STATE OF MINNESOTA | TAX COURT

COUNTY OF RAMSEY | REGULAR DIVISION

Hutchinson Technology, Inc.

Appellant,

vs.

Commissioner of Revenue,

Appellee.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER FOR JUDGMENT

Docket Nos. 7398-R
7504-R

Dated: May 10, 2004

The Honorable Sheryl A. Ramstad, Judge of the Minnesota Tax Court, heard this matter, on February 2, 2004, at the Minnesota Tax Court courtroom, 25 Rev. Dr. Martin Luther King, Jr. Blvd., St. Paul, Minnesota.

Walter A. Pickhardt and Lisa R. Pugh, Attorneys at Law, of the law firm Faegre & Benson represented the Appellant

James W. Neher, Assistant Attorney General represented the Appellee, Commissioner of Revenue ("Commissioner").

Both parties filed post-trial briefs and reply briefs. The matter was submitted to the Court for decision on March 23, 2004.

The Court, having heard and considered the evidence adduced at the hearing, and upon all of the files, records and proceedings herein, now makes the following:

Archived Copy

FINDINGS OF FACT

1. Appellant Hutchinson Technology, Inc. ("HTI") is a corporation organized under the laws of Minnesota. HTI's address is 40 West Highland Park Drive, Hutchinson, Minnesota 55350.
2. HTI is a fiscal year taxpayer. Its fiscal year ends on the last Sunday in September. This case involves HTI's fiscal years ended September 1995 through 1999 ("years in issue").
3. During the years in issue, HTI was primarily engaged in the manufacturing of suspension assemblies, which are parts used in computer hard drives to hold magnetic read-write heads at microscopic distances above the hard drive disks. During the years in issue, HTI also engaged in the design and manufacture of medical devices.
4. During the years in issue, HTI had two wholly-owned subsidiaries: HTI Export, Ltd. ("Export") and Hutchinson Technology Asia, Inc.
5. Export was incorporated in 1985 under the laws of the United States Virgin Islands, and on January 23, 1995, Export reincorporated under the laws of Barbados.
6. During the years in issue, Export was a foreign sales corporation ("FSC") under the Internal Revenue Code ("Code").
7. During the years in issue, Export was engaged in a unitary business with HTI as defined in Minn. Stat. § 290.17, subd. 4(b).

Archived Copy

8. During the years in issue, Export did not own or rent any tangible property (as that term is used in Minn. Stat. § 290.191, subd. 10) located within the United States.
9. During the years in issue, Export did not have any payroll (as that term is used in Minn. Stat. § 290.191, subd. 12) attributable to the United States.
10. During the years in issue, Export owned and used outside the United States advertising and sales promotional materials such as brochures, videos, and product samples that it purchased from HTI. These materials were sent to HTI's Singapore office, HTI's China office, HTI's Japanese office, and a European sales representative who resides in the Netherlands. Export distributed these materials to its customers outside the United States. The value of the promotional materials was: 1995 - $2,920.00; 1996 - $3,058.40; 1997 - $2,599.00; 1998 - $1,321.30; 1999 - $5,733.31.
11. During 1999, Export rented office space from Trident Trust in Tortola, British Virgin Islands. HTI initially paid the office rent and was reimbursed by Export.
12. During the 1995 through 1998 fiscal years, Export had one employee, Alan Tay, who worked in Singapore pursuant to a dual employment contract. Mr. Tay was paid a salary for each year of: 1995 - $58,032; 1996 - $57,998; 1997 - $71,903; 1998 - $50,822.
13. On January 7, 1985, HTI and Export entered into an Inter-Company Agreement. On January 23, 1995, HTI and Export entered into a second Inter-Company Agreement. The two agreements (collectively "Inter-Company Agreements") are virtually identical.

Archived Copy

14. Pursuant to the Inter-Company Agreements, Export was appointed as HTI's non-exclusive agent with respect to sales by HTI of products manufactured by HTI that were sold to customers outside the United States during the years in issue.

15. Pursuant to the Inter-Company Agreements, HTI agreed to pay Export a commission for Export's services as non-exclusive sales agent for HTI, and the amount of the commission was to be computed in compliance with Sections 925 and 927 of the Code. HTI calculated the commission under rules set forth in the Code and applicable Treasury Regulations. During the years in issue, HTI paid Export a commission for Export's participation in export sales.

16. Pursuant to the Inter-Company Agreements, HTI served as Export's agent with respect to certain activities relating to selling or arranging for the sale of products manufactured by HTI that were sold to customers outside the United States during the years in issue.

17. Pursuant to the Inter-Company Agreements, Export agreed to compensate HTI for services rendered by HTI "to the extent required by the Code and regulations thereunder." The parties agreed that the compensation could be paid to HTI in the form of a credit against the commission that HTI would owe Export. During the years in issue, Export paid HTI for services that included contacting the customer and generating the customer's interest in the property, determining the customer's creditworthiness, arranging to take

Archived Copy

orders, as well as transport and delivery of the property, and ensuring that cash was collected or wire transfers made from the customer to HTI.

18. For HTI's serving as an agent for Export, HTI recognized charges ("Charges") pursuant to the Inter-Company Agreements, the Code, and applicable Treasury Regulations.

19. The Charges were determined by reference to HTI's "costs or deductions" pursuant to Treasury Regulations.

20. Export reported both the Commissions and the Charges on its Forms 1120-FSC, as provided in the Code.

21. For each year in issue, an allocation of costs or deductions (both direct and indirect) was performed in accordance with the requirements of the Inter-Company Agreements and Treasury Regulations. One purpose of the allocation was to determine the amount of expenses associated with Export's transactions in order to calculate the fee. A second purpose was to determine taxable income from export transactions.

22. The following table sets forth the commission paid by HTI to Export, as calculated under Inter-Company Agreements and the Code and Treasury Regulations for each of the years in issue:

Year	Commission
1995	$45,758,046
1996	55,493.170
1997	71,506,471
1998	39,630,800
1999	67,661,830

Archived Copy

23. The following table sets forth the fee paid by Export to HTI, as calculated under Inter-Company Agreements and the Code and Treasury Regulations for each of the years in issue:

Year	Fee
1995	$31,993,578
1996	40,741,958
1997	43,555,934
1998	31,182,650
1999	50,877,166

24. All of the amounts necessary to calculate the fee were known by the end of each fiscal year, and the liability of Export to pay the fee was fixed at that time.

25. The Inter-Company Agreements provided that the compensation to be paid by Export for services performed by HTI could be paid to HTI "in the form of a credit" against amounts owed by HTI to Export as a commission.

26. For each of the years in issue, HTI engaged Arthur Andersen LLP ("Andersen") to assist in the determination of the commission and the fee. Mark Thompson, who was then a partner at Andersen, prepared Export's federal income tax returns and provided assisted in the commission and fee calculations. In accordance with his advice and to reduce banking fees and avoid taking cash away from other uses, HTI and Export credited the amount of the fee due to HTI against the commission payable by HTI, which resulted in payment through offsetting journal entries. Export paid the fee for each of the years at issue by offsetting the fee against the commission.

27. HTI timely filed Minnesota corporate franchise tax returns for each of the years in issue.

Archived Copy

28. HTI timely filed an amended 1997 Minnesota return reflecting an increase in federal subtractions related to research expenses.

29. The Commissioner audited HTI's corporate franchise tax returns for the years in issue. On July 16, 2001, the Commissioner issued a Notice of Change in Your Tax assessing a deficiency in tax.

30. HTI timely appealed the July 2001 Notice to the Tax Court. This appeal was assigned Docket No. 7398-R.

31. On January 15, 2002, HTI timely filed a second amended return for the 1997 tax year. On March 7, 2002, and HTI also timely filed amended returns for the 1995, 1996, 1998 and 1999 tax years.

32. The Commissioner audited these amended returns and on September 9, 2002, issued a Notice of Change in Tax denying refunds.

33. HTI timely appealed the September 9, 2002, Notice to the Tax Court. This appeal was assigned Docket No. 7504.

34. The parties have agreed to reserve any issues relating to the computation of tax and interest, including the computation of any net operating losses and any refund, as a result of the Court's rulings, until a final order is issued.

35. The parties have agreed that a penalty for 1995, initially assessed by the Commissioner in the July 2001 Notice, is abated.

CONCLUSIONS OF LAW

1. Appellant Hutchinson Technology, Inc. is entitled to subtract 80 percent of the fees accrued and received from HTI Export, Ltd. In 1995 through 1999 pursuant to Minn. Stat. § 290.01, subd. 19(d)(11).

Archived Copy

IT IS SO ORDERED. THIS IS A FINAL ORDER, LET JUDGMENT BE ENTERED ACCORDINGLY. A STAY OF FIFTEEN DAYS IS HEREBY ORDERED.

BY THE COURT,

Sheryl A. Ramstad, Judge
MINNESOTA TAX COURT

DATED: May 10, 2004

Memorandum

Background

This matter consists of two cases consolidated on November 7, 2002. At issue in both cases was whether HTI Export Ltd. ("Export"), a wholly-owned subsidiary of Appellant Hutchinson Technology, Inc. ("HTI"), was a foreign operating corporation ("FOC") under Minn. Stat. § 290.01, subd. 6(b)(1997). On January 2, 2003, we held as a matter of law that Export was an FOC. On September 15, 2003, we found that HTI was not entitled to the dividend received deduction for dividends deemed paid by Export in Docket No. 7398-R.

At issue now in Docket No. 7504-R is whether HTI was entitled to a refund as a result of a decrease in its Minnesota taxable income arising from a deduction equal to 80% of fees paid by Export to HTI during 1995 through 1999 ("years in issue") under Minn. Stat. § 290.01, subd. 19(d)(11). On February 24,

Archived Copy

2004, a trial on this issue was held. Although the parties entered into a Stipulation of Facts and a Supplemental Stipulation of Facts, HTI called three witnesses who testified regarding the nature and payment of the fee Export paid to HTI during the years in issue.

Issue

Is HTI entitled to subtract from federal taxable income, in determining Minnesota net income, 80% of the fees accrued and received from Export, for services HTI provided to Export, as "fees, royalties or other like income" under Minn. Stat. § 290.01, subd. 19(d)(11)?

Facts

During the years in issue, HTI was primarily engaged in manufacturing suspension assemblies used in computer hard drives to hold magnetic read-write heads at microscopic distances above hard drive discs. HTI was the sole shareholder of Export, which was initially incorporated in 1985 under the laws of the United States Virgin Islands and reincorporated ten years later as a Barbados corporation. Export elected under the Internal Revenue Code ("Code") to be treated as a Foreign Sales Corporation ("FSC") during each of the years in issue.

HTI and Export entered into two Inter-Company Agreements during the years in issue: the first, effective until January 23, 1995, and the second from that day forward. Pursuant to the Inter-Company Agreements, Export was entitled to a commission for serving as HTI's nonexclusive agent with respect to sales by HTI of suspension assemblies sold overseas. HTI paid Export the commission each year by offsetting it against the "fee" Export owed HTI for serving as

Archived Copy

Export's agent with respect to certain activities relating to the sales of the suspensions manufactured by HTI to customers outside of the United States. On its federal income tax returns, HTI deducted the commissions that it paid to Export and included the fees it received from Export as taxable income. The commission deduction was netted against the fee income on HTI's federal income tax return so that the fee paid was in the form of offsetting journal entries.

In Minnesota, a corporation is entitled to a deduction on its Minnesota income tax return equal to "80 percent of royalties, fees, or other like income accrued or received from a foreign operating corporation or a foreign corporation which is part of the same unitary business as the receiving corporation." Minn. Stat. § 290.01, subd. 19(d)(11). The parties dispute the meaning of the term "fees," which is not defined in the statute. According to the Commissioner, HTI does not qualify for the deduction because fees were not paid to HTI by Export for services HTI provided to Export, but, rather, there was just an allocation of certain of HTI's expenses to its foreign income. He also argues that he does not have to allow a subtraction for the fees because they exist only for federal income tax purposes. HTI argues that it is entitled to a deduction under Minn. Stat. § 290.01, subd. 19(d)(11) because it received fees from Export in compensation for services that HTI performed for Export that were calculated according to the rules set forth in the Code and the Treasury Regulations. Further, HTI claims the Commissioner cannot disregard HTI's receipt of the fees

Archived Copy

as an alleged fiction that exists just for federal income tax purposes because to do so would be contrary to the plain language of Minn. Stat. § 290.01, subd. 19(d)(11).[1]

Discussion

Under Minnesota law, a corporation's "net income" is its "federal taxable income," with certain state-required modifications set out in Minn. Stat. § 290.01, subds. 19c and 19d. From there, the corporation's "taxable net income" is computed by applying the apportionment rules found in Minn. Stat. § 290.17. See Minn. Stat. § 290.01, subd. 22. Finally, "taxable income" is determined by subtracting from taxable net income the deductions allowed under Minn. Stat. § 290.01, subd. 29(2)(i)-(iii). At issue here is whether the fees paid by Export to HTI may be subtracted by HTI, in determining Minnesota taxable net income pursuant to Minn. Stat. § 290.01, subd. 19(d)(11). The question turns on whether the amounts calculated as owing were "fees" that Export paid to HTI for services performed pursuant to the Inter-Company Agreements. For the reasons set forth below, we find that because the amounts accrued and received by HTI were for services rendered, HTI is entitled to a subtraction of 80% of the fee accrued and received from Export.

Export's Payment to HTI is a Fee

We first consider the nature of the relationship and payments between HTI and Export during the years in issue. Pursuant to the Inter-Company Agreements entered into by HTI and Export, Export served as HTI's nonexclusive agent with

[1] Unless otherwise indicated, statutory references are to the laws in effect during the year in issue. Minnesota Statute Section 290.01, subd. 19(d)(11) was modified in 1997, the change was

Archived Copy

respect to sales by HTI of suspension assemblies sold overseas. Because Export had only one part-time employee during any year, Export contracted for some services to be provided by a management company known as ABN AMRO Trust Company and by HTI to fulfill its obligations as HTI's agent.

Under the Inter-Company Agreements, HTI also performed services for Export, for which Export was obligated to compensate HTI. Specifically, HTI agreed to do the following:

> all of the services in connection with initially contacting the customer and generating the customer's interest in the property, checking to see if the customer was creditworthy, making arrangements to take the orders, arrange for the transportation and delivery of the property and then ultimately assist[ing] with making sure that cash was collected or wire transfers were made from the customer to H[TI].

Tr. at 49.

For HTI's services, Export paid HTI a "fee" calculated pursuant to rules in the Treasury Regulations governing FSCs as provided in the Inter-Company Agreements.[2] With respect to the charge for services rendered at issue here, Treas. Reg. § 1.925(a)-1T(c)(6)(ii) states, in relevant part, that "[i]f a related supplier [i.e. HTI] performs services under contract with a FSC [i.e. Export], the FSC shall compensate the related supplier an arm's length amount under the provisions of § 1.482-2(b)(1) through (6)."

---

stylistic only, and is now codified as subd. 19(d)(10).

[2] The Code, and Regulations interpreting it, set forth "transfer pricing rules" for determining 1) how much a FSC could charge its parent as a commission, and 2) how much the parent could charge the FSC for services rendered to the FSC. See I.R.C. § 925 NS Treas. Reg. § 1.925(a)-1T.

Archived Copy

Treasury Regulation Section 1.482-2(b)(1) provides generally that "where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group," the charge should be equal to an arm's length charge. Where a FSC uses administrative pricing, as in Export's case, an "arm's length charge shall be deemed equal to the costs or deductions incurred with respect to such services by the member or members rendering such services…" Treas. Reg. § 1.482-2(b)(3). In other words, if a parent company performs services for a subsidiary, it must charge the subsidiary a fee that is determined by the costs or deductions of providing those services.

According to the unrefuted testimony of Mark Thompson who advised HTI on Export's taxation and prepared Export's return, he used the Regulations to determine the costs associated with the services HTI provided. In determining the costs and deductions of providing the services, Thompson took direct and indirect costs into account.[3] To determine the direct and indirect costs, HTI prepared an allocation summary which was used to allocate direct and indirect costs to foreign sales versus domestic sales. This process served a two-fold function: (1) it was used to determine the taxable income on Export transactions, and (2) it was used to determine the expenses incurred by HTI in order to compute the amount that Export paid to HTI. The amount was then paid in the form of offsetting journal entries which, according to Donald Nicholson, who testified as an expert in accounting matters, complied with generally accepted

Archived Copy

accounting principles. Also, Export deducted the amount on its federal income tax return.

We next consider whether the amounts paid in the form of offsetting journal entries constitute "fees" within the meaning of Minn. Stat. § 290.01, subd. 19(d)(11). The Commissioner maintains that the indirect expenses allocated by HTI to foreign sales do not qualify as "fees" paid to HTI by Export. While the Commissioner agrees with HTI that "fees" can be defined as "payments for services performed or to be performed," he argues, without citing authority or producing evidence, that allocation of an indirect expense to a particular class of income does not fit within that definition. Claiming that the "fees" paid to HTI by Export are really just an allocation of deductions for the purpose of obtaining the federal tax benefits accorded to foreign sales under the FSC law, the Commissioner calls the methodology employed by HTI "an artificial federal tax exemption regime based on a legal fiction that bears no relationship whatsoever to Minnesota tax law" (Commissioner's Post-Trial Brief at pp. 9-10).

HTI contends that it is entitled to subtract from federal taxable income, in determining Minnesota net income, 80% of the fees accrued and received from Export, for services HTI provided to Export as "royalties, fees or other like income" under Minn. Stat. § 290.01, subd. 19(d)(11). HTI argues it can do this because HTI (1) performed services for Export, (2) was required by Inter-Company Agreements and the Code and Treasury Regulations to pay a fee for the service, (3) the fee paid to HTI was set according to the Code and Treasury

[3] Treas. Reg. § 1.482-2(b)(4) defines "direct costs or deductions" as "those identified specifically with a particular service", and "indirect costs or deductions" as "those which are not specifically

Archived Copy

Regulations, and (4) the fee was accrued and received by HTI from Export. Further, HTI maintains it went through meticulous allocations in accordance with the Inter-Company Agreements and the Treasury Regulations to determine the amount of the fee it was required to charge Export. Based upon Treas. Reg. § 1.925(a)-1T(c)(6)(ii), HTI maintains that Export, a FSC, "compensate[d]" HTI, a related supplier, for services rendered in accordance with the provisions of Treas. Reg. § 1.482-2(b)(1) through (6) and that the "fee" was reflected on the accounting records of both companies, as well as taken into account on both companies' tax returns.

Since the terms "fees" and "other like income" are not defined in the statute, the words must be considered according to their "common and approved usage." Minn. Stat. § 645.08(1). "Where the statutory language is clear and unambiguous, courts must give effect to its plain meaning." Green Giant Co. v. Commissioner of Revenue, 534 N.W. 2d 710, 712 (Minn. 1995).

Both parties cite Revenue Notice No. 93-24 (November 22, 1993) ("Revenue Notice"), interpreting Minn. Stat. § 290.01, subd. 19(d)(11) as support for their respective positions. The Revenue Notice defines "fees" as "payments for services performed or to be performed." The term "other like income" includes amounts received for the performance of services where the service contract does not use the word "fee."

We find ample evidence that the amounts accrued and received by HTI were fees for services rendered. First, the Inter-Company Agreements described the services to be performed and the fees that were to be paid for such services.

---

identified with a particular activity or service but which relate to the direct costs…."

Archived Copy

Second, there is undisputed evidence that services were performed and that the payment was for services. Finally, the amount of the fee was computed under Treasury Regulations that unambiguously describe the payments as being made for services. See Treas. Reg. § 1.925(a)-1T(c)(6) ("If a related supplier performs services under contract with a FSC…"); Treas. Reg. § 1.925(a)-1T(e)(3)(iii) ("Payment of…service fees…may be in the form of…an accounting entry offsetting the amount due the related supplier…"); Treas. Reg. § 1.482-2(b)(3) ("For the purpose of this paragraph an arm's length charge for services rendered…shall be deemed equal to the costs or deductions incurred with respect to such services…"); and Treas. Reg. § 1.482-2(b)(4) ("Where the amount of an arm's length charge for services is determined with reference to the costs or deductions incurred with respect to such services, it is necessary to take into account on some reasonable basis all the costs or deductions which are directly or indirectly related to the service performed.")

The Commissioner suggests that the fees were not "paid" so that HTI is not entitled to subtract 80% of the fee. We note that the Commissioner offered no authority to support his position. Furthermore, payment is not relevant because HTI did not use the cash method of accounting. Here, the statute allows for the subtraction for "royalties, fees, or other like income accrued or received from a foreign operating corporation… ." Minn. Stat. § 190.01, subd. 19(d)(11) (emphasis added). HTI uses the accrual method of accounting. Treas. Reg. § 1.451-1(a) states:

> Under an accrual method of accounting, income is includible in gross income when all the events have

Archived Copy

> occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

Treas. Reg. § 1.451-1(a).

Under this method, as contrasted with the cash method of accounting, income is not realized in the year it is received. Rather, it is recognized in the year accrued, and accrual depends upon when the right to receive the income is fixed, as well as when the amount can be reasonably estimated. Here, the liability of Export to pay the fee to HTI was fixed and the amount was determinable with reasonable accuracy at the end of each fiscal year. Thus, the fee resulted in income that HTI accrued within each fiscal year. Minnesota Statute Section 290.01, subd. 19(d)(11) provided a subtraction for fees "accrued or received." Since HTI was an accrual basis taxpayer, the operative word here is "accrued," not "received," as the Commissioner would have it. Therefore, since HTI accrued the fee and included it in income, it was entitled to a subtraction equal to 80% of the fee.

In any event, HTI did in fact receive the fee when it was paid by Export. Payment was effectuated through offsetting accounting entries. In other words, since HTI owed a commission to Export, and Export owed a fee to HTI in an amount less than the commission, the two amounts were set off against each other, resulting in a full payment of the fee and a partial payment of the commission. (The balance of the commission was paid by subsequent offset.) The unrefuted testimony at trial was that such an offset is considered to be a payment under generally accepted accounting principles and is a customary business practice between parent companies and wholly-owned subsidiaries.

Archived Copy

Furthermore, offsets of this sort are specifically allowed by Treas. Reg. § 1.925(a)-1T(e)(3)(iii).

In summary, HTI performed services for Export, for which Export was required by the Inter-Company Agreements, the Code and Regulations, to pay a fee. The amount of the fee paid to HTI was set in accordance with the Code and Treasury Regulations, and the fee was accrued and received by HTI from Export. Based upon the lack of evidence in the record contradicting these facts, we find that Export's payments to HTI constituted "fees" under the plain meaning of Minn. Stat. § 290.01, subd. 19(d)(11), and the fees were paid by offsetting the commissions owed Export against the fees owed HTI. The allocation used to measure what the fee had to be did not change the fact that a fee was charged and paid.[4] The allocation was done to calculate the "costs or deductions" by which the fee had to be measured. While the Commissioner suggests the allocation was done to shift expenses from HTI to Export, this argument is contradicted by the Treasury Regulations and the only testimony in the record on this point. See Tr. at 75-76.

The Issue is One of the Plain Language of the Statutes

The Commissioner's second argument is that the legislature did not intend the allocation of expenses to foreign sales as the payment of fees by Export be treated as "fees" within the meaning of Minn. Stat. § 290.01, subd. 19(d)(11). Thus, even though the fee is included in HTI's federal taxable income, the Commissioner contends HTI is not entitled to the subtraction for the fees it

Archived Copy

receives from Export. HTI argues that it should be allowed the subtraction because the fees at issue here were calculated and paid under federal tax law provisions that have been incorporated by reference into Minnesota tax law. We agree with HTI and allow the subtraction based upon the plain language of the statutes.

Again, "[w]here the statutory language is clear and unambiguous, courts must give effect to its plain language." Green Giant. "Looking to legislative history to infer something that is not plainly there is neither necessary nor proper." U.S. Sprint Communications Co. v. Commissioner of Revenue, 578 N.W. 2d 752 (Minn. 1998). See Hutchinson Tech., Inc. v. Commissioner of Revenue, Dckt. No. 7398-R (Minn. Tax Ct. Order dated Jan. 2, 2003).

The Minnesota legislature has adopted federal taxable income, determined under the Code, as the starting point in determining Minnesota taxable income. Specifically, "taxable net income" is federal taxable income as calculated under Section 63 of the Code, apportioned to Minnesota. Once that beginning number is computed, then Minnesota law provides for additions to and subtractions from federal taxable income. Minn. Stat. § 290.01, subds. 19c and 19d. The subtraction here at issue is for 80% of "fees" that are received from an FOC.

Furthermore, the Department of Revenue has adopted a rule providing that where Minnesota incorporates federal tax law by reference, Minnesota law shall be interpreted in accordance with regulations adopted under the Code:

---

[4]Under Treasury Regulations, the "arm's length charge" for services rendered by one affiliated corporation to another had to be "equal to the costs or deductions incurred" by the corporation

Archived Copy

> An incorporation by reference of the Internal Revenue Code in Minnesota Statutes, chapter 290 or 290A shall be interpreted in accordance with any regulations or rulings adopted or issued by the Internal Revenue Service which govern the referenced provisions.

Minn. Rule 8001.9000.

We find the issue here to be one of the plain language of the statute. The provisions of the Code and Regulations used to calculate that income have been unambiguously adopted by the Minnesota legislature and the Department of Revenue. The fees at issue were calculated and paid under the provisions of federal tax law that have been incorporated by reference into Minnesota tax law. To disregard the fees would be to disregard statutory law.

In Green Giant the Minnesota Supreme Court rejected a position similar to the one taken here by the Commissioner that Minnesota should not follow federal law because the legislature might have intended something other than what it said. The Commissioner in Green Giant argued that the legislature could not have intended corporate gross income to exclude income assigned to subsidiaries where the result would have provided assistance to organizations which have no connection with Minnesota. The Minnesota Supreme Court noted:

> The Commissioner's arguments…fail to take into account the most basic rule of statutory construction: "When the words of a law in their application to an existing situation are free and clear from all ambiguity, the letter of the law shall not be disregarded under the pretext of pursuing the spirit."

Id. at 712, quoting Minn. Stat. § 645.16 (1992).

---

performing the service. Treas. Reg. § 1.482-2(b)(3).

Archived Copy

Similarly, the statue here speaks clearly so that we need not supply legislative intent. Although the Commissioner argues that "the Legislature could not have intended that deduction to be available…where Export's sole reason for existence as an FSC was to take advantage of a special federal tax benefit" (Commissioner's Post-Trial Responsive Brief, pp. 9-10), we cannot disregard the letter of the law to pursue the intent of the lawmakers.

The Commissioner's reliance upon Bunge Corp. v. Commissioner of Revenue, 305 N.W.2d 779 (Minn. 1981), is misplaced. In Bunge, the Commissioner sought to disallow an ordinary and necessary business expense deduction for a payment made by a parent company to its subsidiary, which was a Domestic International Sales Corporation ("DISC"). Under the law applicable to the years at issue in Bunge, Minnesota had not incorporated the Code by reference as the starting point for Minnesota net income.[5] Instead, Minnesota had its own provision allowing deductions for ordinary and necessary business expenses. See Minn. Stat. § 290.09 (1978).[6] In holding that the commission payments were not ordinary and necessary business expenses, the Minnesota Supreme Court stated that "Minnesota income tax law does not contain a provision similar to the special treatment provided for federal tax purposes in the DISC statute." Bunge, 305 N.W.2d at 784.

Bunge is distinguishable for several reasons. First, this case involves an entirely different statute which refers to "royalties, fees and other like income."

[5] The legislature incorporated the Code by reference in 1987. See Minn. Laws Ch. 268, art. 1.
[6] In 1987, the legislature repealed this provision so that a corporation now obtains a deduction for ordinary and necessary business expenses under the Code, rather than under a separate provision of Minnesota law.

Archived Copy

Minn. Stat. § 290.01, subd. 19(d)(11). The Court reached its decision in Bunge by construing a statute that has since been repealed. Minn. Stat. § 290.09 (1978). Moreover, the statutory language at issue there allowed a deduction for "ordinary and necessary expenses" which are not involved in this case. Second, Bunge precedes the Green Giant case in which the Minnesota Supreme Court expressly decided that Minnesota follows federal law. At the time of Bunge, Minnesota tax law did not recognize DISCs. That is not the case here, where specific Minnesota provisions address FSCs. See, e.g., Minn. Stat. § 290.01, subd. 5; Minn. Stat. § 290.01, subd. 19c(10); and Minn. Stat. § 290.21, subd. 4(e). Third, this Court has already rejected the Commissioner's argument that Bunge requires FSCs to be disregarded. See Hutchinson Tech., Inc. v. Commissioner of Revenue, Dckt. No. 7398-R (Minn. Tax Ct. Order dated Jan. 2, 2003). Finally, courts in other states have noted that FSCs which are at issue here are different from DISCs at issue in Bunge and should not be disregarded. See SLI Int'l Corp. v. Crystal, 671 A.2d 813 (Conn. 1996); Kimberly-Clark Corp. v. Wisconsin Dep't of Revenue, No. 92-I-306 (Wis. Tax. App. Comm'n, Apr. 12, 1994).

In conclusion, the evidence is unequivocal that fees were paid through offsetting journal entries for services HTI provided to Export so as to entitle HTI to a subtraction equal to 80% of the fees accrued or received from Export under Minn. Stat. § 290.01, subd. 19(d)(11). This manner of payment is not only consistent with generally accepted accounting principles, but also specifically permitted under federal tax law. Treas. Reg. § 1.925(a)-1T(e)(3)(iii). Furthermore,

Archived Copy

because HTI is an accrual basis taxpayer, the issue is not whether the fees were paid, but whether the fees were accrued. The undisputed evidence is that the liability of Export to pay the fee was fixed and the amount of the fee was determinable with reasonable accuracy at the end of each fiscal year. Thus, HTI is eligible for an 80% subtraction of the fees received from Export. Based upon the plain language of the statutes at issue, we decline to infer the legislature intended a different result.

Conclusion

For the reasons set forth above, HTI is entitled to subtract 80% of the fees accrued and received from Export in 1995 through 1999.

S. A. R.

Archived Copy