was clearly not an attempt by Mother to avoid her child support obligation because under the Judgment and Decree, she had no child support obligation. The district court agreed that Mother had not done anything in any attempt to avoid child support. (ADD. 9).

To require the primary custodian to pay the non-custodial parent child support based on income not available to her and is, instead, a transfer of assets, creates an unfair and unreasonable result.

As a result of the district court's order, Mother is required to pay Father child support each month. This result is not only unfair when Mother has parenting time 79% of the time, but totally unreasonable because the support was based on income not available to her.

As discussed in the argument about tax distributions, "income must reflect actual available financial resources and not the oft-time fictional financial picture" created by

the application of the federal tax laws. Fennell v. Fennell, 753 A.2d 866, 868-69. In order to accomplish Dura-Supreme's legal and audit teams' goal of removing the excess "cash reserves" or retained earnings, those funds were required to be distributed to shareholders before they could be transferred to TK Investments. Although Dura-Supreme made distributions to Mother for the transfer to TK Investments (and for tax distributions), they were never available to her to support herself and the children. The distributions in 2009 and 2010 were made directly from Dura-Supreme to TK Investments. (CA. 3). In 2008, the distribution was first made to a revocable trust, as TK Investments had not yet been formed and immediately upon completion of the formation, the funds were transferred to TK Investments. (Id.).

Further, the primary goal behind the amendment to the child support laws in 2007 was to "create a more fair and equitable child support guideline." See The New Income Shares Model for Calculating Child Support in Minnesota by State Senator Tom Neuville, Family Law Forum, Winter 2006, Volume 15, No. 1. (APP. 33-36). It is not a fair and equitable result for a 79% of the time primary custodian to be required to pay child support to the non-custodial parent based on phantom income, income that was never available to her.

If this Court agrees that the transfers to TK Investments should be included as Mother's gross income, a downward deviation in child support is required to accomplish a just and equitable result.

If this Court determines that the earnings transferred to TK Investments are gross income to Mother, despite the legitimate business reasons behind the transfer and the undisputed evidence that Mother is not attempting to avoid a child support obligation,

and that the tax distributions are not ordinary and necessary business expenses, then a deviation to guidelines child support should be made. (APP. 22). Minn. Stat. § 518A.43 allows a court to deviate upward or downward from the presumptive child support obligation and, in doing so, requires a court to take into consideration that party's specific circumstances or resources. Here, although Mother's tax returns may reflect significant income, Mother does not have access to a large portion of those funds. In fact, Mother did not receive a substantial portion the funds in the first place. Instead, they were directly transferred to another business entity to accomplish the proper business goal of expanding Dura-Supreme's business. Dura-Supreme is a closely-held corporation owned by Mother and her two siblings. The transfer of assets from Dura-Supreme to TK Investments should not be considered as a resource for purposes of calculating child support.

In addition, in determining whether a deviation from the guidelines is warranted, the Court is required to look at the standard of living the child would have enjoyed if the parents had remained living together. Minn. Stat. § 518A.43, subd. 1 (3). If the parties were still married, neither the tax distributions nor the funds transferred to TK Investments would be available resources for support of the family. Here, Mother acknowledges that her gross annual income is in excess of \$300,000 and since the parties' dissolution, she has provided the primary care and control of the children. Mother is not attempting to avoid a child support obligation, rather her the income and resources available to her must be considered in calculating child support, not phantom income that is unavailable for purposes of supporting Mother and the children. Upon

remand to the district court, further analysis should be made regarding the income available to Mother to support the children and child support determined thereon.

CONCLUSION

The district court's findings regarding Mother's gross income for child support purposes and resulting child support award to Father are clear error. Tax distributions received for the purpose of making payment toward an S Corporation shareholder's tax liability on pass-through income should not be included as income for support purposes. Although this Court has not made a decision on this precise issue, other jurisdictions (Kansas, Florida, Indiana, and Pennsylvania) that this Court has relied upon in determining factors to be considered when calculating income of an S Corporation minority shareholder, have addressed this issue. All four jurisdictions have found that tax distributions should not be considered as income for support purposes. Further, if tax distributions are included as income, this Court will be treating S Corporation and C Corporation shareholders differently. There is no question that taxes paid by a C Corporation are considered ordinary and necessary expenses required for business operation. The same end result should occur with an S Corporation.

The factors set forth in Hubbard should be extended to this case and the earnings that were transferred to TK Investments should not be included as Mother's income. The district court found that the reasons supporting the transfer of Dura-Supreme retained earnings to TK Investment were legitimate and Mother was not attempting to avoid a child support obligation. It is certain that these earnings would not have been included as Mother's income if they had remained within Dura-Supreme. Mother has no control over

Dura-Supreme distributions and before the majority shareholder made the distributions (which were in turn immediately transferred to TK Investments), he obtained Mother's agreement (and that of the other shareholder, Kevin Stotts) that those specific distributions would be transferred to TK Investments. But for Mother's agreement, the funds would have remained within Dura-Supreme as retained earnings. Once the funds were transferred to TK Investments, Mother's control, or lack thereof, did not change. Dura-Supreme's majority shareholder has 100% of the voting rights for TK Investments.

Neither the tax distributions nor the funds transferred to TK Investments were available to Mother for purposes of paying child support. This Court must reverse and remand the district court's findings regarding Mother's income and resulting child support obligation. Upon remand, the district court should be instructed to look at Mother's current income, not including any amounts transferred to TK Investments or distributions made for payment of Mother's tax liability on her pro-rata share of Dura-Supreme's retained earnings.

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Respectfully submitted,

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