

STATE OF MINNESOTA  
OFFICE OF ADMINISTRATIVE HEARINGS

FOR THE MINNESOTA DEPARTMENT OF REVENUE

In the Matter of the Proposed Rules  
Governing the Application of Sales  
and Use Tax Laws to Isolated and  
Occasional Sales and Sales of  
Personal Property Used in a Trade  
or Business, Minnesota Rule  
8130.5800

**REPORT OF THE  
ADMINISTRATIVE LAW JUDGE**

Administrative Law Judge Barbara L. Neilson conducted a hearing concerning rules proposed by the Minnesota Department of Revenue on June 30, 2008, commencing at 9:30 a.m. in Conference Room 2040 of the Stassen Building, 600 North Robert Street, St. Paul, Minnesota. The hearing continued until everyone present had an opportunity to state his or her views on the rules being proposed by the Department of Revenue (the Department).

The hearing and this Report are part of a rulemaking process governed by the Minnesota Administrative Procedure Act.<sup>1</sup> The legislature has designed the rulemaking process to ensure that state agencies have met all the requirements that Minnesota law specifies for adopting rules. Those requirements include assurances that the proposed rules are necessary and reasonable and that any modifications that the agency made after the proposed rules were initially published do not result in the rules' being substantially different from what the agency originally proposed. The rulemaking process also includes a hearing when a sufficient number of persons request one. The hearing is intended to allow the agency and the Administrative Law Judge reviewing the proposed rules to hear public comment regarding the impact of the proposed rules and what changes might be appropriate.

The Department's Rules Coordinator and Supervising Attorney in this matter is Susan E. Barry. The members of the Department's hearing panel were Michal Garber and Greg Heck, both of whom are attorneys with the Department. Twenty-one people signed the hearing register.

The Department and the Administrative Law Judge received written comments on the proposed rules prior to the hearing. After the hearing, the Administrative Law Judge kept the administrative record open for an additional twenty calendar days, until July 21, 2008, to allow interested parties to submit

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<sup>1</sup> Minn. Stat. §§ 14.131 through 14.20.

written comments. The record remained open for an additional five business days, until July 28, 2008, to allow interested persons to file a written response to any comments received during the initial comment period.<sup>2</sup> Numerous comments were received from members of the public during the rulemaking process. The Department also submitted two post-hearing comments. The hearing record closed for all purposes on July 28, 2008.<sup>3</sup>

## **NOTICE**

The Department must make this Report available for review by anyone who wishes to review it for at least five working days before it takes any further action to adopt final rules or to modify or withdraw the proposed rules. If the Department makes changes in the rules other than those recommended in this report, it must submit the rules, along with the complete hearing record, to the Chief Administrative Law Judge for a review of those changes before it may adopt the rules in final form.

After adopting the final version of the rules, the Department must submit them to the Revisor of Statutes for a review of their form. If the Revisor of Statutes approves the form of the rules, the Revisor will submit certified copies to the Administrative Law Judge, who will then review them and file them with the Secretary of State. When they are filed with the Secretary of State, the Administrative Law Judge will notify the Department, and the Department will notify those persons who requested to be informed of their filing.

Based on the testimony, exhibits, and written comments, the Administrative Law Judge makes the following:

## **FINDINGS OF FACT**

### **I. Background and Nature of the Proposed Rules**

1. In this rulemaking proceeding, the Department seeks to amend Minnesota Rules, part 8130.5800, governing the application of sales and use tax laws to isolated and occasional sales. In their presentation at the hearing, the Department's panel indicated that the rule amendments are being proposed in order to repeal out-of-date information, bring the rules into conformity with changes made in the governing statute, and clarify statutory terms.<sup>4</sup>

2. Rule part 8130.5800 was originally published by the Department in 1974. Since that time, the statutes governing sales and use tax have undergone a number of changes. For example, definitions have been added to the statute

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<sup>2</sup> See Minn. Stat. § 14.15, subd. 1.

<sup>3</sup> Pursuant to Minn. Stat. § 14.15, subd. 2, and Minn. R. 1400.2240, subp. 1, an extension was granted for the preparation of this Report.

<sup>4</sup> Ex. 16 at 1; Testimony of Michal Garber.

to clarify when the exemption for isolated or occasional sales applies,<sup>5</sup> and the original statutory provision (Minn. Stat. § 297A.25, subd. 12) has been divided into two separate provisions: general exemptions relating to occasional sales by individuals that are not made in the normal course of business (codified in Minn. Stat. § 297A.67, subd. 23); and business exemptions relating to the sale of tangible personal property primarily used in trade or business, where the sale is not made in the normal course of business and certain other conditions are satisfied (codified in Minn. Stat. § 297A.68, subd. 25).<sup>6</sup>

3. The rule amendments proposed by the Department remove obsolete statutory references; add and consolidate definitions of terms used in the law, such as “trade or business” and “normal course of business;” and distinguish between sales by individuals and sales by businesses. The proposed rule also provides examples to clarify the practical application of the rule to garage sales, farm auctions, sales by non-profit organizations, flea markets, sales of repossessed items, and other matters. As discussed more fully below, the most controversial portion of the proposed rule pertains to the sales tax treatment to be afforded to transfers between a single member limited liability company which does not elect to be treated as a corporation for federal income tax purposes and its one member.

## **II. Compliance with Procedural Rulemaking Requirements**

2. On May 23, 2002, the Department filed a copy of the Additional Notice Plan for its Request for Comments with the Office of Administrative Hearings and requested the plan be approved pursuant to Minn. R. 1400.2060, subp. 2. Administrative Law Judge George A. Beck approved the Additional Notice Plan for Request for Comments on June 3, 2002.<sup>7</sup>

3. On June 17, 2002, the Department published a Request for Comments on Possible Amendment to Rules Governing Sales and Use Tax Exemption of Isolated and Occasional Sales in the State Register. The notice indicated that the Department had not yet prepared a draft of the proposed rules.<sup>8</sup>

4. As required by Minn. Stat. § 14.131, the Department asked the Commissioner of Finance to evaluate the fiscal impact and benefit of the proposed rules on local units of government. The Department of Finance provided comments in a memorandum dated September 25, 2007.<sup>9</sup>

5. On September 26, 2007, the Department filed copies of the proposed Dual Notice of Hearing, proposed rules, and draft SONAR with the

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<sup>5</sup> See Minn. Stat. § 297A.61.

<sup>6</sup> Statement of Need and Reasonableness (SONAR) at 1.

<sup>7</sup> Approval Letter, Jun. 3, 2002.

<sup>8</sup> 26 SR 1733, 1733-1734 (Ex. 1).

<sup>9</sup> Ex. 4.

Office of Administrative Hearings. The Dual Notice indicated that the hearing would occur on December 6, 2007, if the Department received 25 or more requests for a hearing. The filings complied with Minn. R. 1400.2080, subp. 5. By letter dated October 3, 2007, Administrative Law Judge Barbara L. Neilson approved the Dual Notice.

6. On October 22, 2007, the Department published a Dual Notice in the State Register.<sup>10</sup>

7. On November 27, 2007, the Department notified the Office of Administrative Hearings that it had cancelled the December 6, 2007, hearing and rescheduled it for June 30, 2008. The Department had received 36 requests for a public hearing. Those requesting a hearing did so in response to proposed language concerning transfers of tangible personal property between a single member limited liability company (SMLLC) and its one member. The Department believed that legislation would be proposed during the 2008 legislative session that, if enacted, would nullify the Department's interpretation concerning transfers involving SMLLCs. Therefore, the Department decided to postpone the hearing until after the 2008 legislative session. In the letter to the Office of Administrative Hearings, the Department stated that it would send notice to all who requested a hearing to let them know of the new hearing date, and would publish a Notice of Hearing in the State Register. The Department enclosed a copy of the Notice of Hearing with the letter and requested its approval.<sup>11</sup>

8. On November 29, 2007, the Department mailed a copy of the Notice of Hearing and Notice of Rescheduled Hearing to everyone who had requested a hearing. The Notice contained the elements required by Minn. R. 1400.2080, subp. 2, and identified the date and location of the hearing.<sup>12</sup>

9. Administrative Law Judge Barbara L. Neilson approved the Notice of Hearing by letter dated November 29, 2007.<sup>13</sup>

10. On January 2, 2008, the Department mailed the Notice of Hearing to all persons on its Rulemaking List and Additional Notice Plan mailing list. It also posted the Notice of Hearing on its website.<sup>14</sup>

11. Thirty-six people requested a hearing on the proposed rule and the hearing was held on 9:30 a.m. on June 30, 2008, in Conference Room 2040 in the Stassen Building, 600 North Robert Street, St. Paul, Minnesota.<sup>15</sup>

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<sup>10</sup> Ex. 7.

<sup>11</sup> Letter to OAH, Nov. 27, 2007; Ex. 12.

<sup>12</sup> Ex. 13.

<sup>13</sup> Approval Letter, Nov. 29, 2007.

<sup>14</sup> Ex. 9F; Ex. 9G.

<sup>15</sup> Ex. 10.

12. At the hearing, the Department filed copies of the following documents as required by Minn. R. 1400.2220:

- A. the Request for Comments as published in the State Register on June 17, 2002 (16 SR 1733);<sup>16</sup>
- B. the proposed rules dated September 4, 2007, including the Revisor's approval;<sup>17</sup>
- C. the SONAR;<sup>18</sup>
- D. the Dual Notice as mailed and published in the State Register on October 22, 2007 (32 SR 753);<sup>19</sup>
- E. the Certificate of Mailing the Notice of Hearing to the Rulemaking Mailing List and to the parties identified in the Additional Notice Plan on January 2, 2008;<sup>20</sup>
- F. the Certificate of Accuracy of the Mailing List as of January 2, 2008;<sup>21</sup>
- G. the Certificate of Accuracy of the electronic Additional Notice Mailing List as of October 12, 2007;<sup>22</sup>
- H. a copy of the transmittal letter showing that the Department mailed a copy of the SONAR to the Legislative Reference Library on October 12, 2007;<sup>23</sup>
- I. a copy of the transmittal letter showing that the Department sent a copy of the Dual Notice, proposed rule, and the SONAR to legislators on October 12, 2007;<sup>24</sup>
- J. a copy of the transmittal letter showing that the Department sent a copy of the Notice of Hearing to legislators on January 2, 2008;<sup>25</sup>
- K. the Notice of Hearing as mailed and published in the State Register on January 7, 2008 (32 SR 1253);<sup>26</sup> and

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<sup>16</sup> Ex. 1.

<sup>17</sup> Ex. 2.

<sup>18</sup> Ex. 3.

<sup>19</sup> Ex. 7.

<sup>20</sup> Ex. 8; Ex. 9D; Ex. 12.

<sup>21</sup> Ex. 8.

<sup>22</sup> Ex. 9D.

<sup>23</sup> Ex. 5.

<sup>24</sup> Ex. 6.

<sup>25</sup> Ex. 14.

L. public comments received by the Department before the hearing, and requests for a hearing;<sup>27</sup>

13. The Administrative Law Judge finds that the Department has met all of the procedural requirements under applicable law and rules.

### **III. Statutory Authority**

14. In its SONAR, the Department asserts that its statutory authority to adopt these rules regarding isolated and occasional sales and sales of personal property used in a trade or business is provided in Minn. Stat. § 270C.06.<sup>28</sup> Section 270C.06 generally authorizes the Commissioner of Revenue to “make, publish, and distribute rules for the administration and enforcement of . . . state revenue laws.” In addition, Minn. Stat. § 270C.03, subd. 1(1), authorizes the Commissioner to “administer and enforce the assessment and collection of state taxes.”

15. The Administrative Law Judge finds that the Department has general statutory authority to adopt the proposed rules.

### **IV. Additional Notice Requirements**

16. Minn. Stat. §§ 14.131 and 14.23 require that an agency include in its SONAR a description of its efforts to provide additional notification to persons or classes of persons who may be affected by the proposed rule or explain why these efforts were not made. During the rulemaking hearing, the Department provided documentation certifying that it had provided notice to those on the rulemaking list maintained by the Department and in accordance with its additional notice plan.<sup>29</sup>

17. The Department took action to inform and involve the following interested and affected parties and associations in this rulemaking: the Tax Section of the Minnesota State Bar Association; the Minnesota Auctioneer Association; the Minnesota Bankers Association; the Minnesota Business Partnership; the Minnesota Council of Nonprofits; the Minnesota Farm Bureau; the Minnesota Retailers Association; and others who specifically requested notice.<sup>30</sup>

18. A copy of the proposed rules, the Notice of Hearing, and the SONAR were available on the Department’s website.

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<sup>26</sup> Ex. 7.

<sup>27</sup> Ex. 11.

<sup>28</sup> SONAR at 1-2.

<sup>29</sup> Ex. 8; Ex. 9D.

<sup>30</sup> SONAR at 4.

19. The Department has disseminated the proposed rules to affected parties. Therefore, the Administrative Law Judge finds that the Department has satisfied the notice requirements.

## **V. Impact on Farming Operations**

20. Minn. Stat. § 14.111 imposes an additional requirement calling for notification to be provided to the Commissioner of Agriculture when rules are proposed that affect farming operations. In addition, where proposed rules affect farming operations, Minn. Stat. § 14.14, subd. 1b, requires that at least one public hearing be conducted in an agricultural area of the state.

21. The proposed rules do not affect farming operations, and the Administrative Law Judge concludes that the Department was not required to notify the Commissioner of Agriculture.

## **VI. Compliance with Other Statutory Requirements**

### **A. Cost and Alternative Assessments**

22. Minn. Stat. § 14.131 requires an agency adopting rules to include in its SONAR:

- (1) a description of the classes of persons who probably will be affected by the proposed rule, including classes that will bear the costs of the proposed rule and classes that will benefit from the proposed rule;
- (2) the probable costs to the agency and to any other agency of the implementation and enforcement of the proposed rule and any anticipated effect on state revenues;
- (3) a determination of whether there are less costly methods or less intrusive methods for achieving the purpose of the proposed rule;
- (4) a description of any alternative methods for achieving the purpose of the proposed rule that were seriously considered by the agency and the reasons why they were rejected in favor of the proposed rule;
- (5) the probable costs of complying with the proposed rule, including the portion of the total costs that will be borne by identifiable categories of affected parties, such as separate classes of governmental units, businesses, or individuals;

- (6) the probable costs or consequences of not adopting the proposed rule, including those costs or consequences borne by identifiable categories of affected parties, such as separate classes of government units, businesses, or individuals; and
- (7) an assessment of any differences between the proposed rule and existing federal regulations and a specific analysis of the need for and reasonableness of each difference.

23. With respect to the first factor, the Department indicated in the SONAR that the proposed rule is likely to affect any person or business who sells property or a service on an occasional basis and not in the normal course of business. The Department stated that the proposed rule will also affect businesses that sell taxable property; businesses that sell farm machinery; people who sell tangible personal property at flea markets, craft shows and similar events, and the operators of those events; and brokers and auctioneers. The Department believes that these classes of persons will benefit from the proposed rule because they will have a clearer interpretation of the law, a better understanding of the types of sales that the Department will consider occasional, and a better understanding of the various terms used in the law. The rule clarifies the distinction between the isolated and occasional sales exemption as it applies to individuals and the exemption for the sale of property that is used in a trade or business, but is not made in the normal course of business. The Department anticipates that no costs will be incurred by the general public, but acknowledged that retailers may incur some costs associated with adjusting their records to distinguish between items that are taxable and items that are not subject to tax.<sup>31</sup>

24. With respect to the second requirement regarding the enforcement cost to the agency and any anticipated effect on state revenues, the Department stated in its SONAR that it does not expect that the new rule will cause the Department or other state agencies to incur additional administrative costs. In the Department's view, the proposed rule will clarify how sales tax applies to the sale of tangible personal property or services in different situations, and will thereby tend to increase the efficiency with which sales tax is administered. In addition, the Department asserts that adoption of the proposed rule will ensure better compliance with current tax law because of the guidance provided to taxpayers by the rule.<sup>32</sup>

25. With respect to the third requirement, the Department must determine if there are less costly or less intrusive methods to achieve the purposes of the proposed rules. The Department stated in the SONAR that it is not aware of any less costly or less intrusive methods that could be used to

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<sup>31</sup> SONAR at 2.

<sup>32</sup> SONAR at 2.

achieve the purpose of the proposed rule. Because the governing statutes include terms that need further interpretation, the Department believes that a rule is the most effective method to reference the statutory provisions that apply to this area, explain various terms, and give examples illustrating when property or services are excluded from tax under the isolated sales exemptions applying to individuals and businesses.<sup>33</sup>

26. With respect to the fourth requirement, the Department must describe any alternative methods it considered and the reasons they were rejected. The Department stated in the SONAR that it decided to promulgate this rule because of the interplay between different provisions of the law, the inability of the statutes to explain the various terms and situations that arise when isolated sales are made, and the ability of the rule to appropriately illustrate how these exemptions apply to different types of businesses and situations. Although the Department noted that it has also published a number of revenue notices and fact sheets that deal with occasional sales, farm machinery, and selling events, it concluded that a rule was needed in this area in order to bind taxpayers.<sup>34</sup>

27. With respect to the fifth requirement, the Department must note the probable cost of complying with the proposed rules. The Department acknowledged in the SONAR that the rule may result in some compliance costs because of the need to change accounting systems to separate taxable sales from non-taxable sales. However, it contended that these costs are a direct result of the statutory changes that have been made in this area since the rule was last modified and are only indirectly related to the amendment of the rule.<sup>35</sup>

28. With respect to the sixth factor, the Department must consider the probable cost or consequence of not adopting the proposed rule. The Department asserted that, if the proposed rule is not adopted, the existing rule relating to isolated and occasional sales will reflect obsolete law because of the numerous statutory changes that have taken place since the rule was originally promulgated in 1974. The Department also contended that, without the proposed rule, individuals and businesses making occasional sales and their buyers would be more likely to be unaware of their responsibilities and the available exemptions under the sales tax law.<sup>36</sup>

29. With respect to the seventh factor, the Department asserted, because there are no applicable federal laws in this area, nothing in the proposed rule conflicts with federal regulations.<sup>37</sup>

## **B. Performance-Based Regulation**

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<sup>33</sup> SONAR at 2-3.

<sup>34</sup> SONAR at 3.

<sup>35</sup> SONAR at 3.

<sup>36</sup> SONAR at 3.

<sup>37</sup> SONAR at 3.

30. Minn. Stat. § 14.131 also requires that an agency include in its SONAR a description of how it “considered and implemented the legislative policy supporting performance-based regulatory systems set forth in section 14.002.” Section 14.002 states, in relevant part, that “whenever feasible, state agencies must develop rules and regulatory programs that emphasize superior achievement in meeting the agency’s regulatory objectives and maximum flexibility for the regulated party and the agency in meeting those goals.”

31. In the SONAR, the Department indicated that the proposed rule supports the Department’s strategic plan. The Department stated that its main objective in this rule is to repeal outdated information. By providing additional clarity and certainty in this area of the law, the Department contended that the proposed rule will improve the degree to which these particular tax laws are easy to understand and easy to administer.<sup>38</sup>

32. The Administrative Law Judge finds that the Department has met the requirements set forth in § 14.131 for assessing the impact of the proposed rules, including consideration and implementation of the legislative policy supporting performance-based regulatory systems.

### **C. Consultation with the Commissioner of Finance**

33. Under Minn. Stat. § 14.131, the agency is also required to “consult with the commissioner of finance to help evaluate the fiscal impact and fiscal benefits of the proposed rule on units of local government.”

34. As required, the Department consulted with the Commissioner of Finance. On September 25, 2007, Alexandra Broat, Executive Budget Officer, stated by letter that the proposed rules would have little, if any, fiscal impact on local units of government.<sup>39</sup>

35. The Administrative Law Judge finds that the Department has met the requirements set forth in Minn. Stat. § 14.131 for consulting with the Commissioner of Finance.

### **D. Cost to Small Businesses and Cities under Minn. Stat. § 14.127**

36. Under Minn. Stat. § 14.127, the Department must “determine if the cost of complying with a proposed rule in the first year after the rule takes effect will exceed \$25,000 for: (1) any one business that has less than 50 full-time employees; or (2) any one statutory or home rule charter city that has less than ten full-time employees.” The Department must make this determination before the close of the hearing record, and the Administrative Law Judge must review the determination and approve or disapprove it.

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<sup>38</sup> SONAR at 3.

<sup>39</sup> Ex. 4.

37. In the SONAR, the Department stated that the proposed rules are not anticipated to increase costs by more than \$25,000 for any small business or small city.<sup>40</sup>

38. The Administrative Law Judge finds that the Department has made the determination required by Minn. Stat. § 14.127, subd. 1, and approves the determination that the cost of compliance with the rule will not exceed the threshold established by that statute.

## VII. Rulemaking Legal Standards

39. Under Minnesota law one of the determinations that must be made in a rulemaking proceeding is whether the agency has established the need for and reasonableness of the proposed rules by an affirmative presentation of facts.<sup>41</sup> In support of a rule, an agency may rely on legislative facts, namely general facts concerning questions of law, policy and discretion, or it may simply rely on interpretation of a statute, or stated policy preferences.<sup>42</sup> The Department prepared a SONAR in support of its proposed rules. At the hearing, the Department primarily relied upon the SONAR as its affirmative presentation of need and reasonableness for the proposed rules. The SONAR was supplemented by comments made by Department staff at the public hearing, and by the Department's written post-hearing comments and reply.

40. The question of whether a rule has been shown to be reasonable focuses on whether it has been shown to have a rational basis, or whether it is arbitrary, based upon the rulemaking record. Minnesota case law has equated an unreasonable rule with an arbitrary rule.<sup>43</sup> Arbitrary or unreasonable agency action is action without consideration and in disregard of the facts and circumstances of the case.<sup>44</sup> A rule is generally found to be reasonable if it is rationally related to the end sought to be achieved by the governing statute.<sup>45</sup> The Minnesota Supreme Court has further defined an agency's burden in adopting rules by requiring it to "explain on what evidence it is relying and how the evidence connects rationally with the agency's choice of action to be taken."<sup>46</sup>

41. Reasonable minds might be divided about the wisdom of a certain course of action. An agency is legally entitled to make choices between possible approaches so long as its choice is rational. It is not the role of the Administrative Law Judge to determine which policy alternative presents the

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<sup>40</sup> SONAR at 2.

<sup>41</sup> Minn. Stat. § 14.14, subd. 2; Minn. R. 1400.2100.

<sup>42</sup> *Mammenga v. Dept. of Human Services*, 442 N.W.2d 786 (Minn. 1989); *Manufactured Hous. Inst. v. Petterson*, 347 N.W.2d 238, 244 (Minn. 1984).

<sup>43</sup> *In re Hanson*, 275 N.W.2d 790 (Minn. 1978); *Hurley v. Chaffee*, 231 Minn. 362, 43 N.W.2d 281, 284 (1950).

<sup>44</sup> *Greenhill v. Bailey*, 519 F.2d 5, 19 (8<sup>th</sup> Cir. 1975).

<sup>45</sup> *Mammenga*, 442 N.W.2d at 789-90; *Broen Mem'l Home v. Minnesota Dept. of Human Services*, 364 N.W.2d 436, 444 (Minn. Ct. App. 1985).

<sup>46</sup> *Manufactured Hous. Inst. v. Petterson*, 347 N.W.2d at 244.

“best” approach, since this would invade the policy-making discretion of the agency. The question is, rather, whether the choice made by the agency is one that a rational person could have made.<sup>47</sup>

42. In addition to need and reasonableness, the Administrative Law Judge must also assess whether the Department complied with the rule adoption procedure, whether the rule grants undue discretion, whether the Department has statutory authority to adopt the rule, whether the rule is unconstitutional or illegal, whether the rule constitutes an undue delegation of authority to another entity, or whether the proposed language is not a rule.<sup>48</sup>

43. Because the Department suggested changes to the proposed rules after original publication of the rule language in the State Register, it is also necessary for the Administrative Law Judge to determine if the new language is substantially different from that which was originally proposed. The standards to determine whether changes to proposed rules create a substantially different rule are found in Minn. Stat. § 14.05, subd. 2. The statute specifies that a modification does not make a proposed rule substantially different if the differences are within the scope of the matter announced in the notice of hearing and are in character with the issues raised in that notice; the differences are a logical outgrowth of the contents of the notice of hearing, and the comments submitted in response to the notice; and the notice of hearing provided fair warning that the outcome of that rulemaking proceeding could be the rule in question.<sup>49</sup>

44. In reaching a determination regarding whether modifications result in a rule that is substantially different, the Administrative Law Judge is to consider whether persons who will be affected by the rule should have understood that the rulemaking proceeding could affect their interests; whether the subject matter of the rule or issues determined by the rule are different from the subject matter or issues contained in the notice of hearing; and whether the effects of the rule differ from the effects of the proposed rule contained in the notice of hearing.<sup>50</sup>

### **VIII. Analysis of the Proposed Rules**

45. This Report is limited to discussion of the portions of the proposed rules that received critical comment or otherwise need to be examined, and will not discuss each comment or rule part. Persons or groups who do not find their particular comments referenced in this Report should know that each and every suggestion, including those made prior to the hearing, has been carefully read and considered. Moreover, because sections of the proposed rules were not opposed and were adequately supported by the SONAR, a detailed discussion of each section of the proposed rules is unnecessary.

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<sup>47</sup> *Federal Sec. Adm'r v. Quaker Oats Co.*, 318 U.S. 218, 233 (1943).

<sup>48</sup> Minn. R. 1400.2100.

<sup>49</sup> Minn. Stat. § 14.05, subd. 2(b).

<sup>50</sup> Minn. Stat. § 14.05, subd. 2(c).

46. The Administrative Law Judge finds that the Department has demonstrated, by an affirmative presentation of facts, the need for and reasonableness of all rule provisions not specifically discussed in this Report. The Administrative Law Judge also finds that all provisions not specifically discussed are authorized by statute and there are no other problems that would prevent the adoption of the rules.

47. For the most part, the provisions of the proposed rule received general support from those who commented, testified and requested hearings. For example, Heather Broneak of the University of Minnesota Tax Department stated in her written comment that she was “very impressed by the thoroughness and detail of the proposed rule and related SONAR,” and believed it would provide necessary guidance to taxpayers.<sup>51</sup> In addition, many of those who opposed subpart 3a(B) of the proposed rule voiced support for all other provisions of the rule.<sup>52</sup>

48. However, subpart 3a, item B of the proposed rule, relating to transfers involving SMLLCs, generated much controversy. With one minor exception (see discussion regarding the modification to subpart 10 below), it was the only portion of the proposed rule that received opposition. For that reason, this Report will focus on subpart 3a, item B of the proposed rule.

#### **IX. Subpart 3a, Item B – Sale of property used in a trade or business in transactions qualified and reported under the Internal Revenue Code**

74. Subpart 3a of the proposed rule would add the following new language to current rule part 8130.5800:

**Subp. 3a. Sale of property used in a trade or business in transactions qualified and reported under the Internal Revenue Code.**

A. The sale of tangible personal property primarily used in a trade or business is exempt if the sale is not made in the normal course of business of selling such property; the sale occurs in a transaction subject to, or described in, section 118, 331, 332, 336, 337, 338, 351, 355, 368, 721, 731, 1031, or 1033 of the Internal Revenue Code, and the following conditions are met:

- (1) the sale must qualify, as well as be reported, as a transaction occurring under one of the Internal Revenue Code sections listed in this item; and
- (2) the transfer must be between partnerships and their partners or between corporations and their shareholders or,

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<sup>51</sup> Comment, October 16, 2007.

<sup>52</sup> See, e.g., Test. of Dale Busacker and Public Ex. 1; Test. of Jerome Geis; Test. of B. Anderson.

if the sale is under section 1563(a) of the Internal Revenue Code, between members of a controlled group.

B. Limited Liability companies are generally treated as either corporations or partnerships for federal income tax purposes and transfers between limited liability companies and their members are covered by one of the Internal Revenue Code sections listed in Item A. Single member limited liability companies that elect to be treated as a corporation are also covered by one or more of the Internal Revenue Code sections listed in item A. However, when a single member limited liability company does not elect to be treated as a corporation for federal income tax purposes, the limited liability company is neither a partnership nor a corporation and transfers between the limited liability company and its one member are not exempt from sales tax under this subpart.

75. The Internal Revenue Code sections listed in the proposed rule are drawn directly from Minn. Stat. § 297A.68, subd. 25(a).<sup>53</sup> The enumerated sections of the Internal Revenue Code all pertain to transfers between partnerships and their partners, between corporations and their shareholders, or between members of a controlled group. It is undisputed in this proceeding that none of the specified Code sections address transfers between a single member and a SMLLC where the SMLLC does not elect to be treated as a corporation. In fact, the statute was enacted prior to the time that LLCs and SMLLCs were recognized in Minnesota.

76. Under the language of the proposed rule, a SMLLC can elect to be treated as a corporation, and if covered by one of the enumerated sections, the SMLLC will be exempt from the tax. But if a SMLLC does not elect to be treated as a corporation for federal income tax purposes, the proposed rule specifies that transfers between the LLC and its single member are not exempt from sales tax. Thus, the exemption in Item A of the proposed rule is not available to SMLLCs unless they elect to be treated as a corporation. The Department asserts that the proposed rule is reasonable because SMLLCs that do not elect to be treated as a corporation are not specifically subject to or described in any of the enumerated Internal Revenue Code sections and thus are not exempt under Minn. Stat. § 297A.68, subd. 25.<sup>54</sup>

77. The Department asserts that previously-issued Revenue Notices support its view that transfers of tangible personal property and taxable services for consideration between a person and an LLC or SMLLC are subject

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<sup>53</sup> As discussed more fully below, that statute specifies in pertinent part that “[t]he sale of tangible personal property primarily used in a trade or business is exempt if the sale is not made in the normal course of business of selling that kind of property” and if “the sale occurs in a transaction subject to or described in section 118, 331, 332, 336, 337, 338, 351, 355, 368, 721, 1031, or 1033 of the Internal Revenue Code.”

<sup>54</sup> SONAR at 9; Ex. 16 at 2.

to sales and use tax law. In Revenue Notice # 91-06, the Department stated that a sale “must qualify and be reported as a transaction occurring under one of the listed Internal Revenue Code sections, in order to qualify for the isolated/occasional sale exemption.” In addition, in Revenue Notice # 02-10, the Department explained how a SMLLC is treated for sales tax purposes. Notice # 02-10 states: “For purposes of the sales tax, Minnesota will treat a LLC or SMLLC as a separate legal entity . . . . Transfers of tangible personal property and taxable services for consideration between a person, as defined in [Minn. Stat. § 297A.61, subd. 2] and an LLC or SMLLC are subject to the Minnesota sales and use tax law, unless exempted by statute.”<sup>55</sup>

78. Several objections were raised to the language of item B by those participating in this rulemaking process. Each of these arguments, the Department’s response, and the conclusion of the Administrative Law Judge will be discussed below.

### **Legislative Intent**

79. Dale Busacker, Tax Director for Grant Thornton, and Jerome Geis, an attorney with Briggs & Morgan, testified and submitted written comments on their own behalf in opposition to the last sentence of subpart 3a, item B of the proposed rule. In 1991, both were members of a committee of the Minnesota State Bar Association that participated in the drafting of the exemption that is now codified in Minn. Stat. § 297A.68, subd. 25. They asserted that the statute was intended to exempt the transfer of assets from sales tax when there was a change in the legal ownership of the assets without a change in the beneficial ownership.<sup>56</sup>

80. In his written and oral testimony, Mr. Busacker argued that the “offending sentence of the proposed rule does not conform with the intent and policy that was expressed by the Legislature” when the statute was enacted in 1991. He expressed concern that it would be difficult to explain this rule provision to small business owners and urged that the proposed rule be changed to exempt from sales tax the transfer of assets between an owner and that person’s LLC.<sup>57</sup>

81. Mr. Geis similarly contended that the language of Minn. Stat. § 297A.68, subd. 25, should not be read in isolation, and urged that the examination of the language should include the “scope, context, and purpose” of the statute. He asserted that the Legislature did not intend the listing of specific provisions in the statute to be exclusive, and would not have any logical reason to only tax transfers to and from single member owned LLCs. He argued that the position taken by the Department in the proposed rule would lead to an absurd and unjust result, and urged the Administrative Law Judge to apply the

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<sup>55</sup> Ex. 16 at 2-3.

<sup>56</sup> Public Ex. 1 at 1-2; Public Ex. 2 at 1-2; Letter from J. Geis at 2 (July 17, 2008).

<sup>57</sup> Test. of D. Busacker; Public Ex. 1 at 2.

presumption that the Legislature “does not intend a result that is absurd, impossible of execution, or unreasonable.” Mr. Geis suggested that the rule be amended to specify that transfers to and from an LLC that is owned by a single member of a disregarded entity shall be nontaxable and exempt. In the alternative, Mr. Geis recommended that the rule be applied only in a prospective fashion to allow adequate notice to taxpayers, based upon his view that the proposed rule represents a substantive change in the Department’s interpretation and enforcement of the statute.<sup>58</sup>

82. Bruce Anderson, President of the Minnesota Retailers Association, testified that many of the small business owners in his organization would be unaware of the sales tax implications of transfers to a single member’s LLC under the proposed rule, and stated that the Department’s position was an unfair trap for the unwary.<sup>59</sup> Mike Hickey of the National Federation of Independent Businesses, shared Mr. Anderson’s concern about the double payment of sales tax that many unsophisticated sole proprietors would experience under the proposed rule.<sup>60</sup>

83. The governing statute, Minn. Stat. § 297A.68, is entitled “Business Exemptions.” Subdivision 25 of that statute states:

Subd. 25. Sale of property used in a trade or business.

(a) The sale of tangible personal property primarily used in a trade or business is exempt if the sale is not made in the normal course of business of selling that kind of property and if one of the following conditions is satisfied:

- (1) the sale occurs in a transaction subject to or described in section 118, 331, 332, 336, 337, 338, 351, 355, 368, 721, 731, 1031, or 1033 of the Internal Revenue Code;
- (2) the sale is between members of a controlled group as defined in section 1563(a) of the Internal Revenue Code;
- (3) the sale is a sale of farm machinery;
- (4) the sale is a farm auction sale;
- (5) the sale is a sale of substantially all of the assets of a trade or business; or
- (6) the total amount of gross receipts from the sale of trade or business property made during the calendar month

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<sup>58</sup> Public Ex. 2 at 4; Letter from J. Geis (July 17, 2008); Minn. Stat. § 645.17(1).

<sup>59</sup> Test. of B. Anderson.

<sup>60</sup> Test. of M. Hickey.

of the sale and the preceding 11 calendar months does not exceed \$1,000. The use, storage, distribution, or consumption of tangible personal property acquired as a result of a sale exempt under this subdivision is also exempt.

(b) For purposes of this subdivision, the following terms have the meanings given.

(1) A "farm auction" is a public auction conducted by a licensed auctioneer if substantially all of the property sold consists of property used in the trade or business of farming and property not used primarily in a trade or business.

(2) "Trade or business" includes the assets of a separate division, branch, or identifiable segment of a trade or business if, before the sale, the income and expenses attributable to the separate division, branch, or identifiable segment could be separately ascertained from the books of account or record (the lease or rental of an identifiable segment does not qualify for the exemption).

(3) A "sale of substantially all of the assets of a trade or business" must occur as a single transaction or a series of related transactions within the 12-month period beginning on the date of the first sale of assets intended to qualify for the exemption provided in paragraph (a), clause (5).

84. In its written responses to the comments filed during the rulemaking proceeding, the Department contended that legislative intent should not be considered because Minn. Stat. § 297A.68 is not ambiguous. It argued that, because the plain language of the statute is clear, there should be no resort to the examination of legislative history. The Department emphasized that exemptions from taxation are construed narrowly. The Department also pointed out that the Legislature has explicitly exempted transfers involving SMLLCs in other circumstances.<sup>61</sup>

85. The Department also asserted that, even if the statute was deemed to be ambiguous, it would be impossible to ascertain the intent behind Minn. Stat. § 297A.68. The Department emphasized that, when the exemption referring to the various Internal Revenue Code sections was passed in 1991, the concept of a SMLLC did not exist. It pointed out that the Legislature could have amended section 297A.68, subd. 25, to clearly exempt the transfers at issue after the concept of a disregarded LLC came into federal law in 1996, but it did not do

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<sup>61</sup> Dept. Response (July 21, 2008) at 2-3; Dept. Rebuttal at 4; Laws of Minnesota 2001, First Special Session, Chapter 5, Article 12, Sections 59, 60 and 65 (amending Minn. Stat. §§ 297A.70, subds. 4 and 7, and 297A.71, subd. 6, to specifically provide that certain statutory exemptions applied to transactions of a SMLLC).

so. According to the Department, legislative staff has been aware of the proposed rule since a draft of the rule was published in the State Register on October 22, 2007, and staff from both the House of Representatives and the Senate participated at a meeting with tax practitioners on November 28, 2007, to discuss this controversy. In addition, the Department sent key members of the Legislature a copy of the proposed rule and SONAR on October 12, 2007, and notice of the rescheduled hearing on January 2, 2008. The letter and notice sent in January 2008 explained that those requesting a hearing were concerned about the proposed language concerning transfers of tangible personal property between a SMLLC and its single member, and stated that the Department had decided to postpone the rule hearing until after the 2008 legislative session based on its understanding that the Legislature intended to take up proposed legislation in 2008 which, if enacted, would make the Department's interpretation concerning SMLLC transfers obsolete. Ultimately, no legislative change was proposed in the 2008 session.<sup>62</sup>

86. The Department indicated that its Tax Research Division conducted a revenue analysis of a law change that would exempt the transfers between an SMLCC and its single member in anticipation of legislation, and concluded that .an exemption would cost approximately \$1.2 million per year.<sup>63</sup>

87. State Representative Ann Lenczewski submitted a written comment stating that she was made aware of the proposed rule before the 2008 legislative session, and that proposed legislation was drafted to exempt transfers of property to SMLLCs from sales taxation. She noted that the Department's Research Division estimated the annual cost of the legislation would be between \$1.5 million (in fiscal year 2009) and \$2 million (in fiscal year 2011). Rep. Lenczewski expressed doubt that this estimate was accurate and suggested that there is little evidence that the state has been collecting much tax on these transactions. However, she noted that the Legislature relies on such estimates as part of the legislative budgeting process, and that the significant estimated costs associated with the proposed SMLLC legislation would have limited the Legislature's ability to pursue other important tax changes. Rep. Lenczewski noted that she ultimately chose not to introduce the legislation exempting transfers involving SMLLCs and did not include the provision in the initial draft of the House's 2008 omnibus tax bill. She stated that her decision not to pursue this legislation was based upon many considerations and should not be construed as reflecting a view that the Department's proposed rule is a correct interpretation of the existing sales tax law or appropriate tax policy. In fact, she stated that, "as a matter of good sales tax policy, the tax should not be imposed on transactions that involve a mere change in business form, such as a sole proprietor forming a SMLLC and contributing business assets to it."<sup>64</sup>

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<sup>62</sup> Ex. 16 at 2; Dept. Response at 4; Letter from Representative Ann Lenczewski (July 28, 2008).

<sup>63</sup> Dept. Response at 4.

<sup>64</sup> Letter from Representative Ann Lenczewski (July 28, 2008).

88. Senator Ann H. Rest also submitted a comment during the rulemaking process. She was a member of the Taxes Committee of the House of Representatives and chair of its State Taxes & Tax Laws Subcommittee during the 1991-92 legislative session when Minn. Stat. § 297A.68, subd. 25(a)(1) was adopted. She also served as a member of the House-Senate tax conference committee that adopted the final legislation containing this provision. Sen. Rest asserted that it was the Legislature’s intention in passing § 297A.68, subd. 25(a)(1), to exempt from sales tax “each and every type of transaction that qualified as tax free under the federal income tax laws,” and references were included to each of the relevant provisions of the Internal Revenue Code to make that clear. She asserted, however, that the “broader, underlying principle and goal” of the legislation “was to ensure that mere changes in the business form in which assets were held would not be subject to sales tax.” She noted that, at the time of the enactment, Minnesota had not authorized the formation of LLCs and federal law did not permit “disregarded” single member LLCs. In her opinion, had the law provided for the formation of LLCs or SMLLCs in 1991, the legislation would have explicitly exempted the transfers at issue from sales tax.<sup>65</sup>

89. Under well-established principles of statutory construction, a court is not free to consider the legislative intent if the words of the statute are clear. The canons of construction set forth in Minnesota Statutes specify that, “[w]hen the words of a law . . . are clear and free from all ambiguity, the letter of the law shall not be disregarded under the pretext of pursuing the spirit.”<sup>66</sup> As the Minnesota Supreme Court has recognized, it is not appropriate for courts engaged in the interpretation of statutes to “supply that which the legislature purposefully omits or inadvertently overlooks.”<sup>67</sup>

90. The Administrative Law Judge concludes that, because Minn. Stat. § 297A.68, subd. 25(a)(1), is not ambiguous, the legislative intent of the statute should not be considered. The plain language of the statute enumerates several types of transfers that will be deemed exempt, but does not exempt the transfers between a single member and the SMLLC. The Legislature chose to pass a statute that indicated that only sales occurring in transactions subject to particular sections of the Internal Revenue Code would qualify for exemption. There is no indication in the language of the statute that the list of exemptions was not exhaustive, and there is no statement that similar transfers involving no change in beneficial ownership were also to be deemed exempt. It is a well settled rule of statutory construction that “[e]xceptions expressed in a law shall be construed to exclude all others.”<sup>68</sup> The Minnesota courts also have made it

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<sup>65</sup> Letter from Senator Ann Rest (July 28, 2008).

<sup>66</sup> Minn. Stat. § 645.16.

<sup>67</sup> *Green Giant Co. v. Commissioner of Revenue*, 534 N.W.2d 710, 712 (Minn. 1995).

<sup>68</sup> Minn. Stat. § 645.19; see also *Kelsey v. State Farm Mutual Automobile Ins. Co.*, 365 N.W. 795 (Minn. App. 1985) (recognizing a “presumption of exclusion when the legislature expressly lists elements in a statute”);

clear that exemptions from tax are construed narrowly.<sup>69</sup> The Department is bound by the letter of the statute, and would not have statutory authority to adopt a rule exempting such transfers. Accordingly, the Administrative Law Judge finds that proposed rule subpart 3a is consistent with the plain language of Minn. Stat. § 297A.68, subd. 25.

91. Even if the Administrative Law Judge were to conclude that the statute was ambiguous, statements regarding the intent of individual members of the Legislature and others who participated in the bill drafting process would not constitute persuasive evidence of the intent of the Legislature as a whole in passing Minn. Stat. § 297A.68, subd. 25(a)(1). Although the motivation for passing legislation might be discernible from discussions that occurred during legislative hearings or debates, comments by individual legislators about legislative intent that are made after the enactment of a statute generally are deemed inadmissible when construing a statute.<sup>70</sup> Likewise, the fact that the Legislature failed to enact new legislation during the 2008 legislative session to exempt transfers of property to SMLLCs despite knowledge of the proposed rule is irrelevant and does not constitute evidence of legislative approval of the proposed rule.<sup>71</sup> Thus, inaction by the 2008 Legislature has no bearing on the construction of the statute.<sup>72</sup>

### **Positions of Other States**

92. Gina DeConcini, an attorney with Oppenheimer, Wolff & Donnelly and Vice Chair of the Tax Section of the Minnesota Bar Association, conducted research regarding the statutes in other states and asserted that virtually all states exempt transfers between LLCs and their single members from sales tax. Her research revealed that Minnesota is the only state whose statute refers to specific sections of the Internal Revenue Code; most other states have a broad exemption for occasional sales and/or intercompany transfers. Although two states (Mississippi and North Carolina) tax all intercompany transfers including those involving SMLLCs, Ms. DeConcini testified that only Minnesota would tax transfers to SMLLCs and not tax similar transactions.<sup>73</sup> Several other

<sup>69</sup> *Sprint Spectrum LP v. Commissioner of Revenue*, 676 N.W.2d 656, 666 (Minn. 2004) (because “taxation is the general rule and exemption is an exception in derogation of equal rights,” “there is a presumption that all property is taxable. In consequence, the burden of proof is on the one seeking the exemption to establish that he is entitled to the exemption”).

<sup>70</sup> *Minn. Educ. Ass'n v. Minn. State Bd. of Educ.*, 499 N.W.2d 846, 847 n. 1 (Minn.App.1993); *Cannon River Mfrs. Ass'n v. Rogers*, 51 Minn. 388, 396, 53 N.W. 759, 761 (1892). See also *Starkweather v. Blair*, 245 Minn. 371, 379-80, 71 N.W.2d 869, 875-76 (1955) (“the motives of the legislative body in enacting any particular legislation are not the proper subject of judicial inquiry”); *In re State Farm Mutual Automobile Insurance Co.*, 392 N.W.2d 558, 569 (Minn.App.1986) (“[Post-session] testimony by individual legislators regarding the legislative intent is inadmissible in construing a statute”).

<sup>71</sup> See *A & H Vending Co. v. Comm'r of Revenue*, 608 N.W.2d 544, 550 (Minn. 2000).

<sup>72</sup> *Isles Wellness, Inc. v. Progressive Northern Ins. Co.*, 703 N.W.2d 513, 521 n. 11 (Minn. 2005); *Community Hospital Linen Services, Inc. v. Commissioner of Taxation*, 245 N.W.2d 190, 196 (Minn. 1976) (“no significance whatsoever should be attributed to legislative inaction”).

<sup>73</sup> Test. of G. DeConcini; Ex. 3

individuals commenting on the proposed rule urged the Department to take an approach consistent with that of other states, and exempt transfers involving SMLLCs from sales tax.<sup>74</sup>

93. The Department acknowledged in its post-hearing response that the approaches taken by other states may be reasonable in light of the language of their particular state statutes. However, because the Minnesota statute is unique among states, the Department believes that it is bound by the more restrictive list of exemptions set forth in Minn. Stat. § 297A.68, subd. 25. The Department asserts that any challenge to the wisdom of the policy behind the statute should be addressed to the Legislature.<sup>75</sup>

94. The Administrative Law Judge concludes that the fact that other states exempt transfers between an SMLCC and its single member from sales taxation does not preclude the Department from taxing the transfers under applicable Minnesota law. The Department is bound by the particular provisions of Minn. Stat. § 268A.68, and it is not free to exempt the transfers without new or amended legislation. Because the Minnesota statute governing sales tax exemptions of isolated and occasional sales is unlike that of any other state, the proposed rule is not rendered unreasonable by virtue of its failure to follow the approach used in most other states.

### **Consideration**

95. Walter Pickhardt, an attorney with Faegre & Benson, submitted written comments on his own behalf in opposition to the last sentence of subpart 31, item B.<sup>76</sup> In Mr. Pickhardt's view, that sentence reflects an incorrect interpretation of the law. Mr. Pickhardt agreed that a transfer between an SMLLC and its member is not described in any of the Code sections listed in Minn. Stat. § 297A.68, subd. 25(a)(1), but asserted that the language of the proposed rule is inconsistent with other provisions of Minnesota sales tax law. Mr. Pickhardt argued that transfers between a member and a SMLLC will not be subject to sales tax in many cases because such transfers are for no consideration. He pointed out that sales tax is imposed "on the gross receipts from retail sales," which is defined to mean "any sale, lease, or rental for any purpose, other than resale,"<sup>77</sup> and a use tax is imposed "for the privilege of using, storing, distributing, or consuming in Minnesota tangible personal property or taxable services *purchased* for use, storage, distribution, or consumption in this state . . . ."<sup>78</sup> Based on this statutory language, Mr. Pickhardt asserted that sales tax is imposed only where there is a sale, and use tax is imposed only when there is a purchase. Under Minn. Stat. § 297A.61, subd. 3, the terms "sale" and "purchase" are defined to include any transfer of title or possession, or both, of

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<sup>74</sup> See, e.g., Test. of J. Geis.

<sup>75</sup> Dept. Response at 5.

<sup>76</sup> Testimony of W. Pickhardt and Public Ex. 4.

<sup>77</sup> Minn. Stat. §§ 297A.62, subd. 1, and 297A.611, subd. 4.

<sup>78</sup> Minn. Stat. § 297A.63, subd. 1(a) (emphasis added).

tangible personal property . . . *for a consideration* in money or by exchange or barter . . . .”<sup>79</sup> As a result of these statutory provisions, Mr. Pickhardt concluded that a transfer for no consideration would not constitute a sale or a purchase. He contended that, when a SMLLC distributes an asset to its member and receives nothing in exchange, the transfer lacks consideration and, when a member contributes an asset to a SMLLC and receives nothing in exchange, there frequently is no consideration. In the latter situation, if the SMLLC paid the owner or swapped property with the owner, or if the property were subject to a liability when transferred, Mr. Pickhardt acknowledged that consideration would exist and a tax would be due on the consideration received.<sup>80</sup> Even though the value of a membership interest may increase after property is contributed to the SMLLC, in Mr. Pickhardt’s view “the owner has exactly the same thing before and after the transfer: a 100 percent membership interest.” In addition, he argued that consideration is lacking where items are distributed from a SMLLC to its single member.<sup>81</sup>

96. As a result of his concerns, Mr. Pickhardt suggested that the last sentence of the proposed rule be deleted and replaced with the following language:

A transfer between a single member limited liability company that is disregarded for federal income tax purposes and its member is not covered by one of the Internal Revenue Code sections listed in item A, but such a transfer is not considered to be a “sale” or a “purchase” under Minn. Stat. § 297A.61, subd. 3, if it is for no consideration. For these purposes, a membership interest in a single member limited liability company is not considered to be consideration.<sup>82</sup>

Mr. Pickhardt asserted that the suggested revision would occupy a middle ground between the position that every transfer to or from a SMLLC is exempt and what he believes is the misleading implication in the proposed rule that every transfer to or from a SMLLC is taxable. In the alternative, he suggested that there be no language at all in the proposed rule addressing SMLLCs.<sup>83</sup>

97. In their post-hearing comments on the proposed rule, Dale Busacker, Gina DeConcini, Jerome Geis, and John James agreed with the request by Mr. Geis that the proposed rule exempt all transactions between a member and the member’s LLC, and also supported Mr. Pickhardt’s suggested revision to the language of the proposed rule set forth above. While they noted that they continued to believe the intent of the governing statute is to exempt all transfers between a single member and his or her LLC, they agreed that the

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<sup>79</sup> Emphasis added.

<sup>80</sup> Public Ex. 4 at 4; Letter from W. Pickhardt at 3 (July 24, 2008).

<sup>81</sup> Letter from W. Pickhardt at 2, 3 (July 24, 2008).

<sup>82</sup> Public Ex. 4 at 6.

<sup>83</sup> Letter from W. Pickhardt at 5 (July 24, 2008).

language proposed by Mr. Pickhardt conformed to the literal language of the statute.<sup>84</sup>

98. The Department responded that the issue of consideration is irrelevant to the discussion of the proposed rule because the rule does not address that issue. The Department noted that Subpart 3a is merely intended to explain that the transfers at issue are not exempt under the exemption provided in Minn. Stat. § 297A.68, subd. 25. The Department acknowledged that:

Under the general laws of sales tax, a transfer for no consideration is not a sale or a purchase (Minnesota Statutes, section 297A.61, subdivision 3(b)) and thus no tax is due. This is true for all exemptions. An exemption applies when sales tax would be imposed but for the exemption. No exemption is necessary if there is no sale or purchase.<sup>85</sup>

In its rebuttal, the Department reiterated:

To the extent there is consideration, the transaction will be subject to tax: the sentence in the rule is needed to clarify to taxpayers that the exemption does not apply to the SMLLC transfers at issue because they are not specifically covered by the exemption language of the statute. Obviously, if there were no consideration, then the transaction would not be subject to tax, and a taxpayer would not need to determine if an exemption applies or not.<sup>86</sup>

99. The Department further noted that it disagreed with the interpretation of Mr. Pickhardt, Mr. Busacker, and others that a membership interest in a SMLLC is not for consideration, and declined to make the change in language they proposed. In the Department's view, there is consideration and thus a taxable sale when a transfer between a single member and a SMLLC is made. According to the Department, "[e]xamples of consideration when such transfers are made include a membership interest such as the right to receive distributions of the SMLLC's assets, a transfer of liability, and an assumption of debt by the transferee."<sup>87</sup> The Department contends that, even though the single member owns 100 percent of the membership interest, that interest has gone up in value after the transfer and the additional value constitutes consideration.<sup>88</sup>

100. The Department argued in its post-hearing submissions that Minn. Statutes Chapter 322B, which governs the creation and operation of LLCs and SMLLCs, provides additional support for its view that transferring assets in

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<sup>84</sup> Letter from D. Busacker (July 17, 2008) and attachments.

<sup>85</sup> Dept. Response at 7.

<sup>86</sup> Dept. Rebuttal at 5.

<sup>87</sup> Dept. Response at 7.

<sup>88</sup> Dept. Response at 8; Dept. Rebuttal at 5; Minn. Stat. § 322B (defining membership interest in a LLC).

exchange for a membership interest or increased value to a membership interest constitutes consideration. The Department pointed out that Minn. Stat. § 322B.03, subd. 31, defines “membership interest” as “a member’s interest in a limited liability company consisting of a member’s financial rights, a member’s right to assign financial rights . . . , a member’s governance rights, and a member’s right to assign governance rights . . . .” Moreover, Minn. Stat. § 322B.30, subd. 1, specifies that a membership interest is “personal property.” Thus, the Department argued, the single member acquires valuable rights as a result of the transfer and the ability to assign those rights to a third party and, under Sections 322B.30, subd. 1, the transaction involves an actual transfer of property in exchange for consideration. The Department further asserted that the fact that the Internal Revenue Code elects to treat LLCs and SMLLCs differently for income tax purposes is irrelevant to whether consideration exists for transfers between such entities and their member(s). The Department also cited case law supporting its position.<sup>89</sup>

101. The Administrative Law Judge concludes that the debate between the Department and interested parties regarding whether consideration exists in various types of transfers is largely irrelevant in evaluating the proposed rule. The proposed rule merely makes it clear that transfers between a single member and a SMLLC that has not elected to be treated as a corporation for federal income tax purposes are not exempt from sales tax under Minn. Stat. § 297A.68, subd. 25(a)(1); the rule does not purport to pertain to consideration, and no conclusions regarding whether consideration exists in the transfers can be drawn from the proposed rule. It is unnecessary for the Administrative Law Judge to determine whether consideration exists in every transfer between a SMLLC and its single member. The last sentence of item B as proposed makes it clear that it is only addressing the availability of an exemption “under this subpart,” and the Department has clarified that, if there is no consideration, the transfer will not be subject to sales tax in any case. The Department also has provided legal support for its position. The language of the proposed rule is not confusing or misleading, nor is it rendered unreasonable by virtue of its failure to incorporate the language suggested by the commentators.

102. Mr. Pickhardt also noted that it is likely that a majority of SMLLC transfers will qualify under the “substantially-all” rule and suggested that the proposed rule should explicitly state that a transfer between a member and a SMLLC of substantially all of the assets of a trade or business is exempt from sales tax under that rule.<sup>90</sup> The Department responded that such a clarification is not necessary and may result in confusion. It pointed out that subpart 3b of the proposed rule exclusively deals with situations involving the sale of

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<sup>89</sup> Dept. Rebuttal at 5-6, citing *In the Matter of Robert Weichbrodt*, New York Division of Tax Appeals, ALJ Unit, January 31, 2002 (holding that the transfer of assets from a sole proprietorship to a corporation in exchange for stock, where both entities are wholly owned by the same individual, constitutes a sale subject to sales tax).

<sup>90</sup> Testimony of W. Pickhardt and Public Ex. 4. The “substantially all” requirement is set forth in Minn. Stat. § 297A.68, subd. 25(a)(5)

substantially all of the assets of a trade or business.<sup>91</sup> Under the circumstances, it is not unreasonable for there to be no reference to the “substantially-all” rule in subpart 3a of the proposed rule.

### **Consistency of Department’s Position**

103. Some individuals commenting in opposition to the proposed rule argued that the Department’s position that transfers involving SMLLCs are subject to sale tax is new and inconsistent with the Department’s audit practice.<sup>92</sup> For example, Ms. DeConcini testified that the approach taken in the proposed rule reflected a substantial change from the Department’s past practice in audits conducted with respect to her clients who are SMLLCs, and contended that the issue of transfers between the single member and the SMLLC have not been raised in such audits. She also contended that Revenue Notice #91-06, which was published by the Department in 1991, is irrelevant because it was issued before the concept of an LLC had been created, and that Notice #02-10, issued in 2002, contradicts the position taken by the Department in the proposed rule because it requires consideration for a transfer between the SMLCC and its single member to be taxable.<sup>93</sup>

104. In response, the Department indicated that the purpose of the rule is to explain the Department’s interpretation of Minn. Stat. § 297A.68, subd. 25, and noted that there is no requirement that the rule represent longstanding positions held by the Department. The Department further asserted that this interpretation of the statute has been “represented in a number of audits” and stressed that the rule is, in fact, consistent with the position it took in two earlier Revenue Notices, # 91-06 and # 02-10. Revenue Notice # 91-06 states that a sale must be reported as a transaction occurring under one of the Internal Revenue Code sections listed in the statute in order to qualify for the exemption. The Department emphasized that Minn. Stat. § 270C.07, subd. 2, states that Revenue Notices may be relied upon by taxpayers until revoked or modified, and indicated that Notice # 91-06 has not been revoked and still represents the Department’s position. The Department contended that its “position [in Revenue Notice #02-10 and the proposed rule] remains the same: only transfers for consideration are taxable. As stated below, the transfers at issue are subject to tax because consideration is provided.” Finally, the Department indicated that it conducts audits to enforce the tax laws it administers, but acknowledged that audits do not necessarily detect all issues of noncompliance with the law and argued that the failure to detect noncompliance during an audit does not mean that the transaction is exempt.<sup>94</sup>

105. Although there is no specific requirement that an agency show that an approach proposed to be taken in a rule is consistent with long-standing

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<sup>91</sup> Dept. Response at 8.

<sup>92</sup> See e.g., Test. of J. Geis and Public Ex. 2; Test. of G. DeConcini.

<sup>93</sup> Test. of G. DeConcini.

<sup>94</sup> Dept. Response at 4-5.

past practice, the Administrative Law Judge concludes that the Department has shown some basis for a belief that it has viewed such transfers as taxable events in the past, and the current rule does not reflect a dramatic shift in its approach. The proposed rule will not cause undue confusion and the Department has shown that it is reasonable.

### **Fairness of the Department's Position**

106. Some of those commenting in opposition to the proposed rule argued that it will result in double taxation of the single member who initially buys an item and pays sales tax, then transfers the item to a SMLLC and, in essence, must pay sales tax again.<sup>95</sup> Some assert that the proposed rule presents a trap for the unwary and creates an unjust and absurd result.<sup>96</sup> Mr. Geis contended that the Department's interpretation as reflected in the proposed rule would render Minn. Stat. § 297A.68, subd. 25, unconstitutional under the Equal Protection clause because there is no rational basis for excluding transfers to LLCs from the list of exemptions.<sup>97</sup>

107. The Department responded that Minn. Stat. § 297A.68, subd. 25, is written in such a fashion that, if a new type of entity is created, the statute must be amended if the new entity is to be exempt from tax. In the Department's view, it was reasonable for the Legislature to take this approach rather than enacting an open-ended exemption that would be automatically expanded each time a similar type of business entity was created, without affording the Legislature the opportunity for the Legislature to consider the nature of the newly-created entity and the costs involved. The Department also emphasized that the sales tax laws are not always consistent or logical. For instance, it pointed out that movie tickets are subject to sales tax, while theater tickets purchased from a nonprofit organization are not; an apple bought from a vending machine is subject to sales tax, while an apple bought at a grocery store is not; and magazines sold over the counter are subject to sales tax, but magazines purchased by subscription are not.<sup>98</sup>

108. The Department further responded that sales tax is a transactional tax that is imposed only once on each transaction. However, the same item may be subject to tax on more than one occasion as it moves through the stream of commerce. For example, a car is taxed every time it is sold to a different person. The Department stated that, when a single member buys assets that are later transferred to a SMLLC, the tax is imposed on the single member at the time the member buys the assets and the SMLLC, which is a separate legal entity under Minnesota sales tax law, is taxed when the assets are

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<sup>95</sup> Test. of D. Busacker and Public Ex. 1 at 3; Test. of J. Geis and Public Ex. 2 at 4; Test. of Mike Hickey of the National Federation of Independent Business.

<sup>96</sup> Test. of B. Anderson; Test. of J. Geis and Public Ex. 2 at 3.

<sup>97</sup> Public Ex. 5.

<sup>98</sup> Dept. Response at 6; Dept. Rebuttal at 2.

later sold to it. If the single member buys an asset with the intent of reselling it to the SMLLC, the member can buy it exempt for resale.<sup>99</sup>

109. Regarding the equal protection argument, the Department maintained that, under Minnesota Supreme Court precedent, the Legislature “has broad discretion in granting tax exemptions” and will not reject a tax classification unless it is clearly arbitrary and lacks any reasonable basis.<sup>100</sup> When faced with a challenge to the constitutionality of a sales tax statute that taxed food sold through vending machines while exempting food sold by grocery stores, the Court determined that the law was constitutional and stated: “Of necessity, lines must be drawn for tax classification. For constitutional purposes, absolute equality and uniformity in taxation are not required.”<sup>101</sup>

110. The Administrative Law Judge concludes that the proposed rule has not been shown to be unreasonable. As the Department has pointed out, the tax code appears inconsistent and illogical at times, and frequently treats similar situations differently. In addition, it is not uncommon for some items and assets to be taxed each time they are transferred from one person or entity to another. In the present situation, the proposed rule taxes the single member when he or she buys an asset and taxes the SMLLC, an entity separate from the single member, when that entity receives it. Moreover, it would not be within the Department’s purview to exempt transfers involving SMLLCs in light of the language of Minn. Stat. § 297A.68, subd. 25(a)(1). The statute specifically lists particular Internal Revenue Code sections that were in place at the time the exemption was passed. The Legislature chose to draft the exemption narrowly rather than more broadly describing the types of transfers it wished to exempt. The language of the statute provides a rational basis for the distinction that the Department is making in the proposed rule.

111. The Administrative Law Judge concludes that the Department has shown that subpart 3a, item B of the proposed rule is needed, reasonable, and consistent with statutory authority. While the Judge is sympathetic to the concerns expressed by those opposing this portion of the proposed rules, any concerns about the wisdom of the tax policy reflected in the statute should be addressed to the Legislature.

## **X. Subpart 10 – Consignment sales and consignment auctions**

112. Subpart 10 of the proposed rule pertains to consignment sales and consignment auctions. The subpart treats sales by consignees and brokers in the same manner due to the similarities between consignment sales, consignment auctions, and brokered sales.

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<sup>99</sup> Dept. Response at 6.

<sup>100</sup> Dept. Rebuttal at 3, citing *Council of Independent Tobacco Mfrs. of America v. State of Minnesota*, 713 N.W.2d 300, 308 (Minn. 2006).

<sup>101</sup> Dept. Rebuttal at 3, citing *Minnesota Automatic Merchandising Council v. Salomone*, 682 N.W.2d 557 (Minn. 2004).

113. The Department has included three examples at the end of subpart 10 to illustrate the principles set forth therein. As originally proposed, Example 3 of subpart 10 read as follows:

Example 3. A person rents space from the operator of a craft show to sell craft items. The seller participates in the event for four days. The sales at the show are taxable since this is a selling event under Minnesota Statutes, section 297A.87.

114. Heather Broneak of the University of Minnesota Tax Department submitted a written comment concerning this example. She stated that, as originally drafted, Example 3 suggested that the sales are taxable just because “this is a selling event” even though not all sales at a selling event are subject to tax if an individual sells no more than \$500 per year, and participates in only one sale of three days or less.<sup>102</sup>

115. At the beginning of the rule hearing, the Department proposed the following modification to Example 3 of subpart 10 of the proposed rule:

Example 3. A person rents space from the operator of a craft show to sell craft items. The seller participates in the event for four days. The sales at the show are taxable since ~~this is a~~ the selling event lasts more than three days, as provided under Minnesota Statutes, section 297A.87, subdivision 3.<sup>103</sup>

The Department indicated that it wished to make this modification to clarify that the person is subject to tax because the selling event lasts more than three days.<sup>104</sup>

116. The Administrative Law Judge concludes that subpart 10, as modified, has been shown to be needed and reasonable to provide guidance on when consignment sales and consignment auctions will be deemed to be exempt from sales tax as isolated and occasional sales. The modification does not render the rule substantially different from the rule as originally proposed under Minn. Stat. § 14.05, subd. 2, because it is in character with the proposed rule, was made in response to a public comment, and provides further clarification as to when subpart 10 of the proposed rule applies.

Based on the Findings of Fact, the Administrative Law Judge makes the following:

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<sup>102</sup> Letter from H. Broneak (October 16, 2007).

<sup>103</sup> Ex. 15.

<sup>104</sup> Ex. 16 at 4.

## CONCLUSIONS

1. The Department gave proper notice in this matter. The Department has fulfilled the procedural requirements of Minn. Stat. § 14.14 and all other procedural requirements of law or rule.

1. The Department has demonstrated its statutory authority to adopt the proposed rules, and has fulfilled all other substantive requirements of law or rule within the meaning of Minn. Stat. §§ 14.05, subd. 1; 14.15, subd. 3; and 14.50 (i) and (ii).

2. The Department has demonstrated the need for and reasonableness of the proposed rules by an affirmative presentation of facts in the record within the meaning of Minn. Stat. §§ 14.14, subd. 4; and 14.50 (iii).

3. The amendment to the proposed rules suggested by the Department after publication of the proposed rules in the State Register is not substantially different from the proposed rules as published in the State Register within the meaning of Minn. Stat. § 14.05, subd. 2, and 14.15, subd. 3.

4. Any Findings that might properly be termed Conclusions and any Conclusions that might properly be termed Findings are hereby adopted as such.

5. A Finding or Conclusion of need and reasonableness with regard to any particular rule subsection does not preclude and should not discourage the Department from further modification of the proposed rules based upon this Report and an examination of the public comments, provided that the rule finally adopted is based upon facts appearing in this rule hearing record.

Based on the Conclusions, the Administrative Law Judge makes the following:

## RECOMMENDATION

IT IS RECOMMENDED that the proposed rules, as modified, be adopted.

Dated: September 3, 2008.

s/Barbara L. Neilson

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BARBARA L. NEILSON

Administrative Law Judge

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