No. A09-1164

STATE OF MINNESOTA
IN SUPREME COURT

HMN Financial, Inc. and Affiliates,

Relators,

vs.

Commissioner of Revenue,

Respondent.

BRIEF OF RESPONDENT COMMISSIONER OF REVENUE

WALTER H PICKHARDT
Atty Reg No 086782

ADAM B. THIMMESCH
Atty. Reg. No. 349227

FAEGRE & BENSON, LLP
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 DEMEULES
Assistant Attorney General
Atty. Reg. No. 0191644

445 Minnesota Street, Suite 900
St. Paul, Minnesota 55101-2127
(651) 296-0692

Attorneys for Respondent

TABLE OF CONTENTS

TABLE OF AUTHORITITIES

FEDERAL CASES

STATE CASES

FEDERAL STATUTES

STATE STATUTES

STATE RULES

OTHER AUTHORITIES

STATEMENT OF THE ISSUES

1. Did the Tax Court correctly recognize and apply statutory authority to adjust understated income and common law authority to tax according to the substance, rather than the form of an arrangement, thereby upholding the Commissioner's Order disregarding Relators' tax-avoidance strategy?

The Tax Court held that the Commissioner properly disregarded Relators' REIT strategy where the evidence and testimony showed that Relators used that strategy to understate income properly attributable to Minnesota, and the purported reasons for the strategy were a pretext.

Minn. Stat. § 290.34

Minnesota Tribune Co. v. Comm'r of Tax'n, 37 N.W.2d 737 (Minn. 1949)

Sanders v. Comm'r of Taxation, 23 N.W.2d 565 (Minn. 1946)

St. Paul & C. Ry. Co. v. McDonald, 25 N.W. 453 (Minn. 1885).

2. Did the Tax Court correctly acknowledge this Court's *Hutchinson Technologies* decision, which did not address the scope of statutory or common law authority to tax according to the substance and not the form?

The Tax Court did not deem the Hutchinson Technologies decision controlling.

Hutchinson Tech., Inc. v. Comm'r of Revenue, 698 N.W.2d 1 (Minn. 2005).

3. Did the Tax Court correctly uphold the Commissioner's Order, notwithstanding Relators' claimed right to engage in tax planning and claimed statutory compliance?

The Tax Court correctly concluded that Relators' claimed statutory compliance did not preclude the Commissioner's authority to disregard a tax-avoidance strategy that lacked economic substance.

Anderson v. Comm'r of Taxation, 93 N.W.2d 523 (Minn. 1958)

STATEMENT OF THE CASE

After auditing Home Federal Savings Bank ("the Bank") and its affiliated entities, Home Federal REIT (a real estate investment trust, "HF REIT") and Home Federal Holding (a foreign operating corporation, "HF Holding"), the Commissioner of Revenue assessed additional Minnesota corporate franchise tax for the years 2002-2004. (A.11) The Commissioner found that the Bank's REIT strategy, which transferred income on the Bank's mortgage loan portfolio from the Bank, to HF REIT, to HF Holding, and back to the Bank, lacked credible business purposes and economic substance. (A.19-24). Basing the tax treatment on the substance of the transactions, rather than the form, the Commissioner deemed the REIT strategy an improper assignment of the Bank's income and therefore attributed that income to the Bank. (A.24).

HMN filed a Notice of Appeal with the Minnesota Tax Court on March 2, 2007. (A.1)[1] Trial was held before the Minnesota Tax Court on November 12-13, 2008. (Add.1). At trial, witnesses acknowledged that the claimed non-tax reasons for the Bank's REIT strategy — to manage interest rate risk, generate additional liquidity, and

[1] The Relators here — HMN, the Bank, Osterud, and HF REIT — and HF Holding (which is not a named party) are collectively referred to as "HMN."

for earnings enhancement — were neither necessary nor pursued during the REIT strategy, and that HMN had no purpose for the strategy other than tax savings. (Add.8, 24-25).

The Tax Court issued its Findings of Fact, Conclusions of Law, and Order for Judgment on May 27, 2009. (Add.1). The Tax Court upheld the Commissioner's Order, finding that the Commissioner correctly disregarded HMN's tax-avoidance REIT strategy. (Add.1-2). This appeal followed.

STATEMENT OF FACTS

Relator HMN Financial, Inc., a bank holding company, owns all of the outstanding stock of the Bank. (Add.2) HMN's affiliates filed consolidated federal tax returns although HF REIT, which was not eligible to be included in the affiliated group, filed federal form 1120-REIT. (Add.3) HMN Financial, the Bank, Osterud, and HF REIT filed Minnesota combined income tax returns as a unitary group pursuant to Minn. Stat. § 290.17 (2002). (Add.2) HMN did not include HF Holding in the Minnesota combined report because "at least on paper," HF Holding met the Minnesota foreign operation corporation (FOC) qualification terms. (Add.3, 41)

As explained further below, beginning in 2001, HMN adopted and implemented a Real Estate Investment Trust ("REIT") solution sold by the Bank's tax advisor and independent auditor, KPMG-LLP, Minneapolis. (A.147; R.A.96-97) The Tax Court concluded that HMN's REIT strategy and the claimed business purposes for that strategy "had no economic substance and no genuine business purpose except to avoid Minnesota tax." (Add. 30, 48) HMN does not challenge or dispute the facts that support this conclusion. *See* HMN Br. at 4. Nevertheless, many facts were disputed below and the Tax Court issued detailed findings. Therefore, the supporting testimony and evidence provide the correct context for the Tax Court's rulings.[2]

A. Background: The Bank and its Mortgage/Loan Operations.

The Bank historically operated as a thrift organization with a focus on consumer and home lending backed by a community banking philosophy. (R.A.5) The Bank's retail banking and lending activities are and have been primarily concentrated in "southern Minnesota and Iowa." (Jt. Exh. 79 at 38, 58; A.60) For example, in 2001, over 70% of the Bank-owned single or multi-family residential loans were located in either Minnesota or Iowa. (Jt. Exh. 79 at 39) By 1994, HMN Financial was the holding company for the Bank, the Bank had converted to a federally chartered stock savings bank, and the Bank's strategic mission focused more on commercial banking. (Jt. Exh. 79 at 12, 20; R.A.3). The Bank's lending activities, however, remained focused on

---

2 HMN implies that the Tax Court erred by failing to adopt the parties' stipulation regarding one of the two claimed purposes for the REIT strategy. *See* HMN Br. at 3, 6. The stipulation does not address the legal issue for trial: the validity or legitimacy of HMN's purported business reasons. Further, HMN retreated from the stipulation at trial, by re-framing the claimed purposes and by presenting different purposes to the Tax Court. (R.A.14 "three purposes for doing the transaction;" R.A.2, "we will demonstrate that there were other reasons" besides tax savings)). *See Gethsemane Lutheran Church v. Zacho*, 92 N.W.2d 905, 913-14 (Minn. 1958) (finding trial court not bound by stipulation where "from the very beginning of the trial this issue was litigated by both parties").

Minnesota and Iowa, with over 86% of HMN's commercial loans in those states in 2001. (Jt. Exh. 79 at 38)

The Bank's "core income-producing activity" is investing in and servicing real estate loans and assets. (A.209) The Bank's "net income is significantly dependent on its net interest income, which is the difference between" interest income and interest expense. (Jt. Exh. 79 at 12). The Bank's Asset Liability Committee ("ALCO") is responsible for and monitors interest rate risk exposure, projected profitability, the Bank's asset liability position, investment strategies, and portfolio management. (Add.6).

As of December 31, 2001, the Bank's federal regulator (the Office of Thrift Supervision, "OTS") considered the Bank in "satisfactory financial condition," "sufficiently profitable to support its operations" and well-capitalized with acceptable liquidity and moderate interest rate risk. (Add.4). Neither "credit risk nor [interest rate risk] pose[d] a material threat to the [Bank's] capital position," and the Bank was "fundamentally sound," "stable," and "capable of withstanding business fluctuations." (*Id.*) The Bank was also well-capitalized prior to and during the years at issue here (2002-2004) and did not face a need to mitigate its interest rate risk. (R.A.8-10, 20, 40; Jt. Exh. 74 at 38; Jt. Exh. 75 at 38). There were times between 2001 and 2003 when the Bank's Chief Financial Officer, Tim Johnson, considered the Bank over-capitalized. (R.A.20)

HMN's state income tax expense for 1999, 2000, and 2001 was $794,700.00; $781,000.00; and $682,785.00, respectively. (Add.3-4; Jt. Exh. 79 at 11, 42). KPMG calculated HMN's 1999 Minnesota tax liability as $626,335.00. (R.A.111)

B. KPMG's REIT Strategy.

On June 27, 2001, KPMG representatives and Bank CFO Tim Johnson discussed HMN's interest in a KPMG product known as a "REIT/Offshore solution." (Add.4; R.A.96-97) KPMG and Mr. Johnson agreed to meet on July 10, 2001 "to work up some numbers and spend some time going over the presentation with Tim prior to a presentation to the Board." *Id.* Before that meeting, KPMG representative Jennifer Petersen asked another KPMG employee to "check out" some issues related to OTS thrift supervision, prepare a draft presentation for HMN based on an earlier presentation made to another bank, and estimate tax savings:

> Please estimate savings numbers. I think we do the compliance work for HMN so check the actual returns for Minnesota effective tax rate and taxable income (Bill Toupin, fed tax manager, should know where the returns are if they are not in the tax vault]. If we do not do the compliance work, Ellen should have the financial information to help estimate savings. Basically savings should be equal to HMN's MN apportionment percentage * 9.8% * 80% * 8% interest * real estate loans. Savings should be limited to MN tax currently paid.

(R.A.109).

Mr. Johnson, Bank controller Jon Eberle, and KPMG representatives Jennifer Petersen and Debra Anderson attended the July 10 meeting at HMN. (Add.5) Joint Exhibit 66 is a copy of the materials, similar in most material respects to an earlier KPMG presentation to another financial institution, used at the July 10 HMN meeting. (Add.5; A.92; R.A.21) KPMG presented an overview of the REIT strategy, its application to HMN's ongoing operations, and the opportunities and risks presented by the structure. (A.147) The strategy required a REIT and an intermediate holding company with 80% of its tangible property and payroll located outside the United States. (Add.35; A.148, 150) The REIT would be taxed as a "pass through" entity, which allowed it "to pass through income to its shareholders free of corporate level tax." (A.148) The intermediate holding company would "optimize the structure's efficiency," would be "excluded from the Minnesota unitary group," and because it would pay dividends to the Bank, would provide the Bank with an 80% dividends received deduction. (A.150) KPMG proposed "restructuring objectives" for HMN, including a "$550,000 state tax impact," "increase[d] strategic flexibility," creat[ing] "a structure that may be used to expeditiously raise Tier I capital" or to "monetize relatively illiquid assets held in portfolio," and "enhance employee retention through targeted stock issuance to top performers." (A.154; R.A.22)

Because the REIT strategy "was a tax structure, [Johnson] saw no need to talk [with KPMG] about managing interest rate risk and what types of loans [the Bank] would specifically put in [the structure]. We were looking for loans that would qualify from a tax standpoint in this discussion." (Add.5; A.93) Mr. Johnson recalled a discussion "about the potential [tax] savings that this structure could have to [HMN] from an overall standpoint. We talked about the risks associated with the transaction if we went into it and how long would it be out there or what are the chances of it being reversed out." (R.A.6)

After the July 10 meeting, Ms. Petersen sent Mr. Johnson an "estimated cost/benefit analysis for 2001 and 2002" for the REIT strategy. (Add.6; R.A.110) KPMG calculated the "amount of potential assets to be transferred to REIT," the "potential income generated by REITs taxed at 80/20 company level," and the "estimated annual savings." (R.A.111) KPMG advised the Bank that it had "more than sufficient identified assets available to transfer to REIT to eliminate Minnesota Franchise tax liability." (Add.6; R.A.111)

C. The Bank Implements KPMG's REIT Strategy.

Several days later, Mr. Johnson made a presentation to the Bank's ALCO about the REIT strategy.

> Mr. Johnson presented an offshore 80/20 company structure for the Bank which would provide additional liquidity in the future and also create an income tax benefit in Minnesota. On motion made by Mr. McNeil and seconded by Mr. Jorgensen the Committee recommended that we move forward to establish an 80/20 company.

(A.145) Next, the Bank's Board of Directors considered the REIT strategy on July 24, 2001. (A.57) The Board discussed how long the FOC statutes would remain in place. (R.A.25) The Board considered "how long the structure would have to be in place before the bank could wash through the transaction from a cost standpoint versus a tax standpoint," and whether the Bank was ahead or behind, from an economic standpoint, if Minnesota eliminated the FOC tax benefits within 3 years. (R.A.25-27) The economic impact the directors considered was the Bank's tax savings. (R.A.25).[3]

[3] Later in 2001, the Bank's Directors considered another structure that would provide similar tax benefits when concern arose that "the State might try to start taxing businesses that receive foreign income." (R.A.72) Under this potential new structure, an entity would be set up in Iowa "to avoid being taxed in Minnesota." *Id.* The Bank did not pursue the alternative strategy originally out of concern that its regulator would not approve it. *Id.*

HMN states that KPMG's representatives "were tax specialists, not banking consultants." HMN Br. at 5-6. The record demonstrated that KPMG exceeded its "tax advisor" role from the beginning and continually in its work on HMN's REIT strategy. KPMG, for example, provided HMN with input on and samples of the legal documents and agreements used in similar projects, identified potential foreign service providers (for HMN's FOC), and identified the OTS personnel that KPMG had worked with in the past. (R.A.202-04) KPMG provided HMN with the sample management plan for HF REIT, the sample internal control procedures for HF Holding, and drafts of responses to the OTS's non-tax questions. (R.A.74-76, 136-40; 156-60)

On August 21, 2001, HMN sent its attorney and KPMG's Petersen "a copy of the board resolution approving the REIT structure." (R.A.143) KPMG's Petersen "suggested that the Board Resolution include more information about the business purpose." (R.A.205) KPMG also agreed to "provide sample board resolution language that incorporates the business purpose for the restructuring" to HMN and its attorney. *Id.*

KPMG's Gary Petrangelo sent HMN's attorney, "a copy of sample board resolutions," including a "Preferred alternative incorporating language used most frequently by other clients," and a "Second alternative - incorporating language regarding tax savings [], which has not typically been used by other clients." (R.A.142, 145) That same day, HMN's attorney sent Tim Johnson an e-mail with her "comments" and an edited version of the Board resolution, which with two grammatical changes became the final version. (R.A.213-14; Add.10-11; A.135)

Notwithstanding the Board resolution, KPMG's Petrangelo testified that he understood that the Bank needed a purpose other than tax savings for the REIT strategy, the Bank could not pursue the REIT strategy for tax purposes alone, and he did not recall any purpose that HMN had for the REIT strategy other than tax savings. (Add.8; R.A.56-59)

KPMG provided HMN with a sample "notice" to the OTS, and on August 24, 2001, Mr. Johnson notified the OTS and the Federal Deposit Insurance Corporation (FDIC) that the Bank had decided to establish HF REIT and HF Holding. (R.A.125-31; A.205-210) The notice, drawn largely from KPMG's sample, described each subsidiary's intended activity, Management's Business Plan for HF REIT, and a description of the "business advantages" that might be achieved by segregating "certain real estate assets into a separate operating REIT subsidiary." (*Id.*; Add.11-12)[4] The "activity proposed for [HF REIT was] limited to holding real estate-related assets now held by Bank." (A.209) There "[were] no current plans" to "raise capital through the issuance in the capital markets of a second class of REIT preferred" stock. (Add.11-12; A.207)

On October 12, 2001, KPMG's Petrangelo sent Johnson a "draft of the responses to the OTS questions," and Mr. Johnson sent HMN's responses to the OTS that same day.

---

[4] Exhibits A, B, and C to the August 24 letter (A.206-07) are found at Jt. Exh. 80. KPMG's sample OTS Notice is at R.A.125-31.

(Add.12; R.A.156-60; A.166-170) The response to the OTS's query about the foreign location for HF Holding was as follows:

> A foreign office . . . will increase the after-tax yield of REIT's mortgage loan portfolio. This increased yield is achieved by a reduction in Minnesota income taxes paid by Home Federal Bank and its subsidiaries. Under Minnesota income tax law, the jurisdiction in which a corporation receives income is a significant factor in determining the corporation's Minnesota income tax liability. Under the proposed structure, Holdings' receipt of the dividend income in a foreign jurisdiction results in only 20% of such income being taxed by Minnesota.

(A.166) The Bank agreed to keep a duplicate set of HF Holding's books and records in Minnesota; to limit the foreign employee's authority over HF Holding's bank account; and to require the Bank's officers to directly supervise and monitor HF Holding and the foreign employee. (A.167-68)[5]

On January 24, 2002, the OTS granted the Bank's application to establish both HF REIT and HF Holding, and to allow HF Holding to establish an office in Grand Cayman after it submitted additional documents and representations. (A.193-94) HF Holding and HF REIT were formed as Delaware entities on February 4, 2002, as sibling subsidiaries of the Bank. (Add.14) With one exception, HF REIT and HF Holding's officers and directors were all Bank employees. (Add.14; A.69) HF REIT's and HF Holding's Directors, also Bank employees, were identical. (*Id.*)

---

[5] The foreign service provider, ScotiaBank (or ScotiaTrust), was interviewed on November 2, 2001. (Add.12) The Bank then advised the OTS that it had selected the Cayman Islands "based on [its] comfort with the choice of employees there," (A.183). Mr. Johnson testified that he interviewed ScotiaBank's representatives in the Cayman Islands in July, 2002. (A.94, 102; R.A.4)

D. The Loan Transfers And The Loan Participation Agreement.

1. The Loan Transfers.

On August 22, 2001, KPMG calculated the "estimated amount of assets that will need to be transferred to achieve target tax savings[.]" (Add.11; R.A.146) Assuming an "estimated target annual savings" of $727,501.00 in 2002, $10,445,304.00 in "income shifted to REIT" was needed, which required $163,207,869.00 in "assets that must be transferred to REIT." (R.A.147) Two days later, the Bank notified the OTS that it would contribute to HF REIT "loan participations in the amount of approximately $164 million," and that loans would be selected for transfer to HF REIT based on "achieving a target level of assets." (A.168, A.207)

On February 5, 2002, HMN and KPMG agreed that HF REIT's "operations will commence on February 4, 2002," and the "initial capital contribution of loan participations from the Bank to REIT will occur on February 4, 2002." (Add.14; A.219) However, a "final determination of the loans to be contributed to the REIT [was] currently being made." (A.219; R.A.28-29) Initially, the Bank estimated that it would transfer "approximately $190 million of loan assets" to HF REIT, a sum higher than that disclosed to and approved by the OTS. (A.221, 224) The increase would, however, "provide the interest income necessary to receive the full benefits of the state income tax laws." (R.A.181) At HMN's request and before the initial loan transfer was made, KPMG reviewed the income needed "if the goal is to completely eliminate (or almost completely eliminate MN tax.)." (Add.15; R.A.135) KPMG explained its conclusion as follows:

> If the REIT were to earn $12.5m, this would cause bank to have a loss of $2,448,361 (10,051,639-12,500,000) before it records the dividend from REIT. Upon paying the dividend ([through] Hold co) to the bank, bank would have income of $10,051,639 for book purposes and income of $51,639 for tax purposes (((2,448,361)+12,500,000 dividend-10,000,000 80% DRD). The $51,639 will then be apportioned to MN at 65%, so MN taxable income will be $33,565 and the MN tax liability will be $3,289 (33,565*.098).

Id.

The Bank contributed loans to HF REIT on February 22, 2002 and February 25, 2002, "backdate[ing] these transactions to February 4, 2002." (A.223).[6] After these initial transfers, the Bank actively sought out new loans to purchase and then participate to HF REIT, and a topic for the Bank's ALCO was a "discussion to make sure we keep the REIT 'filled up' in 2003." (A.227; R.A.84) By April 16, 2002, "HMN's state tax provision rate [had] been changed to reflect the expected reduction in HMN's tax liability as a result of the REIT structure." (A.225) Seventeen additional transfers were made between June, 2002 and June 2004, ranging in value from $4.7 million to over $31 million.[7] One transfer, a "capital contribution" of $118 million in loans, was made "to maximize the deduction related to the REIT." (A.136; Jt. Exh. 41 at HMN 961-62)

<u>2.</u> <u>*The Loan Participation Agreement.*</u>

HF REIT acquired participation interests in the Bank's loans pursuant to a Loan Participation and Servicing Agreement made as of February 4, 2002. (A.63-64) Neither

---

6 This practice continued later in the strategy. (R.A.86)

7 *See* Jt. Exhs. 29-45 at HMN 894, 897, 900, 903, 906, 909, 914, 918, 921, 930, 937, 943, 961, 1076, 1093, 1135, 1143.

Mr. Eberle, who signed the Agreement on the Bank's behalf, nor Mr. Johnson, who signed the Agreement on HF REIT's behalf, recalled when the Agreement was actually signed. (R.A.36, 43) As of June 13, 2002, it "doesn't appear that" the Agreement was completed. (R.A.30; Add.15-16) The record showed that HMN was still working on the terms of the Agreement in April and May, 2002. (A.224; R.A.207)

Mr. Johnson testified that it was "common" to backdate Participation Agreements. (R.A35-36). However, the Bank's participation agreement with Crescent Mortgage — an unaffiliated entity (R.A.1), — did not commence until the Bank actually signed the agreement. (R.A.38-39; 163) An agreement with the Federal Home Loan Bank Board ("FHLB"), which held security interests in the Bank's loans and therefore had to approve the transfers to HF REIT, was not signed until May 15, 2003, even though the Bank-HF REIT Participation Agreement recited a "February 4, 2002" agreement with the FHLB. (Add.16; A.280)[8]

The decision to purchase any loan was "at the complete discretion of REIT in accordance with REIT's requirements[.]" (A.281) Bank employees, however, decided which loans would be transferred to HF REIT, and the transfer was made. (Add.16) Bank employee Rick Kvam, who identified loans to transfer to HF REIT, had never read the Loan Participation Agreement. (R.A.53)

---

8 Mr. Johnson waited until loans were transferred to notify the FHLB about the transfers. (Add.15) Mr. Eberle, who signed the FHLB Agreement on behalf of HF REIT and HF Holding, does not recall why the Agreement was signed in May 2003, rather than February 2002, as stated in the Loan Participation Agreement. (R.A.44-45) He had not seen another FHLB agreement related to HF REIT. (*Id.*)

Mr. Johnson notified the OTS that the Bank intended to transfer loans to HF REIT at "net book value instead of fair market value." (A.162) The Loan Participation Agreement, however, required transfer at "the fair market value of the Loans." (A.281).

HF REIT assumed all risks, losses, and expenses in the Participation Agreement. (A.282), and granted the FHLB a security interest in the loans transferred to HF REIT. (R.A.186). The Bank and HF REIT, however, decided that "REIT will not be required" to satisfy that obligation. (Add.16; A.289)

Before approving HF REIT, the OTS had asked whether "credit quality constitutes a consideration in the selection of assets transferred to REIT (i.e. will the assets be segregated in such a manner as to place the 'good assets' with REIT with [the Bank] retaining a higher percentage of the 'riskier assets.')[.]" (A.168) The Bank stated credit quality was not an issue, and committed to notifying the OTS "should [it] become an issue in selecting assets for transfer at any time in the future." (*Id.*) KPMG, however, "instructed" the Bank "to keep delinquent loans out of the REIT." (Add.16). Thus, the Bank adopted a policy based on "discussion with Betty Bowen at KPMG" and "some significant tax consequences," to "transfer all loans > 90 delinquent from the REIT back to the BANK to avoid having any foreclosures take place at the REIT level." (R.A.89) The transfer needed to be done "prior to foreclosing on any mortgage loans that are held in the REIT." *Id.* Loans that were "more than 90 days delinquent," "in bankruptcy," and even "serious delinquencies" were transferred back to the Bank. (R.A.90-91)

Nevertheless, the Bank did not notify the OTS that it had decided to transfer delinquent loans out of HF REIT and back to the Bank.[9] (Add.17)

E. HF Holding's Operations And The Work Of Its Minnesota Officers

The OTS Order authorizing the Bank to establish HF REIT and HF Holding required the Bank to submit evidence of "internal controls that demonstrate adequate oversight of the foreign office . . . and the institution of such internal controls." (A.193-94) KPMG provided a draft of those controls on February 5, 2002. (Add.17; A.219) That same day, KPMG and HMN discussed HF Holding's officers and their payroll:

> The group discussed the importance of avoiding US-based officers to avoid a potential argument by the state of Minnesota that some of the officer salary should be attributed to Holding Co. as payroll. This could cause Holding Co. to fail Minnesota's 80/20 Company tests.

(A.219).

Mr. Johnson submitted the internal controls to the OTS on November 10, 2002 (A.195), and after amending those controls at the OTS's request (A.199), received permission to establish the Cayman office on December 5, 2002. (A.202). He then contacted ScotiaBank representative Carmen Thompson-Lopez "to set up the bank

---

9 HMN states that between "3 and 10" loans were sold back to the Bank. HMN Br. at 11. The documents, however, refer to "several," "some," and "lots of familiar names and serious delinquencies," not specific numbers. (R.A.90-91) Mr. Eberle testified that the number of loans transferred back to the Bank based on the initial $160 million transfer was "not a large number," and he "[did not] know" if it was ten. (A.104)

accounts and establish the employment-rental space agreements" so the Bank could "transfer dividends through the holding company by the end of next week." (R.A.83)

On December 20, 2002, the Bank exchanged 1,532 shares of HF REIT common stock for 100 shares of HF Holding common stock. (Add.17) HF REIT thus moved from a sibling entity of HF Holding to a wholly-owned subsidiary of HF Holding. (Add.17, 35) On December 23, 2002, Mr. Johnson sent an e-mail to ScotiaBank asking to "get the employment agreement wrapped up so we can pay Carmen today" because "[w]e have a need to incur payroll costs for [HF] Holding[.]" (Add.20; R.A.85) He explained that he "must pay you in December of 2002 in order for this transaction to work," namely, "transfer[ring] dividends through the holding company." (Add.21) The employment agreement was dated "as of" December 20, 2002, though Mr. Johnson did not request a "current resume" from Ms. Thompson-Lopez until February, 2003 when he needed to "document an employee file" for her in Minnesota. (Add.21; A.121; R.A.88)

The employment agreement obligated HF Holding to pay an "annual salary" of $7,000.00, which was negotiated with ScotiaBank representative Roger Davies, not Ms. Thompson-Lopez. (Add.21; R.A.162) There was no evidence that HF Holding paid Ms. Thompson-Lopez anything, though it agreed to pay a "salary" or "employment fee." (Add.21) ScotiaTrust sent invoices for "fees," including an "employment fee." (Add.22)

The Bank advised the OTS that it would actively monitor and supervise HF Holding. (A.167-68, 200-01). Thus, the Bank directly supervised Ms. Thompson-Lopez, the Bank's CFO was the designated liaison for the Cayman office, and the Bank maintained a duplicate set of HF Holding's books and stock certificates in the United States for safekeeping. (*Id.*)

HF Holding's Minnesota officers provided "another set of eyes" over the Cayman office, a role that was important to the OTS, which wanted "people in the United States involved any time money was going out of the bank." (R.A.32-33) Further, since HF Holding's foreign employee, Carmen Thompson-Lopez, was not hired until late December, 2002 and had no unilateral authority, Mr. Johnson, in his capacity as an HF Holding officer:

- established and documented "the internal controls of HF Holding over the [Cayman] office," consented to the jurisdiction of the United States and the OTS over the Cayman office, and consented to the disclosure, by Cayman authorities, of "such information on the operations" of the Cayman office that the OTS deemed necessary to enforce HF Holding's compliance with United States law (A.196);
- entered into a Sublease Agreement for the "non-exclusive" use of "Suite A" at Scotiabank in Grand Cayman (A.211);
- entered into an Agreement with Scotiabank for with an "Employment Agreement," "job description," and dividend processing (A.294-300);
- entered into an Employment Agreement with Carmen Thompson-Lopez that prohibited her from accessing the Dividend Account into which HF REIT's payments were deposited. (A.121, 124; R.A.16);

- adopted and affirmed HF Holding's Banking Resolution, which authorized only United States officers to engage in financial transactions on the Dividend Account, and authorized Ms. Thompson-Lopez to engage in financial transactions on the Operating Account only with the signature of a United States officer; (Add.19; R.A.172) and,
- entered into an Electronic Communications Agreement with ScotiaBank, which authorized ScotiaBank to follow HF Holding's electronically delivered instructions when signed by two HF Holding United States officers. (Add.20; R.A.198-201)

F. <u>The Record Before The Tax Court Demonstrated That The Bank's Purposes For The REIT Strategy Were A Pretext</u>.

HMN argued below that "there were legitimate business purposes other than avoidance of tax and that the transaction had economic substance." (Add.48). In this appeal, HMN claims three purposes for its REIT strategy: (1) reduce effective tax rate and increase earnings and capital; (2) improve liquidity and manage interest rate risk; (3) raise capital through the issuance of REIT securities. *See* HMN Br. at 6-7.[10] The Tax

[10] HMN does not rely on one of the alleged purposes it presented below, related to employee satisfaction. A REIT is required to have at least 100 shareholders, although this requirement is waived during the first year. *See* 26 U.S.C. § 856 (a)(5); *id.*, § 856 (h)(2). HMN met this requirement by distributing a single share to each of 112 employees and then claimed this distribution had the added benefit of making those employees "feel good" towards HMN. *See* HMN Post-Tr. Br. at 37 (filed Minn. Tx. Ct., Jan. 30, 2009); (Add.23-24). The record belied the claimed "feel good" purpose because (a) KPMG identified this potential purpose (A.154), and there was no evidence that the Bank considered this possibility when it approved moving forward with the strategy
(Footnote Continued on Next Page)

Court concluded that, apart from tax savings, HMN's purported purposes were a pretext and lacked economic substance. (Add.48-53)

First, the record demonstrated that the reasons cited in HMN's initial communication to the OTS were first articulated by KPMG. (Add.48-49; R.A.22) KPMG suggested that HMN "include more information about the business purpose" in the Bank's Board resolution, and provided HMN with "preferred" language that did not refer to "tax savings." (R.A.142, 145, 205) The potential ability to raise capital by managing interest rate risk or by selling preferred REIT securities originated with KPMG, either in its July 10 presentation, its sample board language, or its draft notice letter to the OTS. (A.154, R.A.125-31, 145)

Even the Bank's purported competitive concerns originated with KPMG in the proposed Board resolution language referring to the Bank's ability to "compete more favorably with its peers in pricing loans." (R.A.318-19) KPMG's "sample" OTS notice also included language about "earnings enhancement" and "competitive pricing" derived from the "lower effective state tax rate" — language that appeared without change in HMN's OTS notice. (R.A.125, 129; A.208). HMN offered no evidence that the Bank

(Footnote Continued From Previous Page)
(A.135, 145; R.A.5, 11); (b) the Bank did not evaluate the business criteria by which employees were selected to receive a REIT share, but simply selected the number needed to ensure the necessary REIT-qualifying individual shareholders. (Add.23; R.A.82, 211); (c) there was no true "investment" option for REIT shareholder employees because there was no alternative benefit if the share was declined, they could not sell the share without first offering it to the Bank, they had no voting rights, and the dividend was an annual $30 payment compared to common stockholder HF Holding's payments ranging from $8 million to $15 million. *See* HMN Br. at 15.

evaluated or considered how the tax savings generated by the REIT strategy would allow the Bank to compete against other banks on any terms, let alone pricing. Finally, even this "purpose" related only to tax savings. There was no evidence connecting HMN's interest in taking advantage of the tax law to other banks' return on equity. (A.91-92; 110-11) Rather, HMN's witnesses testified to the Bank's interest in taking "advantage of the tax law" as it believed "other banks had similar structures." (Add.49; A.110-11).

Second, HMN conceded at trial that the REIT strategy was not needed and had no economic impact on its stipulated reason, the possibility that it could manage interest rate risk. (Add.24) Mr. Johnson testified that "there was no economic impact to the mitigation of interest rate risk. It was all on the tax savings side." (R.A.27) There was no evidence to show that ALCO, the bank committee responsible for managing interest rate risk, ever evaluated how, why, when, or whether to manage that risk with the REIT strategy. In contrast, the record showed that ALCO used "tools" other than the REIT strategy when interest rate risk concerns needed its attention, e.g., capital needs, returning to compliance with investment policy, cash shortages, and budget reductions. (R.A.175-76, reducing dividend to parent company to avoid falling out of "well-capitalized" category; R.A.177-80, noting lack of compliance with investment policy and potential $35 million shortage; R.A.180, 184-85)

Third, HMN's claimed liquidity purpose was based on the potential to track loan history and sell loan pools from HF REIT.[11] (R.A.17) HMN conceded at trial that it had that ability, as well as the ability to track loan pool performance, before any loans were transferred to HF REIT. (Add.24; R.A.18) HMN witnesses further admitted that the Bank did not need additional capital while the REIT strategy was in place, nor did the Bank need HF Holding (the FOC) if it wanted to sell a pool of loans to generate capital. (Add.24; R.A.18-20) Finally, Mr. Johnson admitted that no one at the Bank tracked loan payment history once the loans were in HF REIT. (Add.24, 49; R.A.23-24)

Fourth, HMN witnesses conceded that the potential to raise capital by selling additional shares in HF REIT, or using those shares to count toward the Bank's Tier 1 capital calculation, was not "a high priority" for the Bank, nor a purpose discussed at the Bank because the Bank was well-capitalized. (R.A.7, 12-13) The Bank never attempted to raise capital in the three years the REIT strategy operated. (Add.49)

---

[11] Mr. Johnson testified that a "defined population of pool loans" in HF REIT, i.e., "6 percent mortgages," made it easier to track loan performance. (R.A.23) However, the interest rates in the REIT loan pools varied by 4 percentage points or more, or, had no interest rate information. *See* Jt. Exhs. 29-30, 32-33, 38, 40-41 at HMN 894, 897, 903, 906-07, 930-31, 945, 965-67.

G. There Was No Evidence Of Any Economic Impact Of HMN's REIT Strategy, Apart From Tax Savings.

Once the REIT strategy was implemented, the Bank "continued to administer [the loans transferred to HF REIT] in the same manner it had done in the past and pursuant to the Participation Agreement." (Add.25, 50). The Bank continued to receive payments from mortgage and loan customers (or from Cenlar on the Crescent mortgages), and transferred those payments, less the Bank's 0.25% servicing fee on Bank loans, to HF REIT's account at the Bank. (*Id*).[12]

The Bank monitored the tax advantages the REIT strategy generated and evaluated how to protect those advantages. (Add.25) As Mr. Eberle testified, the Bank "did an ongoing calculation as to the impact that the REIT had on our taxes." (R.A.41) The Bank's internal auditor reminded management "to take steps to ensure that all earnings of the REIT are dividended to HFH, Inc. in the future to secure qualifying for preferred tax treatment." (Jt. Exh. 64 at HMN 1410) Rather than investing excess cash when Bank president McNeil instructed him to do so, Mr. Johnson retained it to use as a dividend from HF REIT to HF Holding. (R.A.73)

---

[12] The Bank actively purchased loans from Crescent to participate to HF REIT, (A.227), but HF REIT had no interactions with either Crescent or Cenlar, contrary to HMN's suggestion otherwise. *See* HMN Br. at 34, n.19. HMN expert Nicholson opined that HF REIT "assumed the servicing relationship with Crescent for those loans purchased by the Bank from Crescent," and that "REIT agreed to pay Crescent 0.25 basis points for servicing." HMN Trial Exh. 1 at 7-8. There was no evidence of any agreement between HF REIT and Crescent by which HF REIT accepted any of the Bank's rights or obligations in the Bank-Crescent contractual relationship. (R.A.50-51)

When asked about the possibility that the government would "try to unwind offshore reits," Mr. Johnson responded:

> The Feds will try to eliminate offshore tax shelters and there are many of them. I don't think they will eliminate the REIT concept. The state may try to eliminate the shelter we are using but it will probably take one or two years to get it done. Per KPMG it is not possible for them to unravel the shelter for 2002.

(R.A.77)[13] When Mr. Johnson expressed "concern that the FOC provisions may be repealed through a retroactive change that would be effective for HMN's [2002] tax year," KPMG advised him that the Bank's "2002 savings are most likely secure." (R.A.80-81)

In 2004, Bank employee Eberle advised Bank president McNeil that it "sounds like the REIT structure may have a chance of surviving this year." (Add.25; R.A.92) Had the structure not been available to the Bank in 2003, the impact to the Bank would have been "approximately $1.2 million. . . . [The Bank's] actual savings in 2003 because of the REIT was approximately $800,000." (*Id.*)

By mid-2004, the Bank's analysis of its state tax liability, with and without the REIT strategy, was as follows:

---

13 A "tax shelter" has been defined as "a transaction that (1) is marketed and tax-motivated, (2) succeeds under at least one literal reading of the governing statute or regulation, (3) misstates economic income, and (4) in doing so reduces the tax on capital, (5) in a manner inconsistent with any purposive or intentionalist reading of the statute or regulation." Bankman, The Tax Shelter Battle at 9, *reprinted in* THE CRISIS IN TAX ADMINISTRATION (Aaron & Slemrod eds. 2004). Mr. Johnson defined a "tax shelter" as "an unacceptable way of saving state taxes," though he believed the REIT strategy was permissible. (R.A.37) KPMG characterized the REIT strategy as a "state tax eliminator." (R.A.209)

	With REIT	Without REIT
2002:	$ 25,00.00	$ 589,700
2003:	$380,100	$1,040,100
2004:	$116,800	$1,068,000

(R.A.93-94) The Bank's state tax decrease due to the REIT was $2,176,600.00. *Id.*

When the Minnesota legislature amended the FOC requirements with specific dollar levels of offshore property and payroll, *see* Minn. Stat. § 290.01, subd. 6b (2006), the Bank dissolved HF Holding and HF REIT. (Add.26) HMN saw "no need to continue with the REIT structure" once the strategy no longer qualified "for the tax deduction." (R.A.46) HMN saw no benefit to retaining HF REIT once the FOC was dissolved. (R.A.54-55)

HMN's expert, Donald Nicholson, who offered opinions on accounting records, what those records led him to conclude about GAAP practices, and the documentation on the existence of the transactions, testified that HMN's accounting records and documents for the REIT strategy were consistent with and typical of generally accepted accounting principles or practices ("GAAP"). (Add.28) Mr. Nicholson conceded that GAAP practices are "the lowest level of generally accepted accounting principles," that GAAP principles are distinct from tax rules, and that "tax rules often prescribe different accounting than generally accepted accounting principles." (Add.28; R.A.47-49)

The Commissioner's expert, Professor Alan Shapiro, was qualified as an expert in the economics of banking operations, corporate restructuring, and corporate finance.

(Add.28) Professor Shapiro reviewed the Bank's formation and capitalization of HF REIT and HF Holding, as well as the loan transfers to HF REIT, to assess the business purpose and economic substance of those activities. (*Id.*) He concluded that the REIT strategy had no substantive effect on the Bank's operations, other than tax savings. (R.A.64) He also opined that the strategy did not enhance the Bank's ability to manage interest rate risk, nor to sell assets, since the Bank had those capabilities before the REIT strategy was implemented, and retained all the necessary information (mortgage and loan history) at the Bank. (R.A.64-67)

ARGUMENT

I. STANDARD OF REVIEW

The Tax Court issued detailed findings that HMN accepts. *See* HMN Br. at 4. Thus, the Tax Court's fact findings are justified, reasonably sustained by the evidence, and correct. *See Watlow Winona, Inc. v. Comm'r of Revenue*, 495 N.W.2d 427, 431 (Minn. 1993); *Morton Bldgs., Inc. v. Comm'r of Revenue*, 488 N.W.2d 254, 257 (Minn. 1992) (citing *Red Owl Stores, Inc. v Comm'r of Taxation*, 117 N.W.2d 401, 407 (Minn. 1962)). HMN's legal challenges are subject to this Court's de novo review and plenary power. *See F-D Oil Co., Inc. v. Comm'r of Revenue,* 560 N.W.2d 701, 704 (Minn. 1997); *Morton Bldgs.,* 488 N.W.2d at 257.

II. BOTH STATUTORY AUTHORITY AND THE COMMON LAW EMPOWER THE COMMISSIONER TO IMPOSE TAX ACCORDING TO THE SUBSTANCE OF TAXPAYER ARRANGEMENTS, RATHER THAN A TAX-AVOIDANCE FORM.

Minnesota imposes tax on every corporation that exercises "the corporate franchise to engage in contacts with this state that produce gross income attributable to sources within this state." Minn. Stat. § 290.02 (2002). Thus, Minnesota's tax laws require taxpayers exercising the corporate franchise privilege to share the burden of the public resources the state provides. *See Great Lakes Pipeline Co. v. Comm'r of Taxation,* 138 N.W.2d 612, 615 (Minn. 1965) (noting that taxes are "pecuniary charges imposed by the legislature to raise money for public purposes," and corporations doing business in Minnesota "are required to keep in mind the established policy in the foregoing statement."), *appeal dism'd,* 384 U.S. 718 (1966).

The Tax Court recognized that HMN's REIT strategy was a "sophisticated tax avoidance plan involving a captive REIT, a holding company, and the transfer of loans and loan proceeds in a circular pattern through HMN entities." Add.31. This strategy, which posed no economic risk nor benefit other than tax savings, enabled the Bank to avoid nearly all of its Minnesota tax liability. *Id.* The Tax Court therefore upheld the Commissioner's statutory authority to adjust "distorted statements of corporate income," Add.32, and applied common law doctrines that authorize courts to "look behind the written documents and view the whole transaction" to determine whether it is a "mere scheme or pretext to evade" a tax. Add.45. Based on the evidence and testimony, the Tax Court concluded that HMN's REIT strategy "had no real business purpose or economic substance, and when looked at as a whole" was used only to avoid taxes. *Id.* at 32.

The Tax Court correctly reviewed HMN's REIT tax avoidance plan by relying on statutory and common law authority. Both by statute and under common law doctrines, the Commissioner is empowered to ensure that the fair and proper income attributable to a taxpayer's Minnesota activities is subject to Minnesota tax. HMN's REIT strategy understated its income in a deliberate effort to avoid Minnesota tax. The Commissioner and the Tax Court correctly rejected that strategy.

A. The Commissioner's Statutory Authority Empowers Him To Disregard Transactions That Improperly Reflect The Income Attributable To A Taxpayer's Minnesota Business Activities.

Following the lead of other states, Minnesota enacted it first income tax in 1933, *see* Ch. 405, 1933 Minn. Laws 688, including broad administrative authority to ensure that a taxpayer's Minnesota taxable income is clearly and fairly reported. These provisions have continuously been a part of Minnesota's tax system from their inception to date.

Thus, to ensure the proper tax determination, the Commissioner can examine and investigate the accuracy of a taxpayer's reported income. *See, e.g.*, Ch. 405, § 43 (a), 1933 Minn. Laws 717 (conferring authority to "make any investigation or examination" to determine correctness of return); Minn. Stat. § 289A.35 (2002) (authorizing "any audit or investigation that is considered necessary"); Minn. Stat. § 270C.03, subd. 1(c) (authority to make "corrections," including "additions," to tax).[14] Once the Commissioner has done so, he computes the proper tax. *See State v. Duluth, M. & N. Ry. Co.*, 292 N.W. 411, 413 (Minn. 1940) (explaining sequence of return filing, investigation, and tax computation), *cert. denied sub. nom.*, 311 U.S. 719 (1941). These provisions placed "[a]bundant power . . . in the [tax administrator] to obtain a computation of the tax upon any theory it might entertain." *Id.*

---

14 Minnesota statute citations are generally to the 2002 version since that was the first year that HMN's REIT strategy operated.

The Commissioner can also require taxpayers to use an accounting system that clearly and fairly reflects income or taxable income. *See* Ch. 405, § 9(a), 1933 Minn. Laws 693 ("clearly and fairly reflect income or the income taxable under this Act"); Minn. Stat. § 290.07, subd. 2 (2002); *see also* Rottschaefer, The Minnesota State Income Tax, 18 MINN. L. REV. 93, 114 (1934) (noting that purpose "is to get a clear and fair determination of" net income and taxable net income, and absent that, the taxpayer is required to use "such method" as the commissioner decides will do so). In addition, for multistate 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. *See* Ch. 405, § 26, 1933 Minn. Laws 708 (authority to use "other methods" to properly reflect taxable net income attributable to Minnesota); Minn. Stat. § 290.20, subd. 1 (2002); Minn. Stat. § 290.01, subd. 6(b) (3) (FOC property and payroll can be "determined under section 290.191 or 290.20"). This broadly stated authority exists because no "system for determining the taxable net income assignable to this state can hope to meet every conceivable case;" thus, "a measure of elasticity" is provided. Rottschaefer, *supra* at 158.

In addition to these targeted powers, the Commissioner has long been vested with broad anti-abuse authority. *See* Ch. 405, § 32, 1933 Minn. Laws 713-14 (authority to determine "reasonable taxable net income but for the arrangements causing the understatement" of that income, or use "such consolidated statements" as are necessary to determine taxable net income); Minn. Stat. § 290.34 (2002). This section confers "power to deal with [rearrangements of corporate structure that siphon income out of Minnesota] by ignoring the devices employed and computing the taxable net income" to more correctly reflect "that part of the net income attributable to the operations carried on within Minnesota." Rottschaefer, *supra* at 165; *see also State v. Oliver Iron Mining Co.*, 292 N.W. 407, 409 (Minn. 1939) (noting that subdivision (b) of Section 32 was "obviously calculated to prevent tax evasion"), *cert. denied*, 311 U.S. 719 (1941); THE MINNESOTA TAX COMM'N, Income Tax Law Of 1933 & Regulations at 124 (1934) ("Section 32 is intended to discourage the formation or utilization of a corporation for the purpose of preventing the imposition of taxes upon its shareholders."). In exercising his anti-abuse authority, the Commissioner is also authorized to "require such combined report" as is necessary to determine the taxable net income of affiliated entities that have their income "regulated" by some "arrangement." Minn. Stat. § 290.34, subd. 2; *see also* Income Tax Law of 1933 & Regulations, *supra*, at 125 (noting that commissioner may require such reports "where a corporation has its income regulated through contract or other arrangement with its stockholders or affiliated interests").

Finally, Minnesota Rule 8034.0100, first promulgated shortly after the 1933 legislation, *see* Income Tax Law of 1933 & Regulations, *supra,* at 124-25 (Article 1901, "Evasion of Tax by Corporation"), broadly describes the Commissioner's authority to disregard "devices commonly employed to distort income attributable" to Minnesota. *See* Minn. R. 8034.0100. "Among others," the Commissioner may ignore the "fixing of income at an arbitrary figure by contract or agreement," and arbitrary charges for expenses such as officer salaries. *Id.*; *see also Luther v. Comm'r of Revenue*, 588

N.W.2d 502, 507-08 (Minn.) (rule has force and effect of law), *cert. denied*, 528 U.S. 821 (1999); Minn. Stat. §270C.06 (2006).

These provisions plainly establish in the Commissioner authority to use a variety of methods to ensure that the income fairly and properly attributable to Minnesota is reported and subject to Minnesota's tax. *See, e.g., Great Lakes Pipeline Co*, 138 N.W.2d at 615; *Western Auto Supply Co. v. Comm'r of Taxation*, 71 N.W.2d 797, 811 (Minn. 1955) (noting allocation problem "is always one of securing for the state a fair, honest, and equitable part of the total corporate income measured in terms of corporate activity within the state"). Minnesota's tax law recognizes that the one who enjoys the economic benefit from the right to receive income is the tax liable party. *See, e.g., Sanders v. Comm'r of Taxation*, 23 N.W.2d 565, 567 (Minn. 1946) (quoting *Helvering v. Horst*, 311 U.S. 112, 119, 61 S.Ct. 144, 148 (1940));[15] *see also* Allocation of Income By Corporate Contract, 44 HARV. L. REV. 935, 942-43 (1931) (state has authority to disregard a contract that effects "an artificial shifting of profits into an affiliated corporation," because the "state has the power to tax the true income of the local corporation"). Indeed, the Legislature's consistent use of flexible concepts ("fairly," "clearly," "reasonable"), and the static nature of the Commissioner's statutory authority since 1933,

---

[15] Minnesota's income tax act is derived from "various federal income tax acts enacted prior thereto," so federal law construing those counterpart acts is relevant to, though not necessarily dispositive of, Minnesota's provisions. *See State v. Stickney*, 5 N.W.2d 351, 352 (Minn. 1942); *see also* Rottschaefer, *supra* at 94 (since Minnesota legislation follows "closely the principles and terminology found in the various federal income tax acts since 1918," legislature likely intended to "mak[e] available . . . a highly developed body of opinion entitled to great persuasive force").

requires that these multiple provisions be construed in harmony and consistent with Minnesota's tax policy. *See, e.g., Apple Valley Red-E-Mix, Inc. v. State*, 352 N.W.2d 402, 404 (Minn. 1984); *see also Wal-Mart Stores East, Inc. v. Hinton*, No. 06-CVS-3928 at 13-14 (N.C., Wake Cty. Sup'r Ct., Dec. 31, 2007) (recognizing similar North Carolina statutes share "common theme" and "address the situation in which a corporate taxpayer does not, for one reason or another, report its 'true' net income"), *aff'd* 676 S.E.2d 634 (N.C. Ct. App. 2009);[16] *Trans-Luxe Corp. v. Meehan*, 652 A.2d 539, 545 (Ct. Super. Ct. 1993) (noting that statute authorizing commissioner to make adjustments between related entities "is plainly written in a way that gives the Commissioner a great deal of discretion," and it would be "linguistically anomalous" to construe language otherwise).

Thus, the Commissioner had the authority to and correctly attributed HF Holding's claimed income to the Bank, HMN's complaints notwithstanding. *See* HMN Br. at 23-24. HMN's arguments boil down to an insistence that once claimed, FOC tax treatment is unassailable. The breadth and plain language of the Commissioner's authority to use "such combined report" and "some other method" to determine income attributable to Minnesota defeats this argument. Further, as explained *infra*, nothing in the FOC regime supports the superiority that HMN claims.

---

16 A copy of the North Carolina district court's opinion is part of the Tax Court record, *see* DeMeules Affidavit, Exhibit 12 (filed Jan. 30, 2009).

B. The Tax Court Correctly Applied Section 290.34 To HMN's Tax-Avoidance Strategy.

The Tax Court applied Section 290.34, subdivision 1, to HMN's REIT Strategy because the requisite corporate status ("corporation liable to taxation") and ownership interests (shares held directly or indirectly by another corporation) were present. Add.43. Next, the Tax Court concluded that all three entities - the Bank, HF REIT, and HF Holding - dealt in the Bank's commodities and services, either the Bank's interest income, or the free services of the Bank's employees.

HMN concedes that Section 290.34 applies to free employee services, it simply asserts its services were "de minimis." But nothing in Section 290.34 recognizes this distinction. Any services at less than fair price, or merely dealing in services, is an arrangement that causes an understatement of income. *See* Minn. Stat. § 290.34, subd. 1; *see also Addison-Miller, Inc. v. Comm'r of Taxation*, 81 N.W.2d 89, 91-92 (Minn. 1957) (recognizing taxpayer cannot "avoid the effects of the statute by merely giving away its . . . services").[17]

Moreover, free employee services were critical to the operation of HMN's REIT strategy. HF Holding was inoperative unless Minnesota personnel routinely and regularly managed, monitored, reviewed, and provided the OTS-mandated oversight for HF Holding's foreign office. Mr. Johnson was the only HF Holding officer to take the

---

[17] The repealed withholding tax rule Minn. R. 8092.0200 (2001), is not relevant because it does not address the Commissioner's statutory authority to disregard improper tax-avoidance arrangements.

necessary operational steps. He approved and submitted the internal controls, and entered into the lease, employment, services, banking, and communications agreements that allowed the Bank to move HF REIT's receipts to HF Holding's foreign bank account and back to the Bank. HF Holding's foreign "employee," in contrast, was virtually powerless without a bank employee's signature; indeed, she could not unilaterally access any of HF Holding's financial accounts.

In short, the free services of HF Holding's Minnesota officers dwarfs Ms. Thompson-Lopez's modest, periodic accounting activities and cannot under any measure be considered minimal. *See, e.g.,* Minn. Stat. § 290.191, subd. 12(b) (recognizing that payroll for employee "working without this state" but "identified with or accountable to an office within this state" is attributed to Minnesota). Further, the arrangement for free services was by design. HMN knew that Minnesota employees had to do the work to move the money through the REIT structure (and it committed to the OTS to use those persons). Thus, without the free services of United States employees, HF Holding would not be able to claim FOC status and the Bank would not be able to secure an 80% tax reduction.

As this Court explained in *Addison-Miller,* "services" is not a narrow term:

> The words 'services' is not a simple word with a simple meaning leaving no room for construction but is a word with a multiplicity of meanings. It may be said that the word varies in meaning according to the context in which it is found. Further, it would be impracticable to attempt a definition which would form a test for every case that may arise. It has also been stated that the term 'services' involves more than mere labor and signifies much more than merely the act of performing labor and may include, as well, expenditures, materials, and things furnished.

81 N.W.2d at 92 (citations omitted).

The Tax Court also correctly recognized that HF REIT and HF Holding dealt in the Bank's commodities or services because all three entities received the same "income." (Add.43) Indeed, passing the Bank's income through HF REIT and HF Holding was critical to the success of the Bank's goal to "completely eliminate (or almost completely eliminate) MN tax liability." Thus, HMN set HF REIT's "income" at the level needed to generate the Bank's targeted tax reduction. Throughout the REIT strategy, HMN shifted the Bank's income to HF REIT, worked to keep HF REIT "filled up," made capital contributions to HF REIT and purchased third-party loans "to maximize the tax benefits" of the strategy. Neither HF Holding nor HF REIT had any operations other than receiving and paying dividends. The Tax Court correctly recognized that in this strategy, the "income" and "dividends" received and paid by HF REIT and HF Holding was the Bank's income, merely transferred through those entities in a circular fashion. *See, e.g., Boulware v. United States,* 128 S. Ct. 1168, 1275 (2008) (noting that facts serve as a "reminder that tax classifications like 'dividend' and 'return of capital' turn on 'the objective economic realities of a transaction rather than… the particular form the parties employ'").

The decision in *Addison-Miller* reinforces the Tax Court's Order. There, the Commissioner increased the corporation's income by adding rent and interest charges based on a rental arrangement and the taxpayer's agreement to allow an affiliate to "just [use] the money from the corporation as it was needed." 81 N.W.2d at 90. Similar to HMN, the taxpayer argued that section 290.34 "would apply only if there was a buying or selling of commodities or services in which the corporation deals." *Id.* at 91. The Court rejected this argument:

> [T]he partnership was able to commence and carry on business with the free use of [the] corporation's money and land and was also able to have the necessary equipment to carry on the business by merely paying what was allowable on the corporation's tax returns as depreciations for such equipment. Who could say (even though the relationship technically created was that of lessor-lessee and debtor-creditor) that this corporation was not performing a valuable service for the partnership?

Id. at 92. The Court held that section 290.34, subdivision 1 "empowers the commissioner to make a determination of what the corporation's income would have been without the arrangement causing the understatement of its taxable net income" based on the "fair profits" that could be realized without that arrangement. *Id.* Nothing in the Court's opinion limits Section 290.34 to "fair pricing" challenges, and more importantly, nothing in the statute has that limitation.

Minnesota Statute Section 290.34, subdivision 2 also authorizes disregard of HMN's REIT strategy. This subdivision empowers the Commissioner to use a combined report to determine the income of any member of a group whose income is regulated by contract or arrangement. *Id.*; *see also* Minn. R. 8034.0100 (authority to disregard "devices" that "distort income attributable to Minnesota," including "fixing income at an arbitrary figure"). While the Tax Court did not address this subdivision, it provides an additional basis for upholding the Commissioner's Order.[18] Specifically, the record

[18] The Commissioner's Order cited subdivision 1 of Section 290.34, but the Commissioner presented subdivision 2 to the Tax Court as an additional basis for
(Footnote Continued on Next Page)

established that HMN regulated its income by transferring loans assets to HF REIT to attain a tax reduction goal; and regulated its income by claiming FOC status through the use of free employee services. The Tax Court noted that "at least on paper," HF Holding met "the literal definition of an FOC." The authority conferred by subdivision 2 is not, however, limited by the forms a taxpayer uses. Further, the Tax Court found that the Bank "understated its income by avoiding the payroll of HF Holding so that FOC status could be claimed." (Add.44)[19] This is exactly the type of device subject to Subdivision 2 since a taxpayer cannot manipulate and avoid its properly due Minnesota tax merely by arranging transactions to avoid the factors on which tax liability is calculated. *See Minnesota Tribune Co. v. Comm'r of Tax'n*, 37 N.W.2d 737, 740-41 (Minn. 1949) (recognizing, among other factors supporting tax order, that "clerical work was performed" in Minnesota by subsidiary's employees "without charge").

C. **<u>This Court's Longstanding Precedent Respects The Substance Of Taxpayer Arrangements And Rejects The Form</u>.**

(Footnote Continued From Previous Page)
upholding that Order. The Tax Court's de novo review allows the Court to consider these alternative arguments. *See* Minn. Stat. § 271.06, subd. 6.

[19] The Commissioner found, as an alternative basis, that HF Holding had not demonstrated that it met the payroll requirements for an FOC because "operations or management of Holding, equal to or greater than that reported as situated in the Grand Caymans, were performed by" Minnesota employees. (A.24) The extraordinarily circumscribed authority of HF Holding's foreign "employee," compared to the comprehensive authority of that entity's Minnesota officers, supported this determination.

For over 100 years, this Court has recognized that the "external dress in which [a] transaction has been clothed" must be rejected in favor of "the substance of the matter." *St. Paul & C. Ry. Co. v. McDonald*, 25 N.W. 453, 456-57 (Minn. 1885). Here, the taxpayer was by contract and statute entitled to a tax exemption for the lands on which railroad tracks were to be built, until it sold, conveyed, or leased those lands. *Id.* at 454. To pay for the track, the taxpayer essentially "sold itself out," holding the lands in name only. *Id.* at 454-55 (noting the railroad had no "valuable or beneficial interest" in the land). When the railroad claimed the tax exemption, arguing that it still owned the land, this Court responded as follows:

> Equity will never suffer the mere appearance or external form to conceal the real nature and purpose of a transaction. The question is not what are the words or terms of a contract on its face, but what is its real character? It would be useless as well as disingenuous for a court to profess to be so blinded by the mere external form as to be unable to perceive the real facts underneath, which would be perfectly apparent to any business layman of ordinary intelligence.
>
> . . . . [T]he evidence compels us to the conclusion that this transaction, although in form a mortgage, is in substance a conveyance, and was intended to operate as such. The state should and must, in letter and spirit, religiously keep its contract obligations; but the law will not tolerate the use of mere forms to evade its spirit. To continue the exemption of these lands from taxation would be a fraud upon the state, and contrary to the meaning and spirit of the statute.

Id. at 456-57; *see also In Re Marshall's Estate*, 228 N.W. 920, 922 (Minn. 1930) ("We cannot adopt the [taxpayer's] contention that the writings conclude the state. . . . the state may go behind the written documents and show the true situation.").

The economic substance doctrine — sometimes referred to as "substance over form" or an impermissible assignment of income — is widely recognized as a judicial tool to uphold legislative tax policy in the face of unwarranted tax results.[20] *See, e.g.*, *United States v. Bayse*, 410 U.S. 441, 450, 93 S.Ct. 1080, 1086 (1972) (rejecting assignment of income, "no matter how clever or subtle," and noting doctrine "stands today as a cornerstone of our graduated income tax system"); *Coltec, Indus., Inc. v. United States*, 454 F.3d 1340, 1354 (Fed. Cir. 2006) (doctrine is "merely a judicial tool for effectuating the underlying Congressional purpose that, despite literal compliance with the statute, tax benefits not be afforded based on transactions lacking in economic substance."), *cert. denied*, 549 U.S. 1206 (2007). These common law doctrines work in tandem with the Commissioner's statutory authority to assure effective implementation of and compliance with Minnesota's tax system. While both *St. Paul & C. Ry. Co.* and *In Re Marshall's Estate* pre-dated Minnesota's income tax, the principles adopted in these cases persist in harmony with the statutory grants of various powers and continue to be applied today, in "assignment of income," "substance over form," and economic substance terms.

For example, in *Sanders v. Comm'r of Taxation*, 23 N.W.2d 565 (Minn. 1946), an income tax case, this Court adopted the assignment of income doctrine from *Lucas v. Earl*, 281 U.S. 111, 50 S.Ct. 241 (1930). Given the broad reach of Minnesota's income tax, the Court concluded that income under taxpayers' "unfettered command" is subject

---

20 "Courts have developed a number of closely related and sometimes overlapping doctrines that can be applied to negate claimed tax benefits in tax cases. These doctrines are often labeled differently by different courts. We label the doctrine discussed herein as the 'economic substance' doctrine[.]" *TD Banknorth, N.A. v. Dep't of Taxes*, 2008 Westlaw 4277177 at 5, n.7 (Vt., Sept. 19, 2008).

to Minnesota tax, whether or not the taxpayer claims it as such. *See id.* at 568-69 (quoting *Corliss v. Bowers*, 281 U.S. 376, 50 S.Ct. 336 (1930)). In *Minnesota Tribune Co.*, 37 N.W.2d 737, also an income tax case, this Court acknowledged judicial authority to look "through the form to the substance of the relationship between two corporations." *Id.* at 739. Once it did so, the Court found that a foreign holding company dominated the operations of a local company, was thus "present and acting in the state through its officers," and was subject to Minnesota tax. *Id.* at 740-41. *See also Bond v. Comm'r of Revenue*, 691 N.W.2d 831, 838 (Minn.) ("Having earned the income, he cannot avoid taxation by contrivances"), *cert. denied*, 545 U.S. 1116 (2005); *Comm'r of Revenue v. Safco Prods. Co.*, 266 N.W.2d 875, 877 (Minn. 1978) (in sales tax case where taxpayer avoids tax entirely court "will disregard a transaction's form to examine its economic substance"); *Midwest Fed'l Savings & Loan Ass'n v. Comm'r of Revenue*, 259 N.W.2d 596, 599 (Minn. 1977) ("We agree that on tax questions a court is free to look to the substance, not just the form, of a transaction").

Contrary to HMN's assertions, the common law addresses more than merely "legally ambiguous" transactions. *See* HMN Br. at 28. Nothing in these decisions discusses legal ambiguities; rather, in each case the Court accepted the economic reality of the transaction and rejected the form the taxpayer adopted. Nor were statutory ambiguities an issue. As the Court noted in *Transport Leasing Corp. v. State*, 199 N.W.2d 817 (Minn. 1972), the "nontechnical language of the statues [was] of sufficient clarity" that no judicial construction was needed. *Id.* at 819; *see also Corliss*, 281 U.S. at 378, 50 S.Ct. at 337 (noting, in rejecting tax avoidance strategy, that case was "too clear to need help . . . from arguments based on the power of Congress to prevent escape taxes").

Minnesota's common law tax avoidance doctrines – whether denominated as "economic substance," "substance over form" or "assignment of income" — play a critical role in enforcing Minnesota's tax policy. The coexistence of these doctrines with the commissioner's statutory authority acknowledges that statutes cannot coherently address every conceivable form a taxpayer may choose to avoid tax obligations. *See Gilbert v. Comm'r of Revenue*, 248 F.2d 399, 411 (2d Cir. 1957) ("statutes are written in general terms and do not undertake to specify all the occasions that they are meant to cover") (Hand, J., dissenting). Further, the Legislature has implicitly accepted the use of these doctrines. While express legislative action is required to abrogate common law doctrines, legislative action is unnecessary to acknowledge the existence of those doctrines. *See Congdon v. Congdon*, 200 N.W. 76, 82 (Minn. 1924); *see also Nelson v. Productive Alternatives, Inc.*, 715 N.W.2d 452, 455 (Minn. 2006) (noting that Minnesota whistleblower act did not repeal common law wrongful discharge claim); *Goodyear Tire & Rubber Co. v. Dynamic Air, Inc.*, 702 N.W.2d 237, 244 (Minn. 2005) (legislature is presumed to act with knowledge of existing law). Thus, these doctrines remain in force and available to the Commissioner and this Court to determine a taxpayer's proper Minnesota tax obligations.

D. <u>The Lack Of Economic Substance And Improper Assignment Of Income Are Undisputed. The Tax Court Therefore Correctly Applied The Common Law Doctrines.</u>

The Tax Court concluded that HMN's REIT strategy lacked economic substance because its purported business reasons were a pretext and there was no economic benefit, other than tax avoidance, to the structure. Add.48.[21] The Tax Court also found that the Bank's income "was not used for the benefit of the REIT or HF Holding; rather, they were mere conduits for the return of that income to HF Bank." Add. 50. <u>HMN does not challenge these conclusions or the findings that support them</u>. Instead, it merely argues that the Tax Court erred in relying on cases from other states. *See* HMN Br. at 36.

The Tax Court's legal conclusions are amply supported by the record. HMN's REIT strategy was devoid of any legitimate purpose other than tax avoidance, a conclusion apparent from HMN's wholesale adoption of KPMG's purported business purposes, OTS communications, operational documents, and "preferred alternative" Board resolution language.[22] *See TD Banknorth v. Dep't of Taxes*, No. 2007-127, 2008

---

[21] There is no substantive "profit" in decreasing taxes. *See Portland Golf Club v. Comm'r of Internal Revenue*, 497 U.S. 154, 170, n.19, 110 S.Ct. 2780, 2790, n.19 (1990) ("profit means economic profit, independent of tax savings") (citations, quotations omitted).

[22] HMN took virtually no independent steps, which is not surprising given KPMG's historical practices. As the United States Congress found, KPMG "is actively involved in implementing the tax shelters which it sold to its clients[.]" <u>Permanent Subcomm. On Investigations of the Committee of Homeland Sec'y & Govt'l Affairs</u>, THE ROLE OF PROFESSIONAL FIRMS IN THE U.S. TAX SHELTER INDUSTRY, at p. 6 (Apr. 13, 2005) (S. Rpt. 109-54). The Subcommittee's report did not address the generic KPMG REIT strategy at issue here. However, consistent with the Committee's conclusions, KPMG here pitched a tax strategy to its audit client (based on an apparently generic
(Footnote Continued on Next Page)

Westlaw 4277177 at 8 (Vt., Sept. 19, 2008) ("The genesis of the idea was a suggestion by taxpayer's accountant that establishing the holding companies would be a 'slam dunk strategy' for achieving substantial bank franchise tax savings."). In contrast to HMN's compulsive focus on tax savings, or its concern with failing to "take advantage of the tax laws," there was no evidence to suggest that HMN had any inclination to evaluate or explore the potential "tools" the REIT strategy allegedly provided. Instead, the record showed that HMN ignored KPMG's purported business reasons, transferred over $150 million in loan assets to HF REIT without a document agreeing to or evidencing either that transfer or the terms of an agreement,[23] all with virtually no change in the Bank's internal or external operations. (Add.49-50) Further, the Bank's officers and directors routinely acted in a dual-capacity, acting on both sides of loan transactions between the Bank and HF REIT, declaring dividends from HF REIT to HF Holding, declaring dividends from HF Holding to the Bank, and authorizing wire transfers for those dividends. *See Anderson v. Comm'r of Revenue*, 93 N.W.2d 523, 530-31 (Minn. 1958)

(Footnote Continued From Previous Page)
presentation), prepared the transactional documents, issued and arranged for opinions, and provided administrative services.

[23] The Tax Court did not deem HMN's "backdating" claim credible. (Add.51) The article that HMN cites explains that improper backdating can occur "when the event described by the backdated document" occurred after the date reflected in the document and "the beneficiary of the backdating can reap an undeserved benefit at the expense of the government . . . only if the event occurred on the earlier date." Kwall & Duhl, *Backdating*, 63 BUS. LAW. 1153, 1157 (2007). HMN sought to secure the tax advantages of the REIT strategy as soon as it declared the REIT established and before the loan transfers occurred and before any agreement memorialized those transfers.

(relying in part on stipulated facts showing "ownership by the same shareholders of 90 percent of the stock in both the old and the new corporations.").[24]

Similarly, the evidence of HMN's improper income assignment, through its domination of HF REIT and HF Holding, is compelling. In simple terms, the Bank controlled which loans would be transferred to HF REIT, with a goal of generating and protecting tax avoidance goals; controlled when loans were transferred to and back from HF REIT; dictated the terms of the loan transfers, including which terms would be respected and which ignored; and decided not to use HF REIT for the purposes it told the OTS it would be used. *See Comm'r v. Sunnen*, 333 U.S. 591, 604, 68 S.Ct. 715, 722 (1948) (noting that entity that "is the source of the right to receive and enjoy the income" remains taxable on that income, regardless of who holds the property interest in the asset that generates the income); *Griffiths v. Helvering*, 308 U.S. 355, 357-58, 60 S.Ct. 277, 278-79 (1939) (taxation is "not so much concerned with the refinements of title as it is with actual command over the property taxed – the actual benefit for which the tax is paid") (citations, quotations omitted).

The tax decisions that HMN dismisses illuminate and confirm that the Tax Court correctly applied the relevant law. In *Fleet Funding*, the Massachusetts Tax Court addressed the same KPMG "REIT solution" at issue here. *See Fleet Funding, Inc. v.*

24 *See e.g.*, Bittker, *Pervasive Judicial Doctrines In The Construction Of The Internal Revenue Code*, 21 HOWARD L.J. 693, 707 (1978) (noting substance over form is properly invoked in self-dealing cases since "the form used often has minimal if any non-tax consequences").

Comm'r of Revenue, Nos. C271862-63, 2008 Westlaw 495485 at 4 (Mass. App. Tx., Feb. 21, 2008) (noting "idea of avoiding" Massachusetts tax on Bank's interest income from real estate loans "was devised and marketed by" KPMG). Fleet's tax avoidance strategy was implemented with a passive investment company (PIC) rather than an FOC.[25] *Id.* As did the Tax Court here, the Massachusetts tax court considered "whether certain intercompany transactions were a sham that lacked economic substance and business purpose, and therefore must be disregarded for tax purposes." *Id.* at 18. As with HMN, tax avoidance "dominated" Fleet Funding's documents and discussions, and the purported business reasons — largely similar to those KPMG proposed to HMN — were a "pretext." *Id.* at 23-24. Substantially all of the REIT's and PIC's income "came from the [Bank's] assets," and the "vast majority of this income was returned to [the Bank] in the form of a dividend, via the PIC intermediaries." *Id.* at 25. There was, the Massachusetts court concluded, no business concern addressed by "transferring part of [the Bank's] loan portfolio to a REIT and receiving the interest income back, mostly tax-free, from a subsidiary." *Id.* at 28; *see also TD Banknorth, N.A.*, 2008 Westlaw 4277177 at 8-9 (disregarding Bank's transfer of participation interests and other assets to controlled subsidiaries that "were nothing other than a vehicle for tax avoidance," since it is "absurd" to believe Legislature intended tax benefit to be "a means through which

---

25 A PIC is used "to shelter corporate profits from state income taxation in states that do not have combined reporting" by "shifting taxable profits into a tax haven subsidiary." Mazerov, State Corporate Tax Shelters And The Need For Combined Reporting, 46 STATE TAX NOTES 621, 622 (Nov. 26, 2007).

taxpayers could almost completely avoid payment of the bank franchise tax"); *Wal-Mart Stores East, Inc.*, No. 06-3928 at 18 (finding that tax-avoidance strategy using a REIT and intervening Delaware entities "allowed [taxpayer] to funnel a substantial amount of their gross income through their respective REITs and Property Companies only to have the 'rent' return to them in a non-taxable form").

These decisions reject, on economic substance grounds, strategies that route income in a circular fashion through wholly controlled and dominated subsidiaries simply to shift income to a different "form" e.g., dividends or rent, and remove it from the taxing jurisdiction. These decisions are persuasive in their analysis of the economic substance doctrine in the context of the administration of state taxes, regardless of the presence or absence of an FOC, and notwithstanding claimed literal compliance with the state's tax laws. *See, e.g., TD Banknorth, N.A.*, 2008 Westlaw 4277177 at 9 ("Regardless of whether the creation of the holding companies appeared to follow the literal requirements [of statute], the entities must still engage in independent economic activities to be considered legitimate for tax purposes")

The other state tax decisions the Tax Court relied on, *see* HMN Br. at 37, while not addressing a REIT strategy, rejected taxpayer structures that shifted and isolated income to re-characterize taxable income as non-taxable. All of these decisions also reflect a glaring absence of any economically sound reason for the taxpayers' transactions. For example, the taxpayer in *The Talbots, Inc.* created a Delaware subsidiary to hold intellectual property assets, and then loaned the subsidiary the funds to purchase the assets. 2007 Westlaw 967883 at 6-9 (N.Y. Tax App., Mar. 22, 2007). The taxpayer paid the subsidiary tax-deductible royalties, the while the untaxed subsidiary made principal, interest, and dividend payments back to the taxpayer. In a thorough analysis, the New York court concluded that the arrangement had no economic substance or valid business purpose, particularly given the "circular flow of funds:"

> This type of circular flow of funds among related entities is an indication of a transaction lacking in economic substance. . . . No one disputes that tax minimization is clearly acceptable as a legitimate aim and exercise, and that tax 'ramifications' are properly considered with respect to 'all business transactions' as a matter of ordinary business prudence. However, . . . it is not acceptable to manufacture tax deductions by the simple expedient of having no legal impediment against creating an extra-jurisdictional subsidiary entity, the only discernable purpose for which is to accept money and then send it back in a tax advantaged circuitous flow."

Id. at 45. (citations omitted); *see also The Classic Chicago, Inc. v. Comptroller*, 2008 Westlaw 1724237 (Md. Tx. Ct., Apr. 11, 2008) (rejecting same structure for lack of entity economic substance); *Pacificare Health Sys., Inc. v. Dep't of Revenue*, 2008 Westlaw 2596371 (Or. Tax Mag. Div., July 1, 2008) (rejecting similar asset licensing arrangement because "a purported transaction that leaves the 'transferor' in command and control of the property, and in no substantially modified economic position," is disregarded); *Syms Corp. v. Comm'r of Revenue*, 765 N.E.2d 758, 765 (Mass. 2002) (rejecting asset licensing arrangement and noting that "payments were not for services provided by [subsidiary] but rather part of a contrived mechanism by which affiliated entities shifted income, tax free, between themselves in a circular transaction for the benefit of [taxpayer].").[26]

---

[26] Reviewing a different factual record, but applying the same legal principles, Massachusetts has had occasion to find an intangible holding company had sufficient
(Footnote Continued on Next Page)

III. <u>NEITHER THE FOC REGIME NOR *HUTCHISON TECHNOLOGIES* SANCTION HMN'S TAX-AVOIDANCE REIT STRATEGY.</u>

HMN's arguments improperly elevate Minnesota's FOC regime as superior to the Commissioner's authority to disregard improper tax avoidance structures. *See* HMN Br. at 45. Claiming that FOCs are "taxed in a special way" HMN argues, the Commissioner cannot override the FOC tax benefit once claimed. *Id.* at 29, 32. HMN also relies heavily on the *Hutchinson Technologies* decision, suggesting that a pure tax-avoidance scheme cannot be challenged so long as an FOC is part of that arrangement. *See id.* at 32-36. Neither argument allows the taxation claimed in HMN's REIT strategy.

A. <u>The FOC Regime Did Not Repeal The Commissioner's Statutory Authority.</u>

Minnesota's FOC regime did not, and was not intended to, eliminate either the Commissioner's multi-faceted statutory authority, nor this Court's common law doctrines. *See, e.g., Fingerhut v. Comm'r of Revenue*, 278 N.W.2d 528, 531 (Minn. 1979) (recognizing court "must evaluate individual taxation provision against the background of the entire statutory scheme"); *see also* Minn. Stat. § 645.39 (with limited exceptions, "a later law shall not be construed to repeal an earlier law unless the two laws are irreconcilable"). Surely the Legislature would have mentioned a restriction on the Commissioner's statutory authority had it intended the FOC regime to supplant Section

---

(Footnote Continued From Previous Page)
economic substance to be taxed as claimed. *See Sherwin-Williams Co. v. Comm'r of Revenue*, 778 N.E.2d 504 (Mass. 2002).

290.34 or other sections designed to assure a correct determination of Minnesota tax.[27] Instead, it is presumed the Legislature intended the FOC regime to coexist with the Commissioner's statutory authority and the common law doctrines. See *Goodyear Tire & Rubber Co,* 702 N.W.2d at 244 (legislature is presumed to act with knowledge of existing law); *see also Minneapolis Eastern Ry. Co. v. City of Minneapolis*, 77 N.W.2d 425, 428 (Minn. 1956) (presuming that Legislature knew and had in mind existing law relating to subject matter, so statutes must be harmonized "with each other and give full effect to all so far as this may reasonably be done").[28]

Further, the FOC provisions can be harmonized with the Commissioner's statutory authority, a result required over HMN's dismissal of that authority. *See* Minn. Stat. § 645.26, subd. 1 (2008) (construe two provisions to give effect to both). In simple terms, claimed FOC status is subject to and operative only after the Commissioner has, in the exercise of his statutory authority, confirmed the taxpayer is entitled to the treatment claimed. *See* Minn. Stat. § 289A.35.

---

27 HMN suggests a "sham in fact" transaction is the only activity prohibited by the Commissioner's statutory authority. *See* HMN Br. at 25. Nothing in Section 290.34 limits the Commissioner's authority to shams in fact. HMN's REIT strategy was a "sham in substance" - "a transaction that lacks the substance its form represents." *See Sherwin-Williams Co.*, 778 N.E.2d at 512, n.6 (distinguishing between sham in fact and sham in substance). Also,

28 The Commissioner does not contend that the FOC provisions are irreconcilable with other provisions in Chapter 290; nevertheless, if such a concern arose, the Commissioner's specific statutory authority over corporations prevails over the general FOC provisions. *See* Minn. Stat. § 645.26, subd. 1 (specific prevails over general); *see also* Minn. Stat. § 290.34 ("Corporations, Special Provisions"); *Commonwealth of*
(Footnote Continued on Next Page)

Thus, the Tax Court correctly assigned HMN the burden to show any error in the Commissioner's Order and to sustain its claimed right to an exemption from tax. *See National Can Corp. v. Comm'r of Revenue*, 437 N.W.2d 416, 418 (Minn. 1989). The FOC regime is an exception to Minnesota's general rule imposing tax on "every corporation" that exercises the privilege to "engage in contacts with [Minnesota] that produce gross income attributable to sources" in Minnesota. Minn. Stat. § 290.02. Since taxation is presumed, *see National Can Corp.*, 437 N.W.2d at 418, HMN's mere claim to FOC status cannot overcome the abundance of evidence revealing a lack of economic substance to the REIT strategy through which FOC tax benefits were claimed.

Moreover, the Tax Court correctly rejected HMN's argument that claimed FOC status is dispositive. Add.44. This is particularly true since it was the entire REIT strategy, not solely HF Holding's FOC status, that generated HMN's tax reduction. *See, e.g., Fleet Funding, Inc.* 2008 Westlaw 495485 at 21 (focusing "only on whether the subsidiaries, rather than the transaction, should be recognized for tax purposes" would require all business activity between two entities to be accepted, an outcome that would "eviscerate the sham transaction doctrine"). Thus, even though the Tax Court acknowledged that HF Holding was an FOC "on paper," and HMN reported its income as a "dividend received," the State may still "go behind the written documents and show the true situation." *In Re Marshall*, 228 N.W.at 922.

(Footnote Continued From Previous Page)
Virginia v. General Elec. Co., 372 S.E.2d 599, 606 (Va. 1988) (similar statutory authority to require a consolidated report to determine income "is specific, not general").

B. *Hutchinson Technologies* Does Not Sanction HMN's Tax-Avoidance Strategy.

This Court's decision in *Hutchinson Technologies* neither considered nor addressed the scope of the Commissioner's statutory authority to disregard transactions used to avoid legitimately incurred Minnesota tax. This decision is therefore not relevant to the tax-avoidance issues here.

> We have held many times . . . that the authority of a decision is coextensive with the facts upon which it is based and with what was actually decided with respect to such fact situation. The language of a decision should be considered in the light of these factors. Language derives meaning from the circumstances and time of its use-the setting communicates both content and color to words. Language of a decision taken out of its context and considered without regard to the facts and circumstances thereof and what was actually decided is apt to be misleading.

State v. Hanson, 38 N.W.2d 845, 850-51 (Minn. 1949) (citations omitted); *see also Haskin v. Hennepin Co. Glen Lake Sanatorium*, 127 N.W.2d 522, 527 (Minn. 1964) ("The scope of any opinion by this court is limited to the facts and issues involved in the decision, and anything said in excess of deciding these issues is pure dictum.").

Hutchinson Technologies involved an entity that was a federal-tax-favored entity, an FSC, which also claimed status as a Minnesota FOC. *See* 698 N.W.2d at 3. The Commissioner challenged the entity's claimed FOC status under Minn. Stat. § 290.01, subd. 6b, due to the express disfavor for FSCs in Minnesota's tax code. The Court began by explaining the purpose of Minnesota's FOC regime: "FOCs are a Minnesota tax entity adopted in 1988 to provide some tax relief for domestic corporations that manufactured goods for export." *Id.* at 4. The FSC regime also allowed "U.S. exporters to reduce their federal income tax on export-related income," so the taxpayer (HTI) "ran its export sales through" its FOC (Export) "in order to maximize federal tax benefits." *Id.* at 4-5. The parties "stipulated that Export had no property or payroll inside the United States." *Id.* at 7. Specifically, Export "owned and used outside the United States advertising and sales promotional materials such as brochures, videos, and product samples that it purchased from HTI." *Hutchinson Tech., Inc. v. Comm'r of Revenue*, Nos. 7398-R, 7504-R, 2004 Westlaw 1161418 at 1 (Minn. Tx. Ct., May 10, 2004).

Thus, *Hutchinson Technologies* involved an entity that had (a) substantial overseas transactions, advertising, and sales with third parties, either through Export or HTI; (b) an FOC that "owned and used" property outside the United States related to those activities; and, (c) a comprehensive federal tax regime that governed the offshore attributes and activities of that entity. Here, in contrast, the Bank and HF REIT had no international business presence or activities, and HF Holding's international "presence" was minimal at best. Further, the income-generating activities were concentrated almost exclusively in Minnesota and Iowa, with the only genuine operations physically occurring in and economically derived from Minnesota. No international activities or attributes <u>generated</u> income. Rather, income began and ended in Minnesota, with the Bank's receipt of customers' interest payments, and the Bank's receipt of HF Holding's "dividend" from those same payments. HF Holding's sole income-producing asset, its investment in HF REIT, was held in Minnesota as was a duplicate set of the company's books and records.

The *Hutchinson Technologies* Court addressed three issues: (1) "We first examine . . . the preliminary issue of whether Export qualified as" an FOC under Section 290.01, subd. 6b, *see* 698 N.W.2d at 6; (2) "The next issue is whether the tax court erred in ruling that under" Section 290.01, subd. 19d(11), HTI could subtract 80% of fees paid, *id.* at 8-9; (3) "The third tax court ruling challenged . . . is that [as an FSC] HTI was not entitled to take the" [dividend-received] deduction under section 290.21, and that as construed, "the exclusion violates the Foreign Commerce Clause," *id.* at 12.

On the first issue, this Court concluded that "the language of subdivision 6b does not require operations in the sense argued by the Commissioner," and based on the stipulated property and payroll facts, Export met the statutory standards to claim FOC status. *Id.* at 8. On the second issue, the Court rejected the Commissioner's proposed construction of "fees," including a requirement that such fees have a "business purpose" requirement to be deductible, because the plain language "requires only that the payments be fees." *Id.* at 12.

On the third issue, a constitutional challenge, the effect of applying the statute as written arose from a perceived variation in the different treatment between domestic and foreign corporations. The Commissioner argued that this differential treatment was constitutionally permissible based on the conduit nature of an FSC under federal tax law, and that treatment was not related to the location of incorporation. *Id.* at 16. The Court rejected this distinction, and in doing so, commented that "the Minnesota legislature did not require that FOCs have actual operations" and given "these minimal requirements for an FOC, there is nothing to prevent any FOC from being an empty shell entity, existing solely to provide tax exemptions, no different in nature from a FSC." *Id.* Thus, "the different treatment accorded the dividends of domestic and foreign FOCs cannot be explained based on a difference in their nature." *Id.* The Court therefore interpreted the dividend-received deduction to avoid a constitutional infirmity. *Id.* at 18.

The legal issues addressed in *Hutchinson Technologies* included FOC statutory qualification issues and a constitutional infirmity analyzed through statutory construction principles. Nothing in the decision addresses the Commissioner's multiple sources of authority to ensure that Minnesota's tax is imposed on the income fairly, properly, and correctly attributable to Minnesota. Nothing in the decision holds, let alone suggests, that this Court overruled decades of precedent recognizing that "the law will not tolerate the use of mere forms to evade its spirit." *St. Paul & C. Ry. Co.*, 25 N.W. at 457. *Hutchinson Technologies* is factually and legally distinct from this case; most importantly because it does not address the Commissioner's authority under Section 290.34 and to tax according to the substance and not the form of a transaction. *See State v. Losh*, 755 N.W.2d 736, 742 (Minn. 2008) (acknowledging the rule of *stare decisis* "is never properly invoked unless in the decision put forward as precedent the judicial mind has been applied to and passed upon the precise question.") (citations, quotations omitted).

Indeed, recognizing the distinct but limited persuasive value of *Hutchinson Technologies* is consistent across the legislative purposes of both the FOC regime and the authority vested in the Commissioner to disregard abusive transactions. The "tax relief" treatment afforded domestic corporations with export sales implements the legislative policy to accurately determine the taxable income of entities that, though incorporated in the United States, have minimal U.S. activities as measured by payroll, sales, and operating expenses. *See Hutchinson Tech., Inc.* 698 N.W.2d at 4 (recognizing purpose of

FOC regime). The FOC regime is a logical extension of Minnesota's water's edge model of taxation because the FOC entity has a domestic nature (thus, 20% of its income/dividend is taxed), yet preserves Minnesota's water's edge policy that excludes foreign income (by exempting 80% of the income/dividend generated by the FOC).[29] *See Id.* at 4-5 (explaining FOC exceptions to water's edge policy of taxation).

In concert, the Commissioner's statutory authority (in multiple sections) and the common law implement a comprehensive legislative objective to impose Minnesota's income tax according to the substance, rather than the form, of transactions and based on the correct taxable income allocable to Minnesota. Section 290.34 advances that policy by authorizing the Commissioner to determine a taxpayer's income without regard to "arrangements" that understate that income. This Court's common law economic substance doctrines ensure that "the use of mere forms to evade [the] spirit" of the law is prohibited. *See St. Paul & C. Ry. Co.*, 25 N.W. at 457.

---

[29] HMN cannot equate its tax-free income circulation with valid uses of S-corps and similar entities. The fact that some entities are statutorily sanctioned and receive tax benefits does not circumscribe the tax administrator's authority. The issue remains whether there are non-tax reasons for using such structures. *See* R.A.68-69. HMN had no such reasons, at least none the Tax Court found credible or supported by the evidence.

IV. NEITHER A TAXPAYER'S RIGHT TO DECREASE TAXES BY LAWFUL MEANS NOR CLAIMED LITERAL STATUTORY COMPLIANCE EXCUSES NON-SUBSTANTIVE TAX-AVOIDANCE STRATEGIES.

HMN's last effort to block scrutiny of its REIT strategy is its claimed right to engage in tax planning and its claimed statutory compliance. Neither argument saves HMN's tax-avoidance strategy.

A. <u>The Right To Engage In Tax Planning Is Subject To The Commissioner's Authority To Tax According To The Substance Of A Transaction</u>.

While it is recognized that a taxpayer has the "legal right" to decrease its taxes by lawful means, *see* HMN Br. at 30 (quoting *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266 (1935)), the Commissioner is expressly authorized to evaluate HMN's tax planning, *see* Minn. Stat. § 290.34 (Commissioner may determine income "but for the arrangements causing" understatement and may use combined report to determine income regulated by contract or arrangement). Thus, HMN's "right" to engage in tax planning remains subject to the Commissioner's authority to evaluate whether in doing so the Bank's income was understated or regulated.

Further, the United States Supreme Court has recognized that the "question for determination is, whether what was done, apart from the tax motive, was the thing the statute intended." *Gregory*, 293 U.S. at 469, 55 S.Ct. Where the "whole undertaking, though conducted according to the terms [of the statute] was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization and nothing else," the "transaction upon its face lies outside the plain intent of the statute." *Id.*; *see* *also Coltec Indus., Inc.* 454 F.3d at 1355 ("although the taxpayer has an unquestioned right to decrease or avoid his taxes by means which the law permits, the law does not permit the taxpayer to reap tax benefits from a transaction that lacks economic reality.") (citation omitted).[30] Thus, while tax planning may be permissible, where an entire transaction is devoid of any purpose or effect other than tax avoidance it is suspect. "The mere presence of tax planning will not, in and of itself, cause a transaction to fail the business purpose requirement. However, to the extent that tax planning purposes dominate a transaction, the entire transaction or structure may be jeopardized." RELATED PARTY TRANSACTIONS AND STRUCTURE: STATE TAX ISSUES, ¶ 315.02 at 43 (2002).

Tax planning not only dominated HMN's REIT strategy, it was the sole purpose for and effect of the strategy. Thus, HMN's claimed right to engage in tax-planning does not insulate its tax-avoidance strategy from scrutiny.

---

30 Justice Harlan's concurrence in *Commissioner v. Brown* does not chang this longstanding judicial policy. In that case, the transaction occurred between unaffiliated entities, with "considerable good faith bargaining at arm's length," resulting in a "bona fide sale." 380 U.S. 563, 568-69, 85 S.Ct. 1162, 1165 (1965). Further, the Commissioner "abandoned . . . the argument that this transaction was a sham," and admitted "that there was real substance." *Id.* at 569, 85 S.Ct. at 1165. Thus, the Court did not consider whether any tax planning motive was permissible because it was faced with and decided only an issue of statutory construction. *See id.* at 570, 85 S.Ct. at 1165-66.

B. Literal Statutory Compliance Does Not Sanction Tax Avoidance.

Next, HMN assumes that literal statutory compliance insulates its strategy from further scrutiny. *See* HMN Br. at 18-22. If this assertion was true, there would be no need for the authority conferred by sections 289A.35, 290.07, 290.20, and 290.34, to investigate and determine the true, correct, and proper income attributable to Minnesota. HMN's position renders multiple, longstanding statutory provisions obsolete, and implicitly overrules many of this Court's precedents.

Wisely, Minnesota has already rejected the talisman of a bare claim to literal compliance:

> A literal compliance with statutory provisions is not conclusive since we are concerned with substance and not form, and this is particularly true in reorganization cases. A series of apparently independent acts or events, separated from each other by a variety of legal devices, may by design or ultimate effect produce an overall plan of reorganization. There are, however, certain minimum statutory requisites that must exist.

Anderson, 93 N.W.2d at 537

In addition, HMN's claimed literal compliance with REIT tax reporting undermines the tax and policy purposes for which REITs were developed while it denies Minnesota the tax intended to be imposed on a REIT's dividend distributions.[31]

---

[31] HMN elicited testimony at trial about KPMG's opinion. *See* HMN Br. at 3 (referring to opinion). A promoter's opinion on the tax structure the promoter sells is questionable. *See* Cummings, *The Range Of Legal Tax Opinions, With Emphasis On The Should Opinion*, 98 TAX NOTES 1125, 1129 (Feb. 17, 2005). Further, KPMG's opinion is not in the record and is therefore not relevant. Finally, KPMG's opinion would not in any case insulate HMN's REIT strategy from the appropriate review under Minnesota law. *See, e.g.*, U.S. TAX SHELTER INDUSTRY, *supra*, at pp. 1, 6, 9, 45 (describing
(Footnote Continued on Next Page)

Historically, the REIT was intended as a vehicle by which a small investor could participate in the financial benefits of a professionally managed real estate portfolio, similar to the investment opportunities provided by a mutual fund. *See BankBoston Corp. v. Comm'r of Revenue*, 861 N.E.2d 450, 451 (Mass. Ct. App. 2007) (noting REITS "are intended to provide access for individual of moderate means to investments that had previously been out of reach due to economies of scale and tax considerations"). HMN's REIT strategy did not provide this opportunity; instead, it provided the Bank with an income circulator that stripped the REIT distributions of their pass-through taxable nature.[32] Further, the Bank employee "investors" had no investment "option," as there was no alternative investment opportunity, they could not sell the REIT share without first offering it for sale to HMN, they had no voting rights, and they received only a nominal annual sum ($30) compared to HF Holding's $5,000.00+ dividend per share. The evidence also demonstrates that any "investment opportunity" available to HF REIT's common stockholder, HF Holding, was dominated and controlled by the Bank.

In short, rather than meaningfully pooling together small investors with a substantively rewarding investment opportunity, HMN merely paid its employees a paltry sum to ensure the Bank could pass $8 million of taxable interest income each year through HF REIT and HF Holding to avoid $1.70 million in Minnesota tax.

(Footnote Continued From Previous Page)
"generic tax products" and the purpose of tax opinion letters in terms of law and likelihood of success if challenged by the IRS).

32 Except to the extent that employees who were given a REIT share paid tax on their dividends. *See* Jt. Exh. 60 at HMN 1380.

CONCLUSION

"The conclusion is inescapable, as the court below very clearly pointed out, that by this roundabout process, [HMN] received the same benefit" it received without the REIT strategy: income generated from Minnesota activities. *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613, 58 S.Ct. 393, 395 (1938). The only difference was that now HMN did not pay Minnesota tax on that income.

For all the reasons stated above, the Commissioner respectfully requests that the Court uphold the Tax Court's Order.

Dated: August 26, 2009

LORI SWANSON
Attorney General
State of Minnesota

Rita Coyle DeMeules

RITA COYLE DEMEULES
Assistant Attorney General
Atty. Reg. No. 0191644

445 Minnesota Street, Suite 900
St. Paul, MN 55101-2127
(651) 296-0692

ATTORNEYS FOR RESPONDENT
COMMISSIONER OF REVENUE

CERTIFICATE OF COMPLIANCE

The undersigned, Rita Coyle DeMeules, hereby certifies pursuant to Minn. R. Civ. App. P. 132.01, subd. 3(c), that the word count of the attached Brief of Respondent Commissioner of Revenue is 13,994 words. The Brief complies with the typeface requirements of the rule and was prepared and the word count was made using Microsoft Word 2003.

Dated: August 26, 2009

LORI SWANSON
Attorney General
State of Minnesota

Rita Coyle DeMeules

RITA COYLE DEMEULES
Assistant Attorney General
Atty. Reg. No. 0191644

445 Minnesota Street, Suite 900
St. Paul, MN 55101-2127
(651) 296-0692

ATTORNEYS FOR RESPONDENT
COMMISSIONER OF REVENUE

AG· #2471084-v1