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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' REPLY BRIEF

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I. Introduction.

The Commissioner argues that he is the ultimate authority within the field of taxation. He claims the power to assess and collect taxes even if they are not imposed under Minnesota Statutes. For example, the Commissioner states: "In simple terms, claimed FOC status is subject to and operative only after the Commissioner has, in the exercise of his statutory authority, confirmed that the taxpayer is entitled to the treatment claimed." Com-Br. 50.[1] The Commissioner, in other words, claims to be the gatekeeper—if he determines that the statute produces a result he doesn't like, then he can reject the statute.

The Commissioner makes this argument through obfuscation. First, he discusses various statutory provisions giving the Commissioner limited powers that can be used in limited situations without ever parsing the statutory language because, if he did, the limitations on his powers would be readily apparent. Next, the Commissioner addresses the substance-over-form cases without noting that this Court has never applied substance-over-form to override a statute, again to create the illusion that the Commissioner may act as an autocrat within the field of taxation, regardless of what the Legislature may do.

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1 "HMN-Br." and "Com-Br." refer to the opening briefs of HMN and the Commissioner, respectively. Abbreviations used by HMN in its opening brief will also be employed in this reply brief. Citations to Minnesota Statutes are to the statutes in effect for the 2002-2004 years in issue, unless otherwise noted.

To build this argument, the Commissioner frequently quotes snippets from the case law out of context. Perhaps the most egregious example is the following: "These provisions [Minn. Stat. §§ 289A.35 and 270C.03] placed '[a]bundant power ... in the [tax administrator] to obtain a computation of the tax upon any theory it might entertain.'" See State v. Duluth, M. & N. Ry. Co., 292 N.W. 411, 413 (Minn. 1940), cert. denied sub. nom., 311 U.S. 719 (1941). Com-Br. 29. Standing alone, this quotation suggests that the law allows the Commissioner to determine tax upon any theory he likes, whether or not there is a statutory basis, as if the Commissioner were the Tax Czar of the State of Minnesota. But, of course, State v. Duluth says no such thing.

In State v. Duluth, this Court decided that a railroad paying the gross earnings tax was not also subject to the corporate franchise tax on the same railroad earnings. It was subject to franchise tax only on its nonrailroad earnings. State v. Duluth, M. & N. R. Co., 292 N.W. 401 (Minn. 1939). After losing the case, the State petitioned for a rehearing in order to obtain a decision that certain items were taxable nonrailroad earnings. The Court discussed those items, rejected the State's arguments, and then it addressed a procedural issue.

The State had brought the case as a tax collection suit against the taxpayer. The law authorized the Tax Commission to conduct an investigation in order to make a determination of tax, and it said that the amount determined "shall be the tax to be paid by such taxpayer." 1933 Minn. Laws, ch. 405, sec. 43. If the taxpayer refused to pay, the State could sue to collect (allowing the taxpayer to raise defenses) but the law required the Tax Commission to file with the court an "itemized summary of the taxable net income." 1933 Minn. Laws, ch. 405, sec. 45. The Tax Commission hadn't done that and, as a result, the trial court excluded evidence that the State sought to introduce in order to demonstrate the incorrectness of the taxpayers' returns. The Commissioner appealed that ruling.

It was in this context that this Court noted that the Tax Commission had "abundant power" to "obtain a computation of the tax upon any theory it might entertain." In other words, its power was to conduct an examination and assess tax. But the Tax Commission still had to follow the statute:

> As we understand the record, no recomputation by the commission setting out its present claims under the sections cited had bee n made when the returns were sought to be attacked in this action. In justice to any taxpayer, individual or corporate, the provisions of the statute must be followed so that he may know with what items of income the state seeks to charge him. This is but common fairness.

State v. Duluth, 292 N.W. at 413. Therefore, the trial court's evidentiary ruling was upheld.

Note that when this Court said that the Tax Commission had the "abundant power" to compute tax, it was talking about the power to make an assessment. But assessments then (as now) are subject to judicial review. The Court was not saying that the Commissioner's had the final authority to determine tax upon "any theory."[2]

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[2] State v. Duluth is also noteworthy because it is one of just two cases since 1933 to address an adjustment by the Commissioner pursuant to Minn. Stat. § 290.34, subd. 1 (or (footnote continuation)

II. Minnesota Statutes Do Not Authorize the Commissioner to Compute Tax "Upon Any Theory."

The Commissioner argues that he may "use a variety of methods" to ensure that the income is fairly reported, and that "the Legislature's consistent use of flexible concepts ("fairly," "clearly," "reasonable") ... requires that these multiple provisions be construed in harmony and consistent with Minnesota's tax policy." Com-Br. 32-33. Although there is nothing wrong with construing statutes "in harmony" with one another, that is not the issue. The issue is whether the language of these provisions matters. See Minn. Stat. §§ 289A.35, 290.07, 290.20 and 290.34.

The Commissioner is asking this Court to hold that these statutes, which by their terms limit the Commissioner's exercise of discretion to specific situations, have some sort of "aura" or "penumbra" when they are considered together such that the limitations drop off, thus allowing the Commissioner to compute tax upon any theory in any situation. The Commissioner's argument is contrary to the principle that "[w]hen 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. This Court has consistently held, especially in tax cases, that courts "must give effect to the plain meaning of statutory text when it is clear and

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predecessor statutes). HMN-Br. 45. It is particularly ironic that the Commissioner would rely on State v. Duluth for the proposition that he can compute tax "upon any theory" because this Court there held that the Commissioner could not change the rate of interest on an intercompany loan. The law did "not empower the commission arbitrarily to increase the amount of taxable income." 292 N.W. at 406.

unambiguous." Hutchinson Technology, Inc. v. Commissioner of Rev., 698 N.W.2d 1, 8 (Minn. 2005). See HMN-Br. 29.

A. The Commissioner's Action Was Not Authorized by Minn. Stat. § 289A.35.

The Commissioner cites Minn. Stat. § 289A.35 for the proposition that "FOC status is subject to and operative only after the Commissioner has, in the exercise of his statutory authority, confirmed that the taxpayer is entitled to the treatment claimed." Com-Br. 50. The statute provides:

> The commissioner has the authority to make determinations, corrections, and assessments with respect to state taxes, including interest, additions to taxes, and assessable penalties.

Minn. Stat. § 289A.35. This statute simply authorizes the Commissioner to correct a return and make an assessment. However, the Commissioner's assessment is subject to challenge in court where it receives *de novo* review.[3] Thus, Minn. Stat. § 289A.35 is merely a procedural statute. It does not confer substantive authority upon the Commissioner to reject "FOC status" if he disagrees with the FOC law.

B. The Commissioner's Action Was Not Authorized by Minn. Stat. § 290.07.

The Commissioner cites Minn. Stat. § 290.07, subd. 2, as one of the statutes conferring authority on him to make the adjustments he made in this case. Com-Br. 29, 59. That section provides, in relevant part:

[3] Indeed, the parties agree that *de novo* review applies here. HMN-Br. 17; Com-Br. 27.

> *Subdivision 2. Accounting methods.* Except as specifically provided to the contrary by this chapter, net income and taxable net income shall be computed in accordance with the method of accounting regularly employed in keeping the taxpayer's books. If no such accounting system has been regularly employed, or if that employed does not clearly or fairly reflect income or the income taxable under this chapter, the computation shall be made in accordance with such method as in the opinion of the commissioner does clearly and fairly reflect income and the income taxable under this chapter.

This provision is analogous to section 446(b) of the Internal Revenue Code ("I.R.C.").[4] Both statutes deal with methods of accounting.

The Commissioner's authority is to require the use of the accounting method he selects when the taxpayer's method does not clearly reflect income. The term "method of accounting" is undefined but it is "generally understood to refer to any regularized practice or procedure for determining when to recognize items of income and expense." Gertzman, Federal Tax Accounting ¶2.01 (2d ed. 1993). Methods of accounting concern the timing of income and expense:

> [A] method of accounting determines the time when an item of income or expense is to be recognized or reported for tax purposes. It does not determine the aggregate amount of income or expense to be recognized from any particular transaction or series of transactions, which should be the same under any method of accounting.

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[4] I.R.C. § 446(b) provides: "If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."

Id. at ¶2.01[1]. Minn. Stat. § 290.07, subd. 2, is inapplicable here because the Commissioner did not adjust the timing of any income or expense item. See State v. Duluth, 292 N.W. at 406 (Tax Commission's authority regarding accounting methods did not permit Commission to adjust the interest rate on a loan from subsidiary to parent because the law was "aimed exclusively at methods of accounting").

C. The Commissioner's Action Was Not Authorized by Minn. Stat. § 290.20.

The Commissioner also relies upon Minn. Stat. § 290.20 for the proposition that "[for] multi-state taxpayers generally and specifically for a claimed FOC, the Commissioner can also employ any method that will 'properly reflect' the taxable income allocable to Minnesota." Com-Br. 30, 59.

The statute provides, in relevant part:

> *Subdivision 1. Statutory methods to determine; petition for the use of other methods.* The methods prescribed by section 290.191 shall be presumed to determine fairly and correctly the taxpayer's taxable net income allocable to this state. If the methods prescribed by section 290.191 do not fairly reflect all or any part of taxable net income allocable to this state, the taxpayer may petition for or the commissioner may require the determination of net income by the use of another method, if that method fairly reflects net income. ...

Minn. Stat. § 290.20 provides a safety valve where the standard three-factor apportionment formulae set forth in Minn. Stat. § 290.191 create a "grossly inequitable allocation" of income to Minnesota. Walgreen Co. v. Commissioner of Taxation, 104 N.W.2d 714, 720 (Minn. 1960).

Minn. Stat. § 290.20 is inapplicable because there is no apportionment issue in this case.[5] Neither party argues that "the methods prescribed by section 290.191 do not fairly reflect all or any part of taxable net income allocable to this state." The taxpayer used the standard three-factor formula in its return, and the Commissioner used the same formula in his order. Accordingly, this is another statute that permits the Commissioner to exercise discretion in a targeted situation that is not presented in this case.

D. The Commissioner's Action Was Not Authorized by Minn. Stat. § 290.34, subd. 1.

The Commissioner primarily relies upon Minn. Stat. § 290.34, subd. 1 ("Subdivision 1").[6] Tellingly, despite the fact that HMN devoted seven pages of its opening brief to explicating the statutory language, HMN-Br. 38-44, the Commissioner does not discuss the statutory language <u>at all</u>.

We note again that there are two issues under Subdivision 1. First, was it triggered? Second, if so, what is the remedy?

1. Clause 2 of Subdivision 1 Was Not Triggered.

The Commissioner asserts that nothing in Subdivision 1 limits the law to fair pricing. Com-Br. 37. He is incorrect. Clause 1 explicitly uses the term "fair price,"

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5 For similar reasons, the Commissioner's reliance on apportionment case law is inapposite. Com-Br. 32. See <u>Great Lakes Pipeline Co. v. Commissioner of Taxation</u>, 138 N.W.2d 612 (Minn. 1965) (interest on short term investments held to be business income subject to apportionment); <u>Western Auto Supply Co. v. Commissioner of Taxation</u>, 71 N.W.2d 797 (Minn. 1955) (rejecting separate accounting in favor of formulary apportionment).

6 In addressing Subdivision 1, we will use the nomenclature employed in our opening brief. See HMN-Br. 38-45.

so it clearly is a fair pricing provision. Clause 2 does not mention "fair pricing" *per se*, but Clause 2 is inapplicable for the following reason.[7]

Clause 2 can apply if a subsidiary "deals in the commodities or services" of its parent. Perhaps HF Holding's receipt of *de minimis* officer services from HF Bank, or HF REIT's purchase of the participation interests (at fair market value) from HF Bank, was a dealing in commodities or services of HF Bank. But Clause 2 requires that such intercompany dealing must occur "in such a manner as to create a <u>loss</u> or <u>improper net income</u> or to <u>reduce the taxable net income</u> attributable to this state." (Emphasis added.)

The transactions did not create a loss. Did they create "improper net income" or "reduce the taxable net income" attributable to Minnesota? No.

In its opening brief, HMN stressed the importance of understanding the Commissioner's order. HMN-Br. 23-25. The key page of the order is at App. 16,[8] which shows the adjustments the Commissioner made:

Taxable Year	**12/31/2002**	**12/31/2003**	**12/31/2004**
MN Net Income per HMN Return	$ 7,075,780	$ 13,752,612	$ 17,453,535
Remove FOC Deemed Dividend	$ (8,626,754)	$ (10,129,448)	$ (15,756,543)
Add HF Holding Income	$ 8,626,754	$ 10,129,448	$ 15,756,543
MN Net Income (Apportionable)	$ 7,075,780	$ 13,752,612	$ 17,453,535

[7] This reason is in addition to the reasons noted in HMN's opening brief. Most importantly, if Clause 2 were applicable the Commissioner's remedy is to adjust the income of a subsidiary, but here the Commissioner adjusted the income of the parent (HF Bank). HMN-Br. 43.

[8] HMN's opening brief cites to App. 236 and, in error, to Add. 29. The proper Addendum cite is Add. 56. The photocopying is clearest, however, at App. 16.

Note that Minnesota net income as reported and Minnesota net income as adjusted by the Commissioner are the same. Thus, the Commissioner concluded in his order that "net income" was proper. "Taxable net income" is the same thing as "net income," except that it is apportioned to Minnesota using the three-factor formula. Because "net income" did not change, "taxable net income" also did not change.[9]

What the Commissioner did, in his order, was to treat HF Holding as if it were a non-FOC by including HF Holding's income on the combined report, but not as a deemed dividend. The order states: "Remove FOC Deemed Dividend." App. 16. As a result, the Commissioner disallowed the dividends received deduction. Disallowing the dividend received deduction did not change "net income" or "taxable net income" because that deduction is taken after "taxable net income" is determined. Minn. Stat. § 290.21, subd. 1.[10]

Thus, the transactions did not occur "in such a manner as to create a loss or improper net income or to reduce the taxable net income." Therefore, Clause 2 is inapplicable.

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9 "Net income" is defined as "federal taxable income" with specified modifications. Minn. Stat. § 290.01, subd. 19. The Commissioner's order refers to "apportionable net income" which is not a statutory term but which, in context, means the same thing as "net income." "Taxable net income" is "net income" apportioned to Minnesota. Minn. Stat. § 290.01, subd. 22.

10 The computation of tax starts with "net income." An apportionment formula is then applied to produce "taxable net income." Three types of deductions are then allowed: the net operating loss deduction; the dividends received deduction; and the charitable contribution deduction. These deductions produce "taxable income." Minn. Stat. § 290.01, subd. 29(2). The tax is imposed on "taxable income."

2. Subdivision 1 Was Not Triggered by Minor Employee Services.

Clause 1 of Subdivision 1 can come into play if related corporations conduct transactions at an unfair price. The Commissioner claims that HMN concedes that Subdivision 1 applies because HF Bank officers provided *de minimis* services to HF Holding at no cost. Com-Br. 34. HMN did not concede this point. HMN's position is that *de minimis* services do not trigger Subdivision 1. HMN-Br. 41

The Commissioner argues that the officer services cannot be considered minimal. Com-Br. 35. This is contrary to the Tax Court's finding that HF Holding had "little activity; it received dividend payments and sent dividends back to HF Bank." Add. 23. Because it had little activity, it had little need for officer services.

The Tax Court also found that one HF Bank officer (Jon Eberle) spent "very little" time on HF Holding matters. Add. 25. Three other HF Bank employees also testified that they did not perform material services for HF Holding: Tim Johnson testified that he did not do "very much" work for HF Holding; Mike McNeil testified that he did no work for HF Holding; and Rick Quam testified that he made two entries in the ~~general ledger per month which took just "a couple of minutes." App. 100, 103, 112,~~ 106. This testimony was consistent with the Tax Court's finding that HF Holding had "little activity." Thus, the Commissioner's contention that the services were beyond *de minimis* is contrary to the Tax Court's findings and to the record.[11]

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[11] The Commissioner points out that Mr. Johnson took certain "operational steps," but these consisted of one-time actions such as signing a lease, signing an employment (footnote continuation)

As HMN noted in its opening brief, it is routine, among affiliated corporations, for employees of one to perform minor services for another—so much so that Minnesota had a withholding tax rule addressing that situation. HMN-Br. 40-41. Yet, since Subdivision 1 was enacted in 1933, no authority (case, rule, revenue notice, etc.) holds that the provision of minor services to an affiliate triggers Subdivision 1.

The Commissioner's position is divorced from reality. The Commissioner seemingly argues that if an employee of one affiliate answers a phone call from an employee of a sister company and renders assistance, Subdivision 1 is triggered allowing the Commissioner to compute tax "upon any theory" he likes. This is clearly a situation calling for the application of the principal: *De minimis non curat lex*. Haugland v. Canton, 84 N.W.2d 274, 281 (Minn. 1957).

3. Subdivision 1 Was Not Triggered by the Sale of the Participation Interests or by the Receipt of Interest Income.

The Commissioner next tries to defend the Tax Court's misconception that "all three entities [HF Bank, HF Holding and HF REIT] received income through the collection of interest income." Add. 43; Com-Br. 36. It is a fact that only HF REIT received interest income from the participation interests. HF Holding and HF Bank received dividends derived from that interest income, but they did not receive the interest

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agreement, etc. Com-Br. 34-35. Mr. Johnson resigned shortly thereafter, on March 31, 2003. R.A. 8.

income.[12] So, what the Tax Court's point seems to be is that when a subsidiary pays a dividend to a parent, the parent enjoys (as a dividend) the income that the subsidiary earned. That is a truism and one cannot dispute it. However, the mere receipt of a dividend from a subsidiary does not trigger Subdivision 1.

Clause 1 of Subdivision 1 could be triggered if HF Bank or HF REIT sold or bought "the commodities or services in which it deals" at "less than the fair price" or "more than the fair price." HMN-Br. 40. HMN acknowledges, as it always has, that a loan can be a service under the statute. Addison Miller, Inc. v. Commissioner of Taxation, 81 N.W.2d 89 (Minn. 1957). Thus, if HF Bank had sold the participation interests for less than fair market value, Subdivision 1 would have been triggered—but it did not do that. Loan participations were sold for fair market value under the Participation Agreement. Add. 16.

Another way that Clause 1 might have been triggered would be if the participation agreement interest rates were not fair, which was the situation in Addison Miller. That case involved an interest-free related-party loan.[13] Here, on the other hand, ~~the participation loans were with unrelated borrowers (the mortgagors) and there is no~~ evidence (and no reason to believe) that the interest rates were not fair.

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[12] Tax law sharply distinguishes between interest and dividends. For example, dividends qualify for the dividends received deduction; interest does not. Moreover, a deduction is generally allowed for the payment of interest, but not for the payment of dividends. The Tax Court obliterated the distinction.

[13] As noted above, the Commissioner alleged an unfair interest rate in State v. Duluth, but the rate was determined to be fair. 292 N.W. at 406.

Thus, HF Bank's sale of participation loans to HF REIT did not trigger Subdivision 1.

4. The Remedy Proposed by the Commissioner Is Not Authorized by Subdivision 1.

HMN explained in its opening brief how Clause 3 of Subdivision 1 provides for a remedy in the event that Clause 1 or Clause 2 is triggered. HMN-Br. 42-43. The statute allows the Commissioner to determine an amount of a company's income "to reflect what would have been its <u>reasonable taxable net income</u> but for the arrangements causing the understatement of its taxable net income or the overstatement of its losses," having regard to "fair profits." (Emphasis added.)

Thus, the Commissioner is entitled to adjust "taxable net income," but that is not what he did. As noted above, the Commissioner's order did not change "net income" or "taxable net income" by even a dollar.

If providing officer services at below cost were the real problem, then the Commissioner could have reduced HF Bank's compensation deduction by the amount attributable to work not performed for HF Bank. That would have been an adjustment to "taxable net income" allowed by Clause 3. However, because the services were *de minimis*, the adjustment would not have generated much tax.

What the Commissioner did instead was: (1) He included HF Holding's income in the unitary return in direct contravention of Minn. Stat. § 290.17, subd. 4; and then (2) he denied the dividend received deduction in direct contravention of Minn. Stat.

§ 290.21, subd. 4. HMN-Br. 45-46. Clause 3 of Subdivision 1 does not authorize the adjustments the Commissioner made.

E. The Commissioner's Action Was Not Authorized by Minn. Stat. § 290.34, subd. 2.

The Commissioner argues that Minn. Stat. § 290.34, subd. 2 ("Subdivision 2"), authorized the adjustments that he made in his order. Com-Br. 37-38. Subdivision 2 permits the Commissioner to "require such combined report as, in the commissioner's opinion, is necessary in order to determine the <u>taxable net income</u> of any one of the affiliated or related corporations." (Emphasis added.) Here, too, the Commissioner's authority is to determine "taxable net income," but the Commissioner's order concluded that HMN reported the correct amount of "taxable net income."

Another problem with this argument is that HMN already filed a combined report for the years in issue. HMN included all of its affiliates on the report with one exception: HF Holding. HF Holding was left off the combined report because the law forbids the inclusion of an FOC:

> 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 <u>shall not be included</u> in the net income or the apportionment factors of the unitary business except as provided in paragraph (g) [relating to deemed dividends]. ...

Minn. Stat. § 290.17, subd. 4(f) (emphasis added). See also Minn. Stat. § 290.17, subd. 4(h) (on a combined report, "there must be included only the income and apportionment factors of domestic corporations or other domestic entities other than foreign operating corporations"); and Minn. Stat. § 289A.08, subd. 3 (FOCs are not required to file returns).

The Commissioner is authorized by Subdivision 2 to require combined reports, but such combined reports have to be consistent with the statute. The Commissioner's order was not consistent with the statute.

III. The Court Should Reject the Commissioner's Reliance on Common Law Theories.

The Commissioner asks this Court to uphold the Tax Court's rejection of statutory law under an economic substance analysis. He also argues that the assignment of income doctrine should apply, although the Tax Court did not adopt that position. Neither argument is correct.

A. This Court Has Never Used Economic Substance as a Rationale for Disregarding Statutory Law.

The Tax Court asserted that In re Marshall's Estate, 228 N.W. 920 (Minn. 1930), launched "more than 70 years" of judicial overruling of statutes through the use of "economic substance." Add. 45. HMN addressed Marshall's Estate in its opening brief. ~~HMN-Br. 26-29. Not satisfied with 70 years, the Commissioner alleges that "for over~~ 100 years" this Court has thrown aside statutory law on substance-over-form grounds. Com-Br. 39. But the Court did nothing of the sort in St. Paul & C. Ry. Co. v. McDonald, 25 N.W. 453 (Minn. 1885). McDonald simply expresses the universal principal that, for tax purposes, the owner of property is not necessarily the one who possesses legal title. Beneficial ownership is what counts. See Helvering v. F. & R Lazarus & Co., 308 U.S. 252 (1939) (person having burdens and benefits of ownership entitled to depreciation).

Thus, MacDonald is in the category of cases addressing what HMN referred to as "legally ambiguous transactions." HMN-Br. 28. These are cases where a transaction might be classified in one of two ways, and so the courts look to the substance to classify it. The issue in MacDonald involved ownership. A railroad owned bare legal title; the burdens and benefits of ownership were held by a construction company. This Court held that the construction company was the real owner. Similarly, a transaction structured as a lease may be treated as a sale if that is the substance of the transaction. Midwest Federal Sav. & Loan Ass'n v. Commissioner of Revenue, 259 N.W.2d 596 (Minn. 1977); Transport Leasing Corp. v. State, 199 N.W.2d 817 (Minn. 1972). A transfer in trust may not be a completed gift if the transferor retains significant rights to enjoy the property until his death. In re Marshall's Estate, 228 N.W. 920 (Minn. 1930) (gift held completed; donor's intent to reduce tax irrelevant). An alleged trust may not be a real trust. Bond v. Commissioner of Revenue, 691 N.W.2d 831 (Minn. 2005) (tax protestor's claim that Social Security Administration formed a trust for him rejected). HMN-Br. 26-28. A "liquidation" may really be a "reorganization" if the shareholders reincorporate the liquidated company under substantially the same ownership. Anderson v. Commissioner of Taxation, 93 N.W.2d 523 (Minn. 1958).

In two other cases cited by the Commissioner, the court mentioned substance-over-form in dictum. Com-Br. 41. In Minnesota Tribune Co. v. Commissioner of Taxation, 37 N.W.2d 737 (Minn. 1949), the Court held that a Delaware holding company was domiciled in Minnesota because its office and meetings were in Minnesota. In dictum, the Court noted that the holding company's status as separate from its subsidiary would normally be recognized "in the absence of circumstances justifying the court in looking through the form to the substance of the relationship between the two corporations." Id. at 739. We will address the separate entity issue below.

In Commissioner of Revenue v. Safco Products Co., 266 N.W.2d 875, 877 (Minn. 1978), the Court said that it would disregard form to examine substance, but it did not do so. The Court simply applied tax exemption statutes to the facts and largely upheld the exemptions.

Thus, although this Court has had occasion to examine the substance of transactions, the Court has never employed the substance-over-form principle in order to override statutory law.

B. The Assignment of Income Doctrine Is Inapplicable.

The Commissioner relies upon the assignment of income doctrine, which typically has been applied in cases involving donative transfers in family situations. See Commissioner v. Sunnen, 333 U.S. 591 (1947) (gift of royalties to wife held an assignment of income where husband owned patents); and Lucas v. Earl, 181 U.S. 111 (1930) (agreement by husband to shift half his salary to wife held an assignment of income). This case does not involve a donative transfer or a family situation.

This case involves interest income. The classic case involving interest is Helvering v. Horst, 311 U.S. 112 (1940). There, a father made a gift to his son of interest coupons that were detached from corporate bonds. The son collected the interest when the coupons matured. The Supreme Court held that the father (i.e., the donor) was subject to tax on the interest:

> When, by the gift of the coupons, [the father] has separated his right to interest payments from his investment and procured the payment of the interest to his donee, he has enjoyed the economic benefits of the income in the same manner and to the same extent as though the transfer were of earnings, and in both cases the import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew.

311 U.S. at 120. Thus, when a taxpayer separates the right to interest from a debt instrument and gives it away, he is subject to tax on the interest. On the other hand, had the father in Horst given away the entire bond (i.e., not just the interest coupons), then he would have been taxed only on the interest that accrued prior to the transfer. Interest accruing after the transfer would be taxed to the donee. Austin v. Commissioner, 161 F.2d 666 (6th Cir.), cert. denied, 332 U.S. 767 (1947); Rev. Rul. 72-312, 1972-1 C.B. 22.[14] This principle is often expressed using a fruit-tree metaphor: Giving away the fruit (interest only) results in an assignment of income—the donor is taxed; giving away the tree (the bond) means that the donee is taxed on the subsequent fruit (the interest).

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[14] This point is also relevant with respect to the Commissioner's backdating concern. Com-Br. 44. The Commissioner appears to agree that using "as of" dating is an "integral part of daily law practice" to memorialize the date of a verbal agreement. HMN-Br. 9. The Commissioner, however, seems to be arguing that HF Bank and HF REIT had not finalized the Participation Agreement by the "as of" date (February 4, 2002). If that is his position, then he should have taxed the interest to HF Bank until after the transfer was final—but that is not what his order did.

This Court followed the Horst case in Sanders v. Commissioner of Taxation, 23 N.W.2d 565 (Minn. 1946), which the Commissioner relies on here. Com-Br. 40. Sanders involved facts similar to Horst and is clearly distinguishable. First, HF Bank received consideration when it transferred the loan participations to HF REIT—there was no gift. Second, HF Bank did not transfer only the right to interest (the fruit)—it transferred the right to principal (i.e., the tree).

The Commissioner's argument seems to be that because HF Holding was a subsidiary of HF Bank, it was "dominated" by HF Bank. The Commissioner claims that "domination" of a subsidiary by a parent allows him to re-assign the subsidiary's income to the parent. Com-Br. 45. This argument is fallacious. The parent of every wholly-owned subsidiary dominates it through the exercise of voting control; nonetheless, the well-established rule is "that courts are reluctant to disregard the separate legal entities of the parent corporation and the subsidiary corporation" for tax purposes. Milwaukee Motor Transportation Co. v. Commissioner of Taxation, 193 N.W.2d 605, 609 (Minn. 1971). In Milwaukee Motor, the Court followed Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), which it quoted:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity.

193 N.W.2d at 610-11. See also HealthEast v. County of Ramsey, 749 N.W.2d 15, 20 (Minn. 2008) ("We have adopted the Supreme Court's Moline Properties rule for purposes of Minnesota corporate income taxes."). Under Moline Properties, a corporation is recognized as a separate entity if it conducts business activity, and "the quantum of business activity may be rather minimal." Hospital Corp. of Am. v. Commissioner, 81 T.C. 520, 579 (1983). In Hospital Corp., the court noted:

> LTD was properly organized under the Companies Law of the Cayman Islands. In 1973, LTD issued stock, elected directors and officers, had regular and special meetings of directors, had meetings of shareholders, maintained bank accounts and invested funds, had at least one non-officer employee, paid some expenses, and, with substantial assistance from petitioner, prepared in 1973 to perform and in subsequent years did perform the KFSH management contract. All of these are indicative of business activity.

Id. at 584. HF Holding engaged in similar activities. It was organized under Cayman law; it issued stock; it had officers and directors; it had bank accounts with ScotiaTrust; it had one Cayman employee; and it paid expenses.

For the above reasons, the assignment of income doctrine is inapplicable and the Tax Court correctly did not rely upon it.

IV. The Court Should Reject the Commissioner's Reliance on Cases From Other States.

The Commissioner relies on cases from other states for the proposition that the FOC law does not have to be applied in this case. He principally relies on a decision of the Massachusetts Appellate Tax Board. See Fleet Funding, Inc. v. Commissioner of Revenue, Nos. C271862-63, 2008 Westlaw 495485 (Mass. App. Tx. Feb. 21, 2008). This was not a judicial decision. The board is a division within the state's department of revenue. Mass. Gen. L. ch. 14, sec. 1. Obviously, that administrative decision has no precedential value here.

As the Commissioner notes, Fleet involved a "passive investment company (PIC)" rather than an FOC. This is a critical distinction. There is no entity defined under Massachusetts law as a PIC. "PIC" was simply a shorthand term that the Board used. By contrast, Minnesota law defines the term FOC and prescribes the tax treatment that applies to FOCs and their shareholders.

This is the most fundamental point that the Tax Court failed to comprehend. When the Legislature establishes rules for the taxation of specially-defined entities, the Commissioner has no authority to apply different rules. Further, despite the Commissioner's overheated rhetoric, tax planning to use such entities is legitimate.[15] Com-Br. 44. As HMN noted in its opening brief, corporations can qualify as S corporations if they meet certain tests regarding such things as type of shareholders (especially trust shareholders). HMN-Br. 29. Tax professionals advising S corporations take great care to ensure that the tests are satisfied. What the Commissioner here calls a "compulsive focus on tax savings" (Com-Br. 44) is, in fact, the bread and butter of legal and accounting tax practice and there is nothing inappropriate about it. HMN-Br. 30-31.

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[15] Chapter 290 recognizes many types of specially-defined entities in addition to FOCs and REITs including RICs, REMICs, FASITs, etc.

V. The Commissioner Has Not Distinguished Hutchinson.

The Commissioner argues that the Hutchinson case is factually distinguishable because the FOC there, Export, had "substantial overseas transactions ... either through Export or HTI." Com-Br. 53. This is misleading. Export engaged in no transactions itself; all transactions were engaged in by its parent, HTI. By contract, Export was a sales agent for HTI, but HTI performed all of the sales activity. HMN-Br. 33-34.[16] Hutchinson Technology, Inc. v. Commissioner of Rev., 2004 Minn. Tax LEXIS 31 (Minn. Tax Ct. May 10, 2004), at 3-4.

The Commissioner asserts that Export "owned and used" property outside the United States, Com-Br. 53, but the property (brochures, etc.) averaged less than $3,130 per year. HMN-Br. 33. The Commissioner asserts that a "comprehensive federal tax regime" governed Export, but such a regime also governed HF REIT.

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." 698 N.W.2d at 16. The Commissioner alleges that Hutchinson is distinguishable because the case did not address the Commissioner's authority to apply substance over form. Com-Br. 55. The Commissioner is incorrect. Hutchinson explicitly addressed whether certain "paper transactions" with "no real business purpose" should be disregarded as lacking economic

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16 It should also be noted that the flow of funds in Hutchinson was circular between the parent and the subsidiary. The Commissioner cites cases from other states regarding circularity, but he fails to mention that this was also a fact in Hutchinson. Com-Br. 48.

substance. This Court held that it was "unwilling to write into a statute what the legislature did not." 698 N.W.2d at 11-12; HMN-Br. 35-36.[17]

The Commissioner also asserts that Hutchinson did not address Minn. Stat. § 290.34. He is correct about that but, for the reasons discussed above, that section does not authorize the adjustments that the Commissioner made in this case.

Finally, the Commissioner claims that there were international sales in Hutchinson, but not here. That is true, but the statute for the years in issue did not require international sales. The Legislature amended the law in 2005 and still did not require international sales. 2005 Minn. Laws, 1st Spec. Sess., ch. 3, art. 3, secs. 5-7. Finally, in 2008, the Legislature added a requirement that at least 80 percent of the gross income of an FOC be "active foreign business income." 2008 Minn. Laws, ch. 366, art. 4, sec. 3. This change was effective for taxable years beginning after December 31, 2007 (i.e., subsequent to the years in issue).

VI. A Motive to Reduce Tax Is Not Relevant.

The Commissioner devotes 23 pages to his version of the facts. Com-Br. 3-26. His overarching theme is that HMN was motivated to reduce its taxes when it formed HF Holding and HF REIT.

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[17] The Commissioner's opening brief in Hutchinson is in the record. See Exhibit 1 to the Affidavit of Walter A. Pickhardt (Item 11). The Commissioner in Hutchinson repeatedly invoked economic substance and business purpose. See, in particular, pages 36-48.

HMN stated in its opening brief that 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." HMN-Br. 3. Accordingly, HMN does not see a need to address the Commissioner's discussion of the facts, even though the presentation is not entirely in accordance with the mandate that the facts be stated fairly.

The Commissioner quotes the United States Supreme Court's decision in Gregory v. Helvering, 293 U.S. 465, 469 (1935), which held that the legal issue there (i.e., the definition of a "reorganization") needed to be decided "apart from tax motive." Com-Br. 57. The Court observed: "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." Yet the Commissioner on the very next page argues that if "tax planning purposes dominate a transaction, the entire transaction or structure may be jeopardized." Com-Br. 58. At bottom, this is the Commissioner's theory of the case, and it is wrong.

This Court in Hutchinson said that it would apply the statute as written, and that "there is nothing to prevent any FOC from being an empty shell entity, existing solely to provide tax exemptions." 698 N.W.2d at 16. In other words, the motivation for forming an FOC is unimportant.

The Commissioner does not agree with the way in which the FOC laws operated in this case—that is his prerogative. But he concedes that HMN filed its tax returns in accordance with the FOC laws. Thus, he had no basis for making the adjustments that he made.

The FOC issue presented in this case is of historical interest. The Legislature did not amend the FOC law in 2004, the year in which HF Bank's president wrote letters to the Legislature requesting that the FOC laws not be changed (especially not retroactively). App. 109, 278-79. However, the Legislature did amend the law in 2005 and again in 2008. The 2005 amendments mitigated, and the 2008 amendments eliminated, the tax advantages of having an FOC own a REIT.

Essentially, the Commissioner is asking this Court to push the effective date of these legislative changes back to the 2002-2004 years in issue. The Court should decline the Commissioner's request.

CONCLUSION

For the reasons set forth herein and in HMN's opening brief, this Court should reverse the Tax Court.

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CERTIFICATE OF COMPLIANCE

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

The undersigned certifies that the Brief submitted herein contains 6,979 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