No. A09-1164

STATE OF MINNESOTA

IN SUPREME COURT

HMN Financial, Inc., and Affiliates,

Relator,

vs.

Commissioner of Revenue,

Respondent.

RELATOR HMN FINANCIAL, INC., AND AFFILIATES' OPENING BRIEF

FAEGRE & BENSON LLP

Walter A. Pickhardt
Atty. Reg. No. 86782

Adam B. Thimmesch
Atty. Reg. No. 349227

2200 Wells Fargo Center
90 South Seventh Street
Minneapolis, MN 55402
(612) 766-7000

Attorneys for Relator

LORI SWANSON
Attorney General
State of Minnesota

Rita Coyle De Meules
Assistant Attorney General
Atty. Reg. No. 0191644

900 Bremer Tower
445 Minnesota Street
St. Paul, MN 55101-2128
(651) 296-0692

Attorneys for Respondent

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LEGAL ISSUE

When the Legislature defines a type of entity (in this case a foreign operating company) and prescribes how that entity and its shareholders are to be taxed, can the Commissioner impose a different treatment if the owner, in forming and operating the entity in conformity with the statute, was motivated to reduce its tax?

- The Tax Court held that the Commissioner could override the treatment prescribed by Minnesota Statutes.

Minn. Stat. § 290.17, subd. 4
Minn. Stat. § 290.34, subd. 1
Minn. Stat. § 290.21, subd. 4
Hutchinson Technology, Inc. v. Comm'r of Rev., 698 N.W.2d 1 (Minn. 2005).

STATEMENT OF THE CASE

By Order dated February 12, 2007, the Commissioner of Revenue (the "Commissioner") assessed Minnesota corporate franchise tax against HMN Financial, Inc. ("HMN"), and certain of its affiliates (collectively, "HMN") for the years 2002 through 2004. On March 2, 2007, HMN contested that Order by filing a Tax Court Notice of Appeal. App. 1.

The case was tried on November 12 and 13, 2008, before the Honorable Kathleen H. Sanberg, Judge of the Minnesota Tax Court. On May 27, 2009, the Tax Court issued its Findings of Fact, Conclusions of Law, and Order for Judgment. Add. 1. Entry of the order was stayed 15 days. The order was entered on June 11, 2009. HMN then filed a petition for certiorari with this Court.

At issue in the case at trial was whether one of HMN's affiliates, Home Federal Holding, Inc. ("HF Holding"), was a "foreign operating corporation" (an "FOC") under Minn. Stat. § 290.01, subd. 6b.[1] The Tax Court determined that HF Holding was an FOC. Add. 41. The Commissioner has not appealed that holding.

A second issue was whether the Commissioner could override the statutory tax treatment of FOCs and their shareholders because the FOC was established for the purpose of reducing Minnesota taxes. The Tax Court determined that HF Holding was formed, and certain intercompany transactions were entered into, in order to reduce Minnesota tax. It then affirmed the Commissioner's order assigning all of the income of HF Holding to the tax return filed by HMN and its affiliates, in direct contravention of Minn. Stat. § 290.17, subd. 4(f) and (h), which say that the income of an FOC "shall not be included in the net income ... of the unitary business." HMN appeals that holding.

STATEMENT OF FACTS

This case concerns the Minnesota corporate franchise tax of HMN and certain of its affiliates for the tax years 2002, 2003, and 2004 (the "years in issue"). HMN is a publicly-held stock savings bank holding company organized under the laws of Delaware. HMN has a wholly-owned subsidiary, Home Federal Savings Bank ("HF Bank"), which operates retail banking facilities in Minnesota and Iowa.

[1] Statutory references are to Minnesota Statutes ("Minn. Stat.") and to the Internal Revenue Code of 1986, as amended (the "Code" or "I.R.C."), as in effect for the years in issue, unless otherwise noted.

During the years in issue, HF Bank owned all of the stock of HF Holding, which was an FOC under Minn. Stat. § 290.01, subd. 6b. HF Holding owned all of the common stock and 90 percent of the preferred stock of Home Federal REIT, Inc. ("HF REIT"), which owned participation interests in mortgage loans that it acquired from HF Bank. See Add. 35 (chart showing ownership).

HF Bank incorporated HF Holding and HF REIT as subsidiaries on February 4, 2002. It then transferred the mortgage participation interests to HF REIT. This was done as part of a restructuring plan that was proposed by its accountants. Other banks had used the same structure to benefit from Minnesota's FOC statute. HMN's officers and directors believed that HMN would be at a competitive disadvantage if it did not form an FOC. Add. 27.

The parties stipulated: "The two reasons HMN and Bank formed HF REIT and HF Holding were (1) the state tax savings on Bank's mortgage portfolio; and (2) Bank could reduce its interest rate exposure." App. 63. The Tax Court, rejecting the parties' stipulation, held that there was only one purpose: reducing taxes. Add. 54.

Although HMN continues to believe that the stipulation was correct, it does not challenge the Tax Court's findings that it deliberately took steps to ensure that HF Holding met the statutory tests (principally the payroll and property requirements) to be an FOC, and that it intended that the tax treatment prescribed in Minnesota Statutes should apply. Indeed, HMN asked for and received an opinion to that effect from its accounting firm. It told its regulator that it intended to lower its tax burden. App. 205. And in 2004, when the Legislature was considering changes to the FOC law, HF Bank's president wrote letters to Minnesota legislators stating that HMN had formed an FOC and urging that the FOC laws not be changed (especially not retroactively). App. 109, 278-79. Accordingly, this appeal does not present any factual issue for the Court to address.

A. KPMG's Proposed Restructuring Plan.

KPMG, LLC ("KPMG") performed accounting services for HMN during the years in issue. On July 10, 2001, KPMG employees met with representatives of HF Bank to discuss a proposal under which the bank could form a subsidiary corporation to hold interests in mortgages and that would qualify as a Real Estate Investment Trust (a "REIT") under I.R.C. § 856.

A REIT is an entity that has income from specified passive real estate interests (including mortgages) and that pays most of its income as dividends each year to its shareholders. I.R.C. § 856-857. REITs are allowed a deduction for the dividends they pay. I.R.C. § 561(a) and I.R.C. § 857(b)(2)(B). Because of the requirement to pay out the income and the dividends paid deduction, REITs generally have little or no taxable income—the income is taxed to the shareholders when they receive dividends from the REIT. Minnesota determines the income of a REIT in the same manner. Minn. Stat. § 290.01, subd. 19(3).

At the meeting on July 10, 2001, KPMG (which prepared HMN's tax returns and advised it on tax matters) explained the requirements to be a REIT. Add. 5. It described a structure in which HF Bank would own a holding company that in turn would own all of the common stock of the REIT. App. 146-155. To satisfy the more-than-100-

shareholder requirement applicable to REITs, preferred stock in the REIT would be issued (as a bonus) to more than 100 employee shareholders. App. 148.

KPMG explained that there would be tax benefits to this structure if the proposed REIT met the requirements to be a REIT, and if the proposed holding company met the requirements to be an FOC under Minnesota law. It explained the Minnesota tax rule that would allow a domestically incorporated holding company to qualify as an FOC if less than 20 percent of the average of its tangible property and payroll were located inside the United States. It also discussed various implementation considerations including asset selection, the regulatory approval process, systems/accounting changes, and other matters. App. 153.

KPMG told HF Bank that a short-term objective of the proposal was to reduce Minnesota tax by $550,000. KPMG described the long-term objectives as including: positioning the bank to meet or exceed performance goals; creating a structure that may be used to raise Tier 1 capital and to monetize relatively illiquid assets; and enhancing employee retention. App. 154. KPMG offered its professional services to assist HF Bank in navigating the complex rules relating to REITs and FOCs.

B. HF Bank's Adoption of the KPMG Proposal.

HF Bank had a committee, its Asset Liability Committee (the "ALCO"), charged with monitoring the assets and liabilities of the bank (including interest rate risk). Tim Johnson, a director and the chief financial officer of HF Bank, who attended the KPMG presentation, was a member of the ALCO. On July 16, 2001, Mr. Johnson discussed the KPMG proposal at an ALCO meeting and described it as having two benefits: It "would provide additional liquidity in the future and also create an income tax benefit in Minnesota." The ALCO voted to move forward with the proposal. App. 145. On July 24, 2001, Mr. Johnson presented the proposal to the Board of Directors, which approved it. App. 135.

HF Bank formally engaged KPMG pursuant to a letter agreement stating that KPMG would "provide tax services to [HMN] with respect to the design and implementation of" a REIT and holding company. App. 271. The KPMG personnel involved were tax specialists, not banking consultants. HF Bank had expertise in banking and did not look to KPMG for help in that area. App. 96, 117, 120.

C. Implementation Actions During 2001.

Forming a REIT and a holding company required regulatory approval from the Office of Thrift Supervision (the "OTS"). HF Bank sent a letter to the OTS on August 24, 2001. App. 205; Add. 11. In the letter, HF Bank stated that one purpose for the transaction was to reduce the effective tax rate and thereby increase earnings and capital. The bank's officers and directors were aware that competing banks had employed a similar structure to improve their return on equity by lowering their effective tax rate. They believed that if HF Bank did not implement a similar structure, investors would react negatively and the bank would be at a competitive disadvantage. App. 91-92; 108-111; Add. 27.

The Tax Court determined that HF Bank's only purpose for creating HF REIT and HF Holding was to reduce its Minnesota tax liability, Add. 48, even though the parties stipulated that there were two reasons: "The two reasons HMN and Bank formed HF

REIT and HF Holding were (1) the state tax savings on Bank's mortgage portfolio; and (2) Bank could reduce its interest rate exposure." App. 63.

With respect to reducing interest rate exposure, HF Bank told the OTS that the new structure could be used to improve liquidity and, thereby, manage interest rate risk (i.e., through selling pools of mortgages). App. 208. Mr. Johnson testified that setting up HF REIT was helpful because "it created a ready pool of loans that gave us a history" which would enable HF REIT to sell the loans as a "seasoned pool" that would command "premium pricing." App. 97.[2]

Another purpose mentioned in the letter to the OTS was that HF Bank could raise capital through the issuance of a second class of REIT securities. According to the letter, such a second class could qualify as Tier 1 capital for HF Bank (i.e., core capital). App. 207-208. However, because HF Bank had sufficient Tier 1 capital, the letter stated that there were "no current plans" to raise capital. Mr. Johnson testified that he did not consider raising capital to be "a high priority." App. 99.

On November 2, 2001, Mr. Johnson and KPMG employees conducted a phone interview of two representatives of ScotiaTrust, a bank located in the Cayman Islands. ScotiaTrust described its banking services, and indicated that ScotiaTrust could rent

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2 As events transpired, HF Bank did not need to use HF REIT to manage its interest rate risk because it was in a "minimal interest rate category" in the subsequent years. Add. 24. Of course, this could not have been known at the outset. Mr. Johnson testified that the structure was "a tool in the box and you never know what the future is going to bring, so you always want tools in the box which will assist you along before a situation arises." App. 98. Nonetheless, the Tax Court viewed the failure to use the structure as evidence that it was never intended to be used to manage interest rate risk.

office space to HF Holding and also provide HF Holding an employee (i.e., a qualified accountant). It agreed to provide the resumes of two candidates for employment. App. 217; Add. 11-12.

D. Implementation Actions During 2002.

On January 24, 2002, the OTS approved HF Bank's application to establish HF REIT. The order also allowed HF Bank to establish HF Holding, but the OTS required additional information before approving HF Holding's request to establish a foreign office. Add. 13.

On February 4, 2002, HF Holding and HF REIT were incorporated under Delaware law. App. 126, 130; Add. 14. On February 5, 2004, HF Bank met with KPMG and its attorneys. The meeting minutes show that HF Bank intended for HF REIT operations to commence on the date of incorporation (February 4). App. 219. It had earlier told the OTS that it intended to transfer approximately $164 million in loans. App. 176. HF Bank began identifying the loans for transfer. App. 221. HF Bank made its first contributions of loans to HF REIT on February 22 and February 25, 2002. App. 223; Add. 15. By February 28, it had identified all such loans and completed the transfer, effective as of February 4. App. 223.

HF Bank and HF REIT entered into a Loan Participation and Servicing Agreement (the "Participation Agreement"). App. 280. The agreement was not finalized until June 2002. Add. 15. However, the final version was dated "as of" February 4, 2002, to memorialize that the decision made in early February to transfer the loans was intended to be effective on the date of HF REIT's incorporation.[3]

Pursuant to the Participation Agreement, HF Bank transferred to HF REIT a 100 percent participation interest in loans having a value of $153,265,308.49, effective February 4, 2002. In consideration for the transfer, HF REIT issued to HF Bank 1,532 shares of the common stock of HF REIT. The loans consisted of: (a) residential mortgage loans originated by HF Bank ("Bank Residential Loans"); (b) commercial mortgage loans originated by HF Bank ("Bank Commercial Loans"); and (c) residential mortgage loans that HF Bank acquired from Crescent Bank & Trust Company d/b/a Crescent Mortgage Co. ("Crescent"), an entity that was unrelated to HMN or its affiliates. App. 63-64.

The transfer of the participation interests was not communicated to mortgagors. App. 64. The standard practice in banking is to notify mortgagors of a mortgage transfer if the servicer is changed (because they need to know where to send their checks), but not otherwise. App. 89-90. It is also common for a bank to retain servicing rights when it

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3 The Tax Court considered this backdating as evidence that HMN did not treat the new entities or transactions in a normal business fashion. It did not find credible unrebutted testimony that it is "not unusual for a company to agree to a deal and then document it later." Add. 51. The Court apparently also did not find credible a recent article that was cited to it, which states: "[B]ackdating that memorializes is an integral part of daily law practice. Business lawyers routinely face situations where a document must be executed after an event has occurred." The article recommends the use of "as of" to disclose the backdating, which is the practice HMN followed. See Kwall and Duhl, <u>Backdating</u>, 63 Business Lawyer 1153 (2008).

sells a portfolio of loans. For example, HMN retained the servicing rights when it sold loans to Fannie Mae. App. 89.

Loan servicing consists of receiving the monthly payments from the borrower and handling escrows. In this case, there were two servicers. The Bank Residential and Commercial Loans were service by HF Bank. The Crescent Residential Loans were serviced by Cenlar, F.S.B. ("Cenlar"), an entity unrelated to HMN or its affiliates. The servicing fee under both the Participation Agreement and the Cenlar subservicing agreement was 0.25 percent. App. 65,70.

As servicer, HF Bank received payments from mortgagors on the Bank Residential and Commercial Loans. HF Bank then transferred the payments to HF REIT, less Bank's 0.25 percent servicing fee, on the 25th day of the month following the month of collection. The transfer was made electronically via journal entries. Essentially the same process was followed for amounts received from Cenlar on the Crescent Residential Loans. App. 65. The documentation and accounting for these, and all of the other transactions involving HF REIT and HF Holding, was consistent with and typical of generally accepted accounting principles or practices ("GAAP"). Add. 28.

HF REIT received net monthly collections of principal and interest. It used a portion of those funds to acquire additional participation interests from HF Bank during the period June 2002 through March 2005. HF Bank also made one additional capital contribution of participation interests to HF Bank in February 2004. App. 65-66. The Loan Participation Agreement provided that the purchase price of the participation interest in the loans purchased by the HF REIT would be the fair market value as of the sale date. App. 281; Add. 16. The decision whether to purchase any Loan was at the complete discretion of HF REIT. Bank employees identified the loans to transfer to HF REIT and made the transfers. Add. 16.

On rare occasions, HF REIT sold loan participations back to HF Bank.[4] Out of thousands of loan participation interests owned by HF REIT, only a few (between three and ten) were sold back. App. 104. This happened because HF REIT and HF Bank had been advised by KPMG that there could be significant adverse federal tax consequences if HF REIT owned delinquent loans. Add. 16-17.[5] HF REIT had to bear any losses. Add. 16.

As noted above, the OTS required additional information before HF Holding could open a foreign office. Such information was to pertain to: the establishment of internal controls; consent to United States jurisdiction and OTS jurisdiction; disclosure by the Cayman government to the OTS; and agreement to terminate in the event the OTS determined that there was undue risk. App. 193-94.

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4 The Tax Court noted: "Nothing in the Agreement allowed HF REIT to transfer or sell loans back to HF Bank, nor required HF Bank to accept a transfer or re-purchase of any loan." Add. 16. However, it is also true that nothing in the Participation Agreement prohibited such a sale. The sales did not violate the Participation Agreement. The Tax Court also noted: "HF Bank did not notify the OTS of the decision to transfer delinquent and defaulted loans from HF REIT back to HF Bank." However, the order approving the formation of HF REIT did not require HF Bank to notify the OTS. App. 193-94.

5 Income from property acquired by foreclosure can be "bad" income for REIT qualification purposes causing a REIT to forfeit its election or be subject to a 100 percent penalty tax. I.R.C. § 856(c)(2)-(3) and I.R.C. § 857(b)(6)(A).

Mr. Johnson worked to obtaining approval from the OTS during 2002. App. 224-227. In July 2002, Mr. Johnson traveled to Grand Cayman and interviewed personnel from ScotiaTrust, including Carmen Thompson-Lopez. App. 94, 101-102.

On November 10, 2002, HF Holding provided additional information to the OTS. App. 195-198. On December 5, 2002, the OTS approved the establishment by HF Holding of an office in the Cayman Islands. App. 202.

On December 20, 2002, HF Holding's board appointed as its first officers. It also authorized: the opening of bank accounts at ScotiaTrust; the issuance of 100 shares of its common stock in exchange for 1,532 shares of HF REIT common stock; qualification in the Cayman Islands; and various agreements. App. 131-134.

HF Holding entered into an Employment Agreement as of December 20, 2002, with Ms. Carmen Thompson-Lopez, whom Mr. Johnson had interviewed the previous July.[6] Ms. Thompson-Lopez was a Senior Account Officer, Banking Services, at ScotiaTrust. Pursuant to the Employment Agreement, Ms. Thompson-Lopez's services for HF Holding were non-exclusive, she reported to the CFO of Bank, and she worked at HF Holding's office in Georgetown, Grand Cayman. App. 69, 131-125.

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[6] In its Memorandum, the Tax Court stated that HF Holding interviewed Ms. Thompson-Lopez after she was hired: "The employment agreement was dated December 20, <u>2001</u>, although Mr. Johnson did not interview her until the <u>following</u> July." Add. 52. (Emphasis added.) The Tax Court confused the dates. The employment agreement was dated December 20, <u>2002</u>. Add. 20; App. 11, 121. Mr. Johnson interviewed Ms. Thompson-Lopez in July 2002 (i.e., before she was hired). App. 94, 101-102.

HF Holding entered into an Agreement as of December 20, 2002, with ScotiaTrust for the purpose of assisting HF Holding's business. App. 68. HF Holding also entered into a non-exclusive sublease as of December 20, 2002, of office space that ScotiaTrust leased from Scotia Realty. App. 68, 211.[7]

E. Ownership of Stock of HF REIT.

On December 20, 2002, Bank transferred 1,532 shares of Common Stock of HF REIT to HF Holding in consideration for 100 shares of Common Stock of HF Holding. As a result, HF REIT became a wholly owned subsidiary of HF Holding. App. 66; Add. 17.

On December 24, 2002, HF Holding purchased 1,000 shares of HF REIT six percent cumulative preferred stock, par value $.01, with a stated value of $500 per share, in exchange for 5 shares of HF REIT common stock. App. 66.

On December 24, 2002, Bank purchased 112 shares of HF REIT preferred stock to distribute to certain employees of Bank or Osterud pursuant to a stock bonus plan. Effective December 31, 2002, Bank distributed one share to each of 112 full-time Bank or Osterud employees that had a start date of employment on or before September 5, 2001. Each share of stock had a value of $500 that was included in each employee's taxable wages. HF Bank gave the employees an additional amount—a gross-up—so that

[7] The Tax Court stated that "the lease was completed without travel to the Caymans." Add. 52. Again, the Court was confused about dates. Mr. Johnson visited Grand Cayman in July 2002; the lease was signed in December 2002. App. 68, 94, 101-102.

the employees' cash compensation would not be reduced by the taxes attributable to the stock. App. 67.

Following the distribution of 112 shares of preferred stock by Bank to the employees, the preferred stock of HF REIT was owned as follows: 1,000 shares (90 percent) by HF Holding; 112 shares (10 percent) by 112 employees of Bank and/or Osterud. The common stock of HF REIT was owned as follows: 1,527 shares (100 percent) by HF Holding. App. 67.

HF REIT filed an election under I.R.C. § 856 to be taxed as a REIT beginning with its taxable year ended December 31, 2002. HF REIT qualified as a REIT in each of the years at issue. App. 67.

F. Operations During 2002-2004.

During 2002 through 2004, HF REIT earned interest on the participated loans. It periodically paid dividends to HF Holding and the employee preferred shareholders, and HF Holding periodically paid dividends to HF Bank.

HF REIT paid all of its taxable income as dividends to its common and preferred shareholders during the years at issue. App. 12. HF REIT reported the following on its federal income tax returns:

	2002	2003	2004
Interest	$ 8,705,390	$ 9,946,576	$16,325,868
Capital gain	$ 8,277	$ -	$ -
Other income	$ 426,304	$ 556,266	$ 108,891
Total income	$ 9,139,971	$10,502,842	$16,434,759
Deductions	$ 424,482	$ 331,443	$ 613,721
Taxable income (before dividends)	$ 8,715,489	$10,171,399	$15,821,038

Dividends paid in year	$ 8,365,992	$ 9,935,648	$15,662,401
Dividends paid in following year per Sec 858(a)	$ 84,682	$ 107,649	$ 158,637
Dividends deemed paid on 12/31 per Sec 857(b)(9)	$ 264,815	$ 128,102	$ -
Total dividends (dividends paid deduction)	$ 8,715,489	$10,171,399	$15,821,038

Add. 26.

HF Holding (as a common and preferred shareholder of HF REIT) received the dividends paid by HF REIT in its bank account at ScotiaTrust. App. 70. It then used the cash to pay its operating expenses and to pay dividends to HF Bank. HF Holding reported the following on its federal income tax returns:

	2002	2003	2004
Dividends received	$ 8,630,807	$ 10,148,432	$ 15,770,050
Interest	$ 450	$ 7	$ -
Total Income	$ 8,631,257	$ 10,148,439	$ 15,770,050
Salaries and Wages	$ 292	$ 6,417	$ 7,000
Rents	$ 125	$ 2,750	$ 3,000
Other deductions	$ 4,086	$ 9,824	$ 3,507
Total deductions	$ 4,503	$ 18,991	$ 13,507
Taxable income	$ 8,626,754	$ 10,129,448	$ 15,756,543

Add. 27.

The rents shown in the above table were paid by HF Holding pursuant to the Sublease Agreement for office space in the Cayman Islands. The salaries shown in the above table were paid by HF Holding pursuant to the Employment Agreement for the services of Ms. Thompson-Lopez.

Although HF Holding had officers who resided in Minnesota, those officers performed minimal services for HF Holding. Mr. Johnson testified that he did not do very much work for HF Holding. App. 100. John Eberle testified that he did "very little." App. 103.; Add. 25. Mike McNeil testified that he did no work as an officer of HF Holding. App. 112. Rick Kvam, who was not an officer of HF Holding, testified that he made two entries per month in a general ledger, and that it took him just "a couple of minutes." App. 106. HF Holding did not pay salaries for these minimal services. Add. 18.

G. Termination in 2005.

The Board of Directors of HF Holding and HF REIT authorized the dissolution of both companies. The companies were dissolved effective September 12, 1995. Add. 26.

ARGUMENT

This is a tax case—an unusual one because the parties agree that the applicable statutes (i.e., the FOC statutes) are clear and that HMN reported its income consistent with those statutes. In a prior case, the Commissioner claimed that the FOC statutes were not clear, but this Court rejected his argument. See Hutchinson Technology, Inc. v. Comm'r of Revenue, 698 N.W.2d 1 (Minn. 2005). This time around, the Commissioner concedes that the FOC statutes are unambiguous, but he argues that he can disregard the legislative scheme when he determines that a taxpayer's transactions do not have economic substance (i.e., when the taxpayer is motivated to reduce its tax).[8]

The Commissioner made essentially the same economic substance argument in the Hutchinson case.[9] There, he asserted that the "operating" designation must be construed as a substance requirement. This Court rejected that claim, stating: "[W]e will not add requirements to the statute beyond those specified by the legislature." Id. at 8.

The Commissioner also argued that the transactions—fee payments for services— ~~in Hutchinson between the parent company and the FOC had "no real business purpose,"~~ and so the fees could not qualify under a statute allowing a subtraction for "fees." The Court said: "[T]he statute at issue here only requires that the payments be 'fees.' While the Commissioner may be correct that the legislature intended a more restrictive definition of fees, the legislature did not say so." Id. at 11-12.

Finally, the Court in Hutchinson held that if the statutory tests for FOC qualification were met, then "there is nothing to prevent any FOC from being an empty shell entity, existing solely to provide tax exemptions." Id. at 16.

The Tax Court purported to distinguish Hutchinson on two grounds: (1) because Hutchinson involved the status of an FOC rather than its transactions; and (2) because the

8 The issue presented is an issue of law that is entitled to de novo review by this Court. Id. at 6.

9 There is one new wrinkle. The Commissioner now claims that Minn. Stat. § 290.34 authorizes him to disregard statutory law using an economic substance/business purpose analysis. See Section VI, *infra*.

FOC in Hutchinson had business dealings with third parties. As discussed below, neither distinction is valid.

I. HMN Reported Its Income Consistent With Minnesota Law.

This case involves provisions of Minnesota law relating to the taxation of: unitary groups (through the combined reporting method); FOCs; and REITs. HMN reported its income in compliance with these rules.

A. HMN Filed Returns Consistent With Minnesota Law Relating to Combined Reporting.

The income of a unitary business conducted by affiliated corporations must, as a general rule, be included on a combined report. Minn. Stat. § 290.17, subd. 4(j). However, there are exceptions. The income of some types of corporations (most notably, foreign corporations and FOCs) must not be included on a combined report. This Court recently explained:

> Minnesota applies the unitary business principle by combining the incomes of separate corporations engaged in a unitary business and then apportioning them to Minnesota using an apportionment formula that takes into account the extent to which the unitary business's sales, tangible property and payroll are made, used, and paid in Minnesota. ... Although the Due Process and Commerce Clauses of the United States Constitution would permit inclusion of the income of foreign members of the unitary group, Minnesota has adopted the "water's edge" model of combined reporting, which includes only the income of domestic members of the unitary group.

Manpower, Inc. v. Commissioner of Revenue, 724 N.W.2d 526, 529 (Minn. 2006) (citations omitted). The exclusion of foreign corporations and FOCs is mandatory. See Caterpillar, Inc. v. Commissioner of Revenue, 568 N.W.2d 695 (Minn. 1997) (holding that the apportionment factors of foreign entities could not be included on a combined report). The law provides:

> (f) The net income and apportionment factors under section 290.191 or 290.20 of foreign corporations and other foreign entities which are part of a unitary business shall not be included in the net income or the apportionment factors of the unitary business. A foreign corporation or other foreign entity which is required to file a return under this chapter shall file on a separate return basis. The net income and apportionment factors under section 290.191 or 290.20 of foreign operating corporations shall not be included in the net income or the apportionment factors of the unitary business except as provided in paragraph (g) [relating to deemed dividends]. ...
>
> (h) For purposes of determining the net income of a unitary business and the factors to be used in the apportionment of net income pursuant to section 290.191 or 290.20, there must be included only the income and apportionment factors of domestic corporations or other domestic entities other than foreign operating corporations that are determined to be part of the unitary business pursuant to this subdivision, notwithstanding that foreign corporations or other foreign entities might be included in the unitary business.

Minn. Stat. § 290.17, subd. 4(f) and (h) (emphasis added).

HMN filed combined reports and did not include the income and apportionment factors of HF Holding—which was an FOC—on those reports. The law required that treatment—there was no option to include them.

B. HMN Filed Returns Consistent With Federal and Minnesota Law Relating to Real Estate Investment Trusts.

HF REIT was a REIT during the years in issue. A REIT is an entity that is classified as a domestic corporation for federal income tax purposes, and that meets certain other requirements. I.R.C. § 856. Most of the income of a REIT must be from passive real property sources. I.R.C. § 856(c).

A REIT must make annual distributions to shareholders at least equal to most of its income. Otherwise, it can be subject to a federal excise tax. I.R.C. § 857. For this reason, REITs generally distribute most (or all) of their annual income. They are allowed a deduction for dividends paid. I.R.C. § 561(a) and I.R.C. § 857(b)(2)(B). Thus, their taxable income is generally zero (or close to it). Minnesota determines the income of a REIT in the same manner as under federal law. Minn. Stat. § 290.01, subd. 19.

HF REIT earned income (primarily mortgage interest income) which it reported on its tax returns. As required to maintain its REIT status, HF REIT paid its income out as dividends to its shareholders, HF Holding and the more-than-100 preferred shareholders, and it received a deduction for the dividends paid. HF REIT was included in the combined report filed by HMN.

C. HMN Filed Returns Consistent With Minnesota Law Relating to FOCs.

An FOC was defined, during the years in issue, to be: (1) a domestic corporation; (2) engaged in a unitary business with a corporation taxable in Minnesota; if (3) the average of the percentages of its tangible property and payroll assigned to locations inside the United States is 20 percent or less. Minn. Stat. § 290.01, subd. 6b. HF Holding was an FOC under this definition.[10]

By law, FOCs do not file corporate franchise tax returns:

> A corporation that is subject to the state's jurisdiction to tax under section 290.014, subdivision 5, must file a return, <u>except that a foreign operating corporation as defined in section 290.01, subdivision 6b, is not required to file a return</u>.

Minn. Stat. § 289A.08, subd. 3 (emphasis added). HF Holding accordingly did not file a Minnesota tax return.

As discussed above, Minnesota law provides that the net income and apportionment factors of an FOC <u>must not</u> be included in the net income or the apportionment factors of the unitary business of which it is a part. Minn. Stat. § 290.17, subd. 4(f) and (h). Thus, HMN did not include the net income and apportionment factors of HF Holding on the combined report that they filed.

The adjusted net income of an FOC is deemed to be paid as a dividend on the last day of its taxable year to its shareholders. Minn. Stat. § 290.17, subd. 4(g). The inclusion of a deemed dividend is also mandatory. It is a *quid pro quo* for excluding the income and factors from the combined report.

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[10] The Commissioner asked the Tax Court to find that HF Holding was not an FOC on the theory that some United States payroll of HF Bank should be reassigned to HF Holding. However, the Commissioner did not quantify the amount of payroll that he wanted reassigned and did not show how a reassignment would cause HF Holding to fail the statutory averaging test. Nor did he cite any applicable authority for his position. The Tax Court held that "HF Holding meets the literal definition of an FOC." Add. 41. The Commissioner has not appealed.

FOC shareholders are entitled to claim a dividends received deduction. Minn. Stat. § 290.21, subd. 4. Dividends actually paid by an FOC are eliminated on the combined report. Minn. Stat. § 290.17, subd. 4(g).

HF Holding earned income (primarily dividend income received from HF REIT) which it reported on its federal income tax returns. HMN did not include the income or apportionment factors of HF Holding on their combined report. However, HMN did include on its combined reports HF Holding's adjusted net income ($8.6 million for 2002; $10.1 million for 2003; and $15.8 million for 2004) as deemed dividends, and they claimed a dividends received deduction (equal to 80 percent of the deemed dividends).

II. The Commissioner's Order, Which Was Affirmed by the Tax Court, Assessed a Tax That Was Not Consistent With Minnesota Law.

Notwithstanding the Taxpayer's compliance with Minnesota law, the Commissioner assessed tax. The order stated that HF Holding "does not have any net income under Minn. Stat. § 290.17, subd. 4(g) and thus it does not have a 'deemed dividend' nor eligibility for a dividends received deduction" because "the arrangements that transferred the income on the portion of Home Federal Bank's loan portfolio to HF REIT and then to HF Holding lacked economic substance and are ignored for purposes of determining the taxable income of their combined group." App. 236; Add. 29. The Tax Court upheld the Commissioner's order. It framed the issue as follows:

> May the intercompany transactions between the bank ("HF Bank"), the REIT ("HF REIT") and the holding company ("HF Holding") be disregarded by the Commissioner for income tax purposes, if the transactions were lacking economic substance or business purpose and the relevant entities were created solely to avoid Minnesota taxes?

Add. 32. The Tax Court agreed that the transactions should be disregarded.

Oddly enough, however, neither the Commissioner nor the Tax Court actually disregarded the intercompany transactions. To the contrary, the Tax Court found that the transactions factually occurred and were accounted for consistent with GAAP. It also gave them effect for tax purposes.

The Tax Court found that HF Holding and HF REIT were validly incorporated entities. Add. 3. It found that "HF REIT acquired participation interests" pursuant to the Participation Agreement. Add. 15. It found that HF REIT owned the participation interests and bore any losses. Add. 16. It found that HF REIT received principal and interest as a result of holding those interests. Add. 25, 36. It found that HF REIT had income and expenses. Add. 26. It found that HF REIT reported its net income (including interest income from the participation interests) on its tax returns. Add. 26. The Commissioner's order did not make <u>any</u> change in HF REIT's reporting of its income and expenses—it respected the transactions on HF REIT's returns. It found that HF REIT paid dividends to its common and preferred shareholders (HF Holding and more than 100 other shareholders). Add. 22. It found that HF Holding was authorized to do business in Grand Cayman and had two bank accounts there, as well as an employee (i.e., a bookkeeper) and an office. Add. 17-21 It found that HF Holding received the dividends paid by HF REIT in its bank accounts and paid dividends to HF Bank. Add. 22.

Thus, although the Commissioner's order and the Tax Court's decision spoke as if they were disregarding transactions, that isn't what they actually did. What the

Commissioner's order (as affirmed by the Tax Court) actually did was the following: (1) it subtracted from the Taxpayer's income the FOC dividend that was deemed paid by HF Holding ($8.6 million for 2002; $10.1 million for 2003; and $15.8 million for 2004); and (2) it added to the Taxpayer's income amounts identical to the subtractions—i.e., it added the net income of HF Holding (but not as a deemed dividend). App. 236; Add. 29.

These additions and subtractions were, on their face, offsetting entries. However, they generated tax because the subtracted deemed dividend qualified for the dividends received deduction, whereas net income of HF Holding that was added back did not qualify.

There are two ways to characterize these changes. One way to look at it is that the Commissioner treated an FOC (HF Holding) as if it were a non-FOC. The income of a non-FOC is includible on its parent's combined report. That is what the Commissioner did: He included HF Holding's income on HMN's combined report. However, the statute says twice that an FOC's income must not be included on the combined report. See Minn. Stat. § 290.17, subd. 4(f) and (h).[11]

A second way to look at the Commissioner's order is this. If it did treat HF Holding as an FOC, then it properly included a deemed dividend (HF Holding's income) on HMN's return, but it improperly did not allow the dividends received deduction.

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[11] The order stated an "alternative" ground that HF Holding was not an FOC. App. 236. However, the Tax Court held that HF Holding was an FOC. Add. 41.

Deemed dividends from FOCs are permitted that deduction. See Minn. Stat. § 290.17, subd. 4(g) and § 290.21, subd. 4.[12]

Thus, regardless of how one characterizes the Commissioner's order, the order overrode the FOC statutes.

III. The Tax Court Erred When It Held That the Commissioner Could Override the Statute Because HMN Complied With the Statute in Order to Reduce Its Taxes.

The Tax Court held that the Commissioner could disregard statutory law because the transactions at issue lacked economic substance. A transaction lacks economic substance, according to the Court, when a taxpayer is motivated to reduce its taxes.

The Court said that HMN was mistaken when it relied Hutchinson's holding that "there is nothing to prevent any FOC from being an empty shell entity, existing solely to provide tax exemptions." Indeed, HMN's argument was contrary to "70 years of Minnesota law disallowing sham transactions." If HMN were correct, according to the Court, they "could submit fraudulent reports without consequence." Add. 44.

It obviously is not HMN's position that the law should permit the filing of fraudulent reports. For example, if a parent's transactions with its FOC never occurred—i.e., they were shams—then the filing of a tax return as if they had occurred would be

[12] Although the Tax Court never said that it was disallowing the dividends received deduction, it did say that deductions are a matter of legislative grace and that HMN bore the burden of showing entitlement "to the deductions." Add. 39. Perhaps this was a reference to the dividends received deduction—no other deduction was at issue. But since the statute allowing the dividends received deduction is not ambiguous, the "legislative grace" rule of construction is not called for here.

fraudulent and contrary to law. But here, the Tax Court found that the transactions did occur and that the accounting for the transactions was consistent with and typical of GAAP. Add. 28.

On the other hand, it is the Taxpayer's position that the Tax Court erred when it held that their motivation for establishing and utilizing an FOC (i.e., to reduce their tax liability) was determinative. The Taxpayer's position is that this Court meant what it said in Hutchinson: "[T]here is nothing to prevent any FOC from being an empty shell entity, existing solely to provide tax exemptions." They also contend that that Hutchinson is squarely within this Court's tax jurisprudence and was not a deviation from "70 years of Minnesota law disallowing sham transactions." Add. 44.

The oldest case cited by the Tax Court, In re Marshall's Estate, 228 N.W. 920 (Minn. 1930), certainly does not support the proposition that a transaction is a sham if it is motivated by a desire to reduce taxes. The Court in that case observed:

> It is true that the motive which impelled the creation of the trust was to lessen the surtaxes which Mr. Marshall's businesses were subjected to; but apparently the government has found nothing illegal or wrong in that desire and has accepted the tax as proper.

Id. at 923. The case concerned whether a transfer to a trust was subject to inheritance tax because it was "intended to take effect in possession or enjoyment at or after" the transferor's death.[13] A husband ("Husband") transferred assets to a trust in 1922, four

[13] Note that intent was an element of the statute at issue, but not the intent to reduce taxes. Rather, it was the intent to possess or enjoy property until death.

years before his death, for the benefit of himself, his wife, and his five children. Id. at 923. The State argued that although Husband nominally transferred the assets, the fact that Husband "borrowed or appropriated" income from the trust showed that the arrangement was a sham (i.e., that he intended to continue to enjoy the benefit until his death). Id. at 922. The Court held that the transfer was not a sham because "time, effort and expense" were incurred in forming and administering the trust, because "accurate books were kept," and because Husband issued notes to the trust that he had the ability to pay. Id. at 923.

Thus, contrary to the Tax Court's belief, Marshall's Estate did not launch 70 years of judicial overruling of statutory law based on a taxpayer's motivation to reduce its tax bill. The statute there required the Court to assess whether Husband intended to make a present transfer in trust, as opposed to a future transfer at death, and the Court simply weighed the facts and applied the statute.

The Tax Court mentioned four other cases as comprising this Court's 70-year history. Two of the cases stand for the proposition that "although Minnesota gross income is defined as federal adjusted income, the Minnesota Commissioner of Revenue may adjust a taxpayer's gross income based on its own investigation of the taxpayer." Weed v. Commissioner of Revenue, 550 N.W.2d 285, 289 (Minn. 1996); Specktor v. Commissioner of Revenue, 308 N.W.2d 806 (Minn. 1981). These cases are not pertinent. HMN has never argued that the Commissioner is limited to piggybacking on federal adjustments.

The Tax Court also cited Bond v. Commissioner of Revenue, 691 N.W.2d 831 (Minn. 2005). Add. 46. In Bond, the taxpayer (a tax protestor) claimed that the Social Security Administration had established a constructive trust for him that entitled him to deduct all of his income as fiduciary fees. The Court noted that there was no such trust. It went on to note that a court is free to look at substance, not just form. 691 N.W.2d at 838. However, this was an unnecessary comment because there was no trust in either substance or form. As Justice Page observed in concurrence, the taxpayer's position "was without factual or legal basis." 691 N.W.2d at 840. Again, the Court did not overrule a statue, which is what the Commissioner seeks in this case.

Finally, the Tax Court cited Midwest Federal Sav. & Loan Ass'n v. Commissioner of Revenue, 259 N.W.2d 596 (Minn. 1977), for the proposition that courts look to substance rather than form. Add. 46. Midwest Federal was a use tax case. The taxpayer entered into a sale-leaseback arrangement and claimed that it was really a conditional sale. This Court stated that it was free to look at the substance and reject the form, but then held that the form was consistent with the substance (i.e., it really was a conditional sale). Here too, the Court did not judicially overrule a statute. All that it did was to assign a legal characterization (conditional sale) to an ambiguous transaction. See also Transport Leasing Corp. v. State, 199 N.W.2d 817, 820, n. 4 (Minn. 1972) ("We have in several cases looked beyond form to substance in finding that what purports to be a lease is really a conditional sale.") Courts are frequently called upon to characterize legally ambiguous transactions. See, e.g., Great Lakes Gas Transmission L.P. v. Commissioner of Revenue, 638 N.W.2d 435 (Minn. 2002) (exchange of fuel for pipeline services held a "purchase" in substance despite different treatment for GAAP).

Thus, this Court does not have a 70-year history of disregarding statutory law. To the contrary, in tax cases this Court has adhered to the following rule: "When the words of a law in their application to an existing situation are clear and free from all ambiguity, the letter of the law shall not be disregarded under the pretext of pursuing the spirit." Minn. Stat. § 645.16. See Green Giant Co. v. Commissioner of Revenue, 534 N.W.2d 710, 712 (Minn. 1995) (this rule "specifically applies in the context of construing revenue statutes"); Commissioner of Revenue v. Richardson, 302 N.W.2d 23, 26 (Minn. 1981) ("No room for judicial construction exists when the statute speaks for itself"); and Hutchinson, 698 N.W.2d at 8 ("We have repeatedly held that we must give effect to the plain meaning of statutory text when it is clear and unambiguous").

FOCs are corporations that, because they meet certain tests, are taxed in a special way. In this respect, they are similar to S corporations which (like FOCs) are generally not subject to tax. Instead, S corporation shareholders are taxed on the corporation's income. Like FOCs, S corporations must meet certain requirements. I.R.C. § 1361(b)(1). In addition, the shareholders must file an S election. I.R.C. § 1361(a). No case holds that the shareholders must have a business purpose before making an S election. Indeed, since the election only has tax significance, it would be impossible to satisfy such a requirement.

Another election that only has tax significance is the check-the-box election by which certain entities can choose be classified as a corporation or a partnership, or to be disregarded, for federal and Minnesota income tax purposes. Such an election is meaningful only for tax purposes—the election has no independent business significance—yet the election is respected because that is what the law provides. See Manpower, *supra*.

Further, there is no rule precluding tax planning. Indeed, Hutchinson stands in a broad sense for the proposition that when the Legislature enacts a tax incentive by defining a special type of entity, such as an FOC, then taxpayers are entitled to arrange their affairs so as to qualify for that incentive. Hutchinson is consistent with United States Supreme Court tax precedent. "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." Gregory v. Helvering, 293 U.S. 465, 469 (1935). "The fact that favorable tax consequences were taken into account by [the taxpayer] on entering into the transaction is no reason for disallowing those consequences." Frank Lyon Co. v. United States, 435 U.S. 561, 580 (1978).

In Commissioner v. Brown, 380 U.S. 563, 579-580 (1965), the United States Supreme Court considered a highly-structured, deliberately tax-motivated transaction between taxable corporations and a tax-exempt charity. The Court upheld the taxpayer's position. Justice Harlan, concurring made the following observation:

> Were it not for the tax laws, the respondents' transaction … would make no sense … . However, the tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source. … If such sales are considered a serious abuse, ineffective judicial correctives will only

> postpone the day when Congress is moved to deal with the problem comprehensively.

380 U.S. 563, 579-80 (1965).

In short, when the Legislature enacts laws defining entities and according them special tax treatment, taxpayers are entitled to conform their transactions to such laws in order to reduce their tax bill. As Justice Harlan pointed out, "the tax laws exist as an economic reality in the businessman's world." Here, HMN knew that other banks had established FOCs to lower their taxes, and that HMN would be at a competitive disadvantage if it did not follow suit. A "tax dollar is just as real as one derived from any other source," and it would have been foolish for HMN to pass up the tax savings its competitors enjoyed when the law so clearly allowed them.

Justice Harlan's observation that "ineffective judicial correctives will only postpone the day when Congress is moved to deal with the problem comprehensively" is also apt. HMN was well aware that the Legislature might change the FOC laws because FOCs received significant attention during the 2004 legislative session.[14] App.137. HMN's president wrote to the Legislature in 2004 and asked it not to change the law. No changes were made in 2004. App. 109, 278-279. However, in 2005 the Legislature modified the definition of an FOC by changing the payroll and property tests. 2005

[14] The use of FOCs by banks was discussed in 2004 at the Legislature and in the media. See, e.g., Sweeney, "Business Tax Drop Puzzling—Loophole in Law May Spur Offshore Shelters," St. Paul Pioneer Press, July 11, 2004, at A1. ("Anderson said many Minnesota banks, including midsize institutions, have set up FOCs to cut their taxes. … She said it has been common for banks to bundle mortgages into a real estate investment trust and assign the trust to an offshore FOC.")

Minn. Laws 1st Spec. Sess., ch. 3, art. 3, secs. 5-7. HF Holding could not qualify and it was dissolved. The 2005 changes did not change the taxation of FOCs that owned REITs, but in 2008 the Legislature made additional changes, some of which were specifically targeted at FOCs receiving REIT dividends. 2008 Minn. Laws, ch. 366, art. 4, secs. 3 and 5.

Thus, over time, the Legislature reached the conclusion that the FOC tax incentive was overly broad and it enacted restrictions. This is the way tax policy should be ~~transformed into law—through legislative action. Tax policy should not be made by the~~ Commissioner's overriding clear statutes because taxpayers have conformed their transactions to the statutes in order to reduce their taxes.[15]

IV. The Tax Court Failed to Distinguish the Hutchinson Case.

The Commissioner argued below that the Hutchinson case was distinguishable because "it is not the status of HF Holding as an FOC that is being questioned, as in Hutchinson," but instead it "is the transactions that are under scrutiny here." Add. 42. The Tax Court agreed, although (as discussed above) it did not actually set aside the transactions. The Tax Court also believed that Hutchinson was distinguishable because

[15] It is also worth noting bills were introduced each year from 2005-2008 to add business purpose and economic substance tests to the statute, but they did not become law. See S.F. No. 1080 and H.F. No. 1388 (84th Legislative Session, 2005) (proposal to give the Commissioner the authority to disqualify a corporation from being an FOC for lack of business purpose and economic substance); S.F. No. 3716 (84th Legislative Session, 2006) (proposal to give the Commissioner authority to disregard transactions that he determined to be without "business purpose" and "economic substance"); and S.F. No. 763 (85th Legislative Session, 2007) (same); S.F. No. 2869 (85th Legislative Session, 2008) (same).

the FOC there "had separate business dealings with third parties." Add. 46. However, Hutchinson cannot be distinguished for either reason.

In Hutchinson, the taxpayer ("HTI") was a Minnesota corporation that manufactured precision parts used in computer hard drives. To take advantage of the tax laws, HTI formed a subsidiary ("Export"). With the assistance of its accounting firm, HTI qualified Export as a foreign sales corporation (an "FSC") under federal tax law and an FOC under Minnesota tax law.[16] Export was a shell company. It had one employee—~~an individual who was also an employee of the parent company, HTI.~~[17] ~~This individual~~ was paid a salary (averaging less than $60,000 per year) that covered his work for both HTI and Export. Hutchinson Technology, Inc. v. Comm'r, 2004 Minn. Tax LEXIS 31 (Minn. Tax Ct. May 10, 2004), at 3-4. Export's total property averaged less than $3,130 per year. It consisted of advertising brochures, videos, and product samples that it purchased from HTI. Id. at 3. Export also rented shared office space from a bank located in the Virgin Islands. Id. at 3.[18]

Export's only business was to act as a commissioned sales agent for HTI. However, HTI continued to perform (on Export's behalf) all of the sales activity it performed prior to forming Export, including "contacting the customer and generating the customer's interest in the property, determining the customer's creditworthiness,

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16 HMN's accounting firm likewise provided substantial assistance to HMN. Add. 48-49.

17 HF Holding likewise had only one employee. Add. 52.

18 HF Holding likewise rented shared office space in Grand Cayman. Add. 18.

arranging to take 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." Id. at 3-6. Export had no dealings with third parties, other than these activities which were conducted by HTI's own employees.[19] Thus, from the point of view of HTI's customers, nothing changed.[20]

HTI paid Export a sales commission; Export paid HTI a fee for the services. Id. at 4-6. These payments were circular (i.e., between the parent and subsidiary) and were all done through book entries (i.e., no cash was involved).[21] The method of payment was consistent with GAAP.[22] The commission was substantially larger than the fee so the parties simply netted the fee against the commission. Id. at 6. Export earned income in this way and paid its earnings to HTI in the form of dividends. Id. at 7.

The first issue in the case was whether Export qualified as an FOC—i.e., the "status issue" referred to by the Tax Court. The Commissioner argued that a corporation had to have "genuine operations" to qualify as an FOC. This Court rejected that assertion

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[19] HF REIT likewise had no direct contacts with third parties, although it owned participation interests in third-party mortgages, some of which were serviced by Cenlar, an unrelated entity. HF REIT also had third party preferred shareholders. HF Holding had no direct contacts with third parties other than its bank (ScotiaTrust).

[20] Similarly, the Tax Court noted that "from the outside, nothing changed" in HMN's structure. Add. 50.

[21] Similarly, the Tax Court characterized the transfer of loan participation interests to HF REIT, and the subsequent payment of dividends by HF REIT and HF Holding, as circular. Add. 31, 34. However, in this case there were dividend payments in cash from HF REIT to HF Holding, which had a bank account at ScotiaBank, and from HF Holding to HF Bank. Add. 22.

[22] Similarly, the Tax Court noted that HMN's accounting records and documents for the REIT strategy were consistent with and typical of GAAP. Add. 28.

and held that "we will not add requirements to the statute beyond those specified by the legislature." Hutchinson, 698 N.W.2d at 8.

Although the Tax Court distinguished Hutchinson because "it is the transactions that are under scrutiny here," Add. 42, in fact Hutchinson also addressed transactions. The specific transactions at issue were the fees paid by Export to HTI. Whether they qualified for the "fee subtraction" under Minn. Stat. § 290.01, subd. 19d(11), was the second issue the Court discussed.

The Commissioner argued "that any fees paid by Export do not qualify for the fee subtraction because they were merely paper transactions, intended only to qualify HTI for federal tax benefits, with no genuine business purpose." 698 N.W.2d at 9. The Supreme Court rejected that argument. After concluding that the question was one of state law, the Court said:

> The tax court made factual findings, noted above, that services had been provided and fees had been paid for those services. We cannot ignore those findings. ... The tax court found that fees were paid for services. ... Also, the method of payment, by offsetting bookkeeping entries, is consistent with GAAP. We conclude that the Commissioner has not given us an adequate basis to reject these findings of fact.
>
> The Commissioner urges us to conclude that because there was no real business purpose served by transactions here, the payments cannot qualify as fees subject to subtraction. ... the statute at issue here only requires that the payments be "fees."
>
> While the Commissioner may be correct that the legislature intended a more restrictive definition of fees, the legislature did not say so. Rather, the statute provided that an FOC can subtract "fees," and the tax court found that fees were paid. We find no sound basis on which to disagree. We reiterate

> that we are unwilling to write into a statute what the legislature did not. Green Giant, 534 N.W.2d at 712.

698 N.W.2d at 11-12 (emphasis added).

Clearly, Hutchinson cannot be distinguished as a case that dealt only with FOC status. The Court did address FOC transactions and held that because the transactions actually occurred, they had substance and would be respected even though they were paper transactions whose only purpose was tax-related.

As discussed above, the Tax Court in this case also found that the various transactions at issue actually occurred. See pp. 22-23, *supra*. Further, as in Hutchinson, HMN's accounting records and documents for transactions were consistent with and typical of GAAP. Add. 28. Thus, as in Hutchinson, the transactions were not shams. They really happened. Moreover, it bears repeating that the Commissioner's order here did not disregard those transactions. See pp. 22-23, *supra*.

Although the Tax Court thought Hutchinson could be distinguished because the FOC there had separate business dealings with third parties, Add. 46-48, the facts in Hutchinson do not support the Court's observation. Export was a shell corporation. It did not have separate business dealings with third parties. Its commissioned sales activities were not separate—HTI employees performed all sales activities, just as they would have if Export had not been formed.

V. The Tax Court Erroneously Relied on Cases From Other States That Do Not Have FOC Laws.

Instead of following the decision in Hutchinson, the Tax Court relied on cases from other states. In footnote 15, the Court said that all of these cases had fact patterns nearly identical to HMN's, including a REIT and a holding company. Add. 46-47. In actual fact, none of them did.

Indeed, most of the cited cases did not involve a REIT at all.[23] Four of the cases that did involve a REIT concerned an issue not presented here: Whether, under state law, there was a deduction for dividends received from a REIT.[24] Minnesota law does not allow such a deduction and HF Holding (the recipient of the REIT dividends) did not claim one. One case, which involved a REIT but not a holding company, raised the issue ~~of whether North Carolina could include a REIT on a consolidated return.[25] Minnesota~~ law requires the inclusion of a REIT on a combined report and HF REIT was so included. Another case involved the issue of whether Louisiana had jurisdiction to tax the shareholder of a REIT.[26] There is no jurisdictional issue in this case. Finally, the

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[23] The following cases do not involve REITs: Pacificare v. Dept. of Rev., 2008 WL 2596371 (Or. Tax. Regular Div. 2008); The Talbot's, Inc., 2007 WL 967883 (N.Y. Div. Tax. App.); TD Banknorth, N.A. v. Dep't of Taxes, 967 A.2d 1148, 2008 VT 120; Nordstrom, Inc. et al. v. Comptroller, 2008 WL 4754842 (Md. Tax Ct. 2008); The Classic Chicago, Inc. et al. v. Comptroller, 2008 WL 1724237 (Md. Tax Ct. Apr.11, 2008); Sherwin-Williams Co. v. Tax Appeals Tribunal of the Dep't of Tax. & Fin. of the State of N.Y. et al., 784 N.Y.S.2d 178 (N.Y. App. Div. 2004); and Syms Corp. v. Commissioner of Revenue, 765 N.E.2d 758 (Mass. 2002).

[24] The following cases involved the dividends received deduction for REIT dividends: BankBoston Corp. v. Commissioner of Revenue, 861 N.E.2d 450 (Mass. 2007); UNB Inv. Co., Inc. v. Director, Div. of Taxation, 21 N.J. Tax 354 (N.J. Tax Ct. May 13, 2004); In the Matter of the Tax Appeal of HEI & Subsidiaries, T.A., No. 03-0169 (Haw. Tax Ct. 2005); and In the Matter of the Tax Appeal of Central Pacific Bank, Inc., T.A. Nos. 00-0075 (Haw. Tax Ct. 2005). (We were unable to find the Hawaii tax appeal decisions referred to by the Court. However, they are described at: http://www.state.hi.us/tax/pubs/05annrpt.pdf.).

[25] Wal-Mart Stores East v. Hinton, 676 S.E.2d 634 (N.C. Ct. App. 2009).

[26] Bridges v. AutoZone Properties, Inc., 900 So.2d 784 (La. 2005).

Massachusetts Appellate Tax Board held that a REIT was not entitled to a dividends paid deduction.[27] Minnesota law allows a dividends paid deduction and there is not dispute about that deduction taken by HF REIT.

The cases from other states all have major factual differences. They also have one enormous legal difference: None of them involved a statute like Minnesota's FOC statute. This Court has held that tax cases from other jurisdictions, where the laws are not the same, are not helpful:

> Our attention has been called to a number of cases from foreign jurisdictions allegedly supporting the positions of the respective parties. We see no useful purpose in attempting to reconcile these cases with, or distinguish them from, the facts now before us. In many of them, the statutes are not the same as ours; in others, the facts are distinguishable. No case has been called to our attention identical to the case before us on both statute and facts.

Midwestern Press, Inc. v. Commissioner of Taxation, 203 N.W.2d 344, 347 (Minn. 1972). That many of the decisions were merely agency decisions, without precedent even in the states where they were decided, reinforces the conclusion that the Tax Court should not have relied upon them.

VI. The Commissioner Exceeded His Authority Under Minn. Stat. § 290.34.

The Tax Court held that the Commissioner had the authority to assess tax under Minn. Stat. § 290.34, subd. 1. ("Subdivision 1"). This holding presents two questions.

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27 Fleet Funding, Inc. v. Commissioner of Revenue, No. C271862-63 (Mass. App. Tax Bd., Feb. 21, 2008).

First does the statute apply? Second, if it does, can the Commissioner use it to override another statute?

Subdivision 1 consists of a single sentence containing three principal clauses:

> *Subdivision 1. Business conducted in such a way as to create losses or improper taxable net income.* **[CLAUSE 1]** When any corporation liable to taxation under this chapter conducts its business in such a manner as, directly or indirectly, to benefit its members or stockholders or any person or corporation interested in such business or to reduce the income attributable to this state by selling the commodities or services in which it deals at less than the fair price which might be obtained therefor, or buying such ~~commodities or services at more than the fair price for which they~~ might have been obtained, **[CLAUSE 2]** or when any corporation, a substantial portion of whose shares is owned directly or indirectly by another corporation, deals in the commodities or services of the latter corporation in such a manner as to create a loss or improper net income or to reduce the taxable net income attributable to this state, **[CLAUSE 3]** the commissioner of revenue may determine the amount of its income so as to reflect what would have been its reasonable taxable net income but for the arrangements causing the understatement of its taxable net income or the overstatement of its losses, having regard to the fair profits which, but for any agreement, arrangement, or understanding, might have been or could have been obtained from such business.

Minn. Stat. § 290.34, subd. 1. Because the statutory language is complex, it helps to analyze Clause 1 and Clause 2 separately. Clause 3 is a remedy provision that could apply if either Clause 1 or Clause 2 were applicable, and therefore will be discussed in conjunction with Clauses 1 and 2.

A. The Commissioner's Order Is Not Authorized by Clause 1.

Clause 1 of Subdivision 1 provides:

> When any corporation liable to taxation under this chapter conducts its business in such a manner as, directly or indirectly, to benefit its members or stockholders or any

> person or corporation interested in such business or to reduce the income attributable to this state by selling the commodities or services in which it deals at less than the fair price which might be obtained therefor, or buying such commodities or services at more than the fair price for which they might have been obtained …

Clause 1 could apply if HF Bank or HF REIT[28] sold or bought "the commodities or services in which it deals" at "less than the fair price" or "more than the fair price." HF Bank sold participation interests to HF REIT but the Commissioner did not claim (and the Tax Court did not find) that the price was unfair.

On the other hand, the Tax Court noted that HF Bank provided officer services to HF Holding at no cost. Add. 44. These services were *de minimis* because, as the Tax Court found, HF Holding had "little activity; it received dividend payments and sent dividends back to HF Bank." Add. 23. The Tax Court found that one HF Bank employee, Jon Eberle, spent "very little" time on HF Holding matters. Add. 25. The Court made no findings about services by other HF Bank employees, but the record is clear that those employees also spent very little time on HF Holding matters after HF Holding became operational in December 2002. App. 100, 103, 112, 106; see pp. 15-16, *supra*.

It is routine, among affiliated corporations, for the employees of one corporation (often the parent) to perform *de minimis* services for others at no cost—so much so that Minnesota had a withholding tax rule during the years in issue providing that an officer

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[28] HF Bank and HF REIT were subject to tax. HF Holding, on the other hand, was an FOC not subject to tax.

who "performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is not considered to be an employee of the corporation." 2001 Minn. Rule 8092.0200. Thus, it is HMN's position that these *de minimis* services did not trigger Clause 1.

However, even if they did, the Commissioner far exceeded the authority prescribed in Clause 3 of Subdivision 1:

> ... **[1]** the commissioner of revenue may determine the amount of its income / **[2]** so as to reflect what would have ~~been its reasonable taxable net income but for the~~ arrangements causing the understatement of its taxable net income or the overstatement of its losses, / **[3]** having regard to the fair profits which, but for any agreement, arrangement, or understanding, might have been or could have been obtained from such business.

Phrase [1] gives the Commissioner the discretion to make a determination of "its income"—i.e., the income of the "corporation liable to taxation" that is selling or buying commodities or services at an unfair price. Phrases [2] and [3] say that the Commissioner can modify income to reflect "reasonable taxable net income" having regard for "fair profits." In other words, the Commissioner's remedy is to correct unfair pricing between related parties.

This is precisely what occurred in the only Minnesota Supreme Court decision to apply Subdivision 1. See Addison Miller, Inc. v. Commissioner of Taxation, 81 N.W.2d

89 (Minn. 1957).[29] In that case, a corporation and a partnership were related by common ownership. There were two related-party transactions: (1) the corporation rented equipment to the partnership at a below-market rental rate; and (2) the corporation made an interest-free loan to the partnership. The corporation, which was a Minnesota taxpayer, thus understated its income. This Court held that the Commissioner could adjust the income of the corporation upwards to reflect what the true fair market rental and interest income would be.

Here, perhaps the Commissioner could have adjusted HF Bank's compensation deduction because its employees performed *de minimis* services for HF Holding. However, such an adjustment might have generated, at most, just a few dollars of additional tax. Instead, the Commissioner took all of HF Holding's income and included it on HF Bank's return. It then denied the dividends received deduction—all in the face of statutes saying that such income must not be included on the combined report, except as a deemed dividend entitled to the dividends received deduction. This goes far beyond what Clause 3 authorizes.

B. The Commissioner's Order Is Not Authorized by Clause 2.

Clause 2 of Subdivision 1 provides:

> ... or **[1]** when any corporation, a substantial portion of whose shares is owned directly or indirectly by another corporation, / **[2]** deals in the commodities or services of the

29 The Tax Court implied that HMN argued that Subdivision 1 applied only to buyers and sellers. Add. 43. To the contrary, HMN consistently has recognized (and even stressed) that Addison Miller's application of a fair pricing analysis to rents and interest.

> latter corporation / **[3]** in such a manner as to create a loss or improper net income or to reduce the taxable net income attributable to this state …

Phrase 1 limits the application of Clause 2 to specific corporations—those that have a substantial portion of their shares "owned directly or indirectly by another corporation." In other words, Clause 2 applies where there is a subsidiary whose shares are owned by a parent. Phrase 2 says that the statute applies if the subsidiary "deals in the commodities or services of the latter corporation." The "latter corporation" refers to the parent company. Thus, for Clause 2 to apply, a subsidiary must have "deal[t] in … commodities or services" that were provided by its parent.

If Clause 2 is triggered, then the remedy provisions of Clause 3 allow the Commissioner to "determine the amount of <u>its</u> income." (emphasis added). The antecedent of "its" is "any corporation, a substantial portion of whose shares is owned directly or indirectly by another corporation"—in other words, the subsidiary. Thus, the Commissioner is authorized to adjust the income of the subsidiary.

So, again, <u>perhaps</u> Clause 2 was triggered by the *de minimis* officer services (i.e., the subsidiary "deal[t] in … services" of the parent). But if so, then the Commissioner's authority under Clause 3 was to adjust the income <u>of the subsidiary</u>—HF Holding. The Commissioner, instead, adjusted the income of the parent (HF Bank) by assigning HF Holding's income to HF Bank and denying the dividends received deduction. Clause 3 does not authorize the adjustment the Commissioner made.

The Tax Court offered another, extremely confusing, analysis based on the notion that "all three entities received income through the collection of interest income" and therefore "dealt in same services, holding the same mortgage loan proceeds." Add. 43. This simply isn't accurate. After the participation interests were acquired by HF REIT, only HF REIT received the interest income. That HF REIT paid its income (less deductions) to HF Holding as a dividend (as required by federal tax law) did not mean that HF Holding also had mortgage interest income. But again, even if the Court's reasoning were correct, Clause 3 would permit an adjustment to the subsidiary's income, not HF Bank's.

C. The Commissioner's Order Is Not Authorized by Minn. Rule 8034.0100.

The Court cited, but did not rely upon, Minn. Rule 8034.0100, which is an implementation of Subdivision 1. Add. 44. The rule provides, in part:

> **[1]** In any case where a corporation, which is subject to Minnesota corporate franchise tax, / **[2]** conducts business transactions with its members or stockholders, or with any person or corporation interested in the business of the corporation, / **[3]** in a manner as to reduce the taxable net income attributable to this state, or affect the amount of credit against the tax, or both, / **[4]** the commissioner may determine the income of the corporation to reflect what would have been its reasonable taxable net income or tax credit but for such business transaction.

Phrase 1 says that the rule applies where a corporation is subject to Minnesota tax. HF Bank was so subject (but HF Holding was not). Phrase 2 says that if the corporation (HF Bank) conducts business with its "its members or stockholders, or with any person or corporation interested in the business of the corporation," then the rule might apply. But HF Bank did not conduct business upstream (with its stockholders), it conducted business downstream—by providing officer services to HF Holding. Thus, the rule does not apply. Moreover, the rule goes on to cite five "devices commonly employed to distort income," and all of them are variations on a failure to charge an arm's length price. Minn. Rule 8034.0100.

In any event, the rule cannot expand upon the authority given to the Commissioner in the statute, and as discussed above the statute does not authorize him to make the adjustments he did in this case.

D. Subdivision 1 Does Not Authorize the Commissioner to Override the Statute.

A technical analysis of the statute demonstrates that Subdivision 1 was not triggered or, if it was, then the Commissioner's assessment was far in excess of what the statute authorized for the *de minimis* provision of officer services at no cost.

But there is an additional, more fundamental, point to be made. Subdivision 1 does not authorize the Commissioner to override statutes. The provision has been in Minnesota's tax law since 1933. 1993 Minn. Laws ch. 405, art. IV, sec. 32. Addison Miller, which involved unfairly low rents and interest, is the only case in the ensuing 76 years to uphold the Commissioner's use of Subdivision 1. 81 N.W.2d 89. We know of just one other case in which the Commissioner employed Subdivision 1. It, too, involved an attempt to require a fair interest rate on a loan. State v. Duluth, M. & N. R. Co., 292 N.W. 401, 406 (Minn. 1939) (rejecting the proposed adjustment because the taxpayer's interest rate was fair).

Here, the Commissioner did not make a pricing adjustment. Instead, he nullified two statutes. He overrode Minn. Stat. § 290.17, subd. 4(f) and (h), which say that the "net income ...of foreign operating corporations shall not be included" on a combined report, and that "there must be included only the income ... of domestic corporations ... other than foreign operating corporations." He also overrode Minn. Stat. § 290.17, subd. 4(g), and Minn. Stat. § 290.21, subd. 4, which together deem a dividend to be paid by an FOC and allow the parent to claim a dividends received deduction.

Subdivision 1 does not provide the Commissioner with the authority to nullify statutes. Taxation in Minnesota is governed by law, not by Commissioner fiat. The Commissioner must apply Subdivision 1 consistent with the statutory language. That language does not authorize the assessment the Commissioner made here.

CONCLUSION

When this Court in Hutchinson said that "there is nothing to prevent any FOC from being an empty shell entity, existing solely to provide tax exemptions," it was holding that the motivation for forming and operating an FOC was irrelevant. Hutchinson, 698 N.W.2d at 16. An FOC could exist solely to reduce Minnesota tax.

During the years in issue, the statutes defining FOCs were clear. The statutes prescribing the tax treatment for FOCs and their shareholders were mandatory and unambiguous. The income of an FOC "shall not be included in the net income ... of the unitary business," except as a deemed dividend. Minn. Stat. § 290.17, subd. 4(f). Hutchinson applied the statutes as written. It held that inquiries into taxpayer motive were irrelevant.

In upholding the Commissioner's order assessing tax, the Tax Court did not apply the statutes as written because, in its view, the only purpose for the transactions undertaken by HMN was to reduce its Minnesota tax through the use of an FOC. The Tax Court's reliance on taxpayer intent to override the unambiguous and mandatory FOC statutes was clear error. This Court should reverse.

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Walter A. Pickhardt, #86782
Adam B. Thimmesch, #349227
Faegre & Benson LLP
2200 Wells Fargo Center
90 South Seventh Street
Minneapolis, MN 55402
(612) 766-7000

Attorneys for Relator

fb.us.4256781 07

CERTIFICATE OF COMPLIANCE

WITH MINN. R. APP. P 132.01, Subd. 3

The undersigned certifies that the Brief submitted herein contains 12,990 words and complies with the type/volume limitations of the Minnesota Rules of Appellate Procedure 132. This Brief was prepared using a proportional spaced font size of 13 pt. The word count is stated in reliance on Microsoft Word 2007, the word processing system used to prepare this Brief.

Walter A. Pickhardt