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Child Support for Business Owners Following *Haefele v. Haefele*

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The Supreme Court's decision in *Haefele v. Haefele* (Minn. 2013), changes the landscape in child support litigation involving owners of closely-held businesses. Before *Haefele*, disputes in such cases frequently centered on the availability of the owner's income. The reason for retaining earnings, degree of control, and true cash flow were always topics of inquiry and debate. After *Haefele*, these considerations still matter, but not with respect to calculating income and applying the child support guidelines.

Haefele arose out of a post-decree child support modification, where the central issue in dispute was whether certain subchapter S corporation distributions received by wife constituted her income. Wife had non-controlling interests in three family-owned businesses. She was a 20%



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owner of Dura-Supreme, a one-third owner of Howard Lake Properties and a one-third owner of TK Investments, LLC. On the advice of Dura-Supreme's legal counsel and its audit firm, TK Investments was established by the family to receive Dura-Supreme's cash reserves and serve as a lender for Dura-Supreme in order to facilitate Dura-Supreme's expansion plan. Wife and the other two owners of Dura-Supreme received significant distributions from Dura-Supreme which they, in accordance with TK Investments' Member Control Agreement, transferred to that entity. Wife also received distributions from Dura-Supreme to pay her income taxes on her share of Dura-Supreme's income.

Husband argued that all of wife's distributions should be counted as her gross income for child support. Wife argued that the portion of the distributions from Dura-Supreme that were simply passed through to her and transferred to TK Investments should be considered retained earnings and not income. Wife also argued that the portion of the distributions from Dura-Supreme that were made to cover her income taxes on her share of Dura-Supreme's income should be excluded from her income. The district court focused on the definition of gross income at Minn. Stat. § 518A.29(a) and

held that both types of distributions needed to be included in calculating wife's income for child support.

Wife appealed and the Court of Appeals reversed and remanded for recalculation of child support. In evaluating the nature of the distributions transferred to TK Investments, the Court of Appeals looked to its decision in *Hubbard County Health & Human Services v. Zacher*, 742 N.W.2d 223 (Minn. Ct. App. 2007), which held that corporate motivation and degree of control were crucial considerations in evaluating whether earnings retained by a subchapter S corporation constituted income for child support. Since the distributions earmarked for TK Investments were made for a legitimate business purpose, they were similar to legitimately retained corporate earnings, with wife merely serving as a minority owner conduit to transfer the funds from one entity to another. The analysis of the distributions made to wife solely for payment of her income taxes on her share of Dura-Supreme's income turned on Minn. Stat. § 518A.30, which governs income from self-employment and excludes from such income "ordinary and necessary expenses required for self-employment or business operation." Since a business's tax expenses are ordinary and

necessary expenses for operating a business, the distributions made to wife to pay her income taxes on her share of Dura-Supreme's income should have been excluded from her income for child support.

The Supreme Court reversed the Court of Appeals, and rejected the analysis of *Zacher* as inapposite for two reasons. First, *Zacher* was decided under the 2004 version of the child support statutes which lacked the direction in the existing statutes specifying that income from self-employment included income from joint ownership of a closely held corporation. Second, *Zacher's* focus on corporate motivation in retaining earnings introduced to the analysis of gross income a concept that found no support in the plain language of the child support statutes.

In defining "gross income," Minn. Stat. § 518A.29(a) focuses on whether there has been a "periodic payment to an individual." Although husband argued that all of the Dura-Supreme distributions were periodic payments that satisfied this definition, and wife argued that the distributions were not available payments, both parties' arguments overlooked the key statute, Minn. Stat. § 518A.30 which governs income from self-employment and which is incorporated into the definition of "gross income" at Minn. Stat. § 518A.29(a). Minn. Stat. § 518A.30 establishes a formula for calculating income from self-employment, which does not depend upon whether a payment is periodic and does not depend on whether any payment (distribution) has been made: gross receipts, less cost of goods sold, less ordinary and necessary expenses. Thus, even though both parties had analyzed wife's income by looking at the distributions, the Court of Appeals erred by not applying the statutory

formula to calculate wife's gross income.

The Supreme Court also reversed the Court of Appeals' determination that the distributions made to cover wife's income taxes on her share of Dura-Supreme's income should not be considered in calculating wife's gross income for child support. The district court acted within its broad discretion when it "reasonably concluded" that disallowing a deduction for taxes was necessary in order to calculate a gross income figure for wife because allowing the deduction would have the effect of using an after-tax income figure for wife while using a pre-tax figure for husband. Although the Supreme Court agreed with the district court's reasoning, a remand was necessary on that issue in order to properly apply the entire formula at Minn. Stat. § 518A.30.

The Supreme Court acknowledged that its holding "could have significant potential for unfairness" for owners of closely-held businesses with retained earnings but emphasized that the calculation of child support is a two-step process in which district courts first apply the guidelines and then consider whether to deviate. The result produced by application of the guidelines "is merely a rebuttable presumption" and the statute "requires" a further determination of whether to deviate by considering certain factors. The Supreme Court did not express an opinion on whether a deviation was appropriate, although it noted that the unavailability of funds included in gross income could be a reason to deviate.

Thus, *Haefele* does not end the complexity in child support cases involving owners of closely-held businesses. Rather it shifts the battleground from calculating income in step one to considering whether to

deviate in step two. Control, corporate motivation for retaining earnings, and cash flow are still relevant, but only in terms of considering whether to deviate from the guidelines in step two. By emphasizing that the guidelines are only the first step in any child support analysis and by breathing new life into the often-ignored deviation factors, *Haefele* represents a surprising shift away from the guidelines and introduces an element of uncertainty into all child support cases, not just those involving closely-held businesses.

Disclosure: Alan C. Eidsness and Melissa J. Nilsson represented the wife in Haefele v. Haefele.

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