

Alert 10-117



Minnesota Supreme Court Gets it REIT: Rejects 'Economic Substance' Challenge

In a landmark decision issued yesterday, the Minnesota Supreme Court struck a blow for taxpayers by reversing a Minnesota Tax Court decision that had allowed the Minnesota Department of Revenue to disregard a taxpayer's captive-REIT structure on the basis that the transactions creating the structure lacked economic substance. Describing as "radical" the Department's attempt to disregard the structure as a sham, the Minnesota Supreme Court held for the taxpayer, explaining: "If Minnesota statutes allow a favorable tax treatment, neither our court nor the Commissioner has the power to disregard those statutes and impose a different tax treatment. And, if we conclude a taxpayer has complied with the relevant statutes, that ends our analysis." *HMN Financial, Inc. and Affiliates v. Commissioner of Revenue*, Supreme Court of Minnesota, Docket No. A09-1164 (decided May 20, 2010).

Background

The dispute involved a classic mortgage REIT with an 80/20 twist to make it effective within Minnesota's unitary-combined filing regime. Captive REIT structures are intended to produce a double deduction: a dividends-paid-deduction ("DPD") for the Real Estate Investment Trust that pays a dividend, and a dividends-received-deduction ("DRD") for the receiving shareholder. At the core, the structure works when a state (1) conforms generally to the Internal Revenue Code, and thus conforms to the IRC § 857(b)(2)(B) DPD for REITs, but (2) decouples from federal DRD rules and thus fails to follow the federal rule that denies a DRD to the shareholder who receives a dividend for which a DPD was taken.¹

In its version of the REIT strategy, HMN Financial, Inc. ("HMN") was the holding company for Home Federal Savings Bank ("HF Bank"). In 2002, HF Bank incorporated two subsidiaries, Home Federal Holding, Inc. ("HF Holding") and Home Federal REIT, Inc. ("HF REIT"). HF Holding was an 80/20 foreign operating corporation. HF Holding held all of the stock of HF REIT, except for preferred shares held by 112 HF Bank employees.² HF Bank secured and serviced commercial and residential loans. It then transferred certain participation interests in those loans to HF REIT (but continued to service the loans).

HF REIT earned income from the loans but paid all of its taxable income out as dividends to its shareholders. HF Holding, in turn, paid dividends to its sole shareholder, HF Bank. Under Minnesota and federal law, HF REIT, as a real estate investment trust, was entitled to a tax deduction for dividends paid.³ After taking the deduction for dividends it paid to shareholders, therefore, HF REIT had close to zero net taxable income in Minnesota.

As a unitary business, HMN reported its income as a group, but excluded HF Holding's income because it qualified as a foreign operating corporation under Minnesota's "80/20" rules. The Minnesota Revenue Department found (and the Tax Court agreed) that HMN owed \$2.5 million in tax for 2002, 2003 and 2004 because the transactions between HF Bank, HF REIT, and HF Holding "had no economic substance and no genuine business purpose except to avoid Minnesota tax."⁴

The Minnesota Supreme Court disagreed. It held that the Commissioner of Revenue lacked authority to disregard HF Bank's captive-REIT structure when it organized its business in compliance with the relevant statutes—even though the court did not dispute the Tax Court's finding that HF Bank's creation of the captive-REIT structure was motivated solely by a desire to reduce its taxes. Specifically, "neither Minnesota statutes nor case law grants the Commissioner the power to disregard HMN's business structure in assessing HMN's taxes. When a business complies with all of the relevant tax

statutes, that business is subject to tax in accordance with those statutes." So since HMN complied with Minnesota law, it was entitled to the protections and benefits of the law...even though those benefits included significant tax savings.

Why Is This Exciting News?

"Sham" battles continue to rage around the country. Fueled both by the federal common law economic substance doctrine and a variety of state statutes that purport to "more clearly reflect income" or correct "distortion" (a myth, as we have explained in other contexts), these state challenges received a boost earlier this year when Congress in the Health Care and Education Reconciliation Act of 2010 codified the common law sham doctrine in new 26 U.S.C. § 7701(o). In 2002, the Massachusetts Supreme Court decided *Sherwin-Williams*.⁶ There the court ruled: "[T]ax motivation is irrelevant where a business reorganization results in the creation of a viable business entity engaged in substantive business activity..."⁷ The Minnesota Supreme Court has now taken this a step further. It essentially recognizes that "business purpose" is irrelevant in the context of corporate structure, and that the Commissioner of Revenue is not free to substitute her judgment for that of businesspeople when the letter of the law is followed.⁸

Companies should take heart in this intellectually honest decision that shows an enlightened understanding of this fundamental Due Process principle of fairness: Taxpayers ought to be able to rely upon the straightforward application of the law, and should not have to worry about rogue administrators who seek to enforce the "thrust" of the law.⁹

This exciting development should change the way taxpayers evaluate their national captive-REIT (and potentially their intangible holding company) defense and settlement strategies.

This decision should also impact the way taxpayers consider other structuring decisions that, like the captive-REIT structure, were intended to take advantage of specific federal and state statutory provisions that by their very nature are designed to encourage tax-motivated behavior.

The opinion also makes it clear that although state revenue departments may be granted discretion in the application of statutory anti-abuse provisions, those provisions still must be applied based on their actual statutory language. The Minnesota Supreme Court refused to apply the statutory anti-abuse provisions cited by the Department of Revenue as a general license to reverse results produced by other statutory provisions. Although the Department cited a series of statutory anti-abuse provisions that they argued allowed them to ignore HF Bank's captive-REIT structure, the Minnesota Supreme Court addressed each of these provisions and demonstrated that none of them, either separately or in combination, provided the Department with the authority to disregard a corporate structure where HF Bank had complied with all relevant statutes..

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To discuss the potential opportunities this decision has created, please contact any of the authors of this Alert, or the Reed Smith attorney with whom you regularly work. For additional information on Reed Smith's State Tax Practice, visit www.reedsmith.com/ILtax.

1. I.R.C. § 243(d)(3).
2. HF Bank purchased 112 shares of preferred stock from HF REIT and distributed it, one share each, to HF Bank employees, so that HF REIT met the 100 shareholder requirement of I.R.C. § 856(a)(5).
3. Minn. Stat. § 290.01, subd. 19 (2002) (referencing I.R.C. §§ 561(a) and 857(b)(2)(B)).
4. *HMN Financial, Inc. v. Commissioner of Revenue*, Minnesota Tax Court, No. 7911-R, May 27, 2009.
5. *HMN Financial, Inc. and Affiliates v. Commissioner of Revenue*, Supreme Court of Minnesota, Docket No. A09-1164 (decided May 20, 2010).
6. *The Sherwin-Williams Co. v. Massachusetts Comr. Of Rev.*, 778 N.E.2d 504 (Mass. 2002)
7. *The Sherwin-Williams Co. v. Massachusetts Comr. Of Rev.*, 778 N.E.2d 504, 518 (Mass. 2002)
8. The Minnesota Supreme Court is unwilling to "add a 'business purpose' test to a statute dealing with foreign operating corporation tax treatment" where the legislature has not see fit to do so." *HMN Financial, Inc. and Affiliates v. Commissioner of Revenue*, Supreme Court of Minnesota, Docket No. A09-1164 (decided May 20, 2010).
9. See *BankBoston Corporation v. Commissioner of Revenue*, 861 N.E.2d 450 (Mass. Appls. Ct. 2007) affirming Appellate Tax Board Docket No. C270546 (2006).

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