

No. A06-0468

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STATE OF MINNESOTA  
IN SUPREME COURT

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Manpower Inc.,

Relator,

v.

Commissioner of Revenue,

Respondent.

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**RELATOR MANPOWER INC.'S  
REPLY BRIEF**

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## ARGUMENT

### **I. Introduction**

Manpower and the Commissioner agree on the following points: (1) if MPF is a foreign entity, its income and apportionment factors are not included in Manpower's income and apportionment factors; (2) if MPF is a domestic entity, its income and apportionment factors are included in Manpower's income and apportionment factors; and (3) the statutory definitions of "domestic" and "foreign" that apply to corporations (Minn. Stat. § 290.01, subd. 5 and 5a) have the same meaning when applied to a partnership or other entity. Mpr-Br. 9-11; Com-Br. 7.\*

Manpower and the Commissioner disagree on just one issue: Whether MPF, a French SARL, is "created or organized in the United States, or under the laws of the United States."

### **II. Far From Ignoring the Statute's "Under the Laws" Language, Manpower Primarily Relies Upon That Language.**

The determination of whether an entity is domestic is determined under the following language:

[An entity is domestic if it is] created or organized in the United States, or under the laws of the United States or of any state, the District of Columbia, or any political subdivision of any of the foregoing but not including the Commonwealth of Puerto Rico, or any possession of the United States; ...

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\* "Mpr-Br." and "Com-Br." refer to the opening briefs of Manpower and the Commissioner, respectively. Abbreviations used by Manpower in its opening brief will also be employed in this reply brief.

Minn. Stat. § 290.01, subd. 5. An entity is foreign if it is not domestic. Minn. Stat. § 290.01, subd. 5a.

The Commissioner claims that Manpower focuses only on the “created or organized in the United States” language, that Manpower ignores the “or under the laws of the United States” language, and that Manpower urges the Court to adopt an “exclusively ‘geographical’ approach” that turns on where the entity was created. Com-Br. 9-12.

This is simply not true. Manpower places primary emphasis on determining the jurisdiction whose laws are used to grant legal personality to an entity through the issuance of a charter. For example, at page 16 of our opening brief, we stated:

The point is this: MPF was organized in France under French law. It is chartered in France. Therefore, it is a foreign entity for federal income tax purposes.

Mpr-Br. 16 (emphasis added). We also noted:

Nationality depends on whose laws the entity in question—whether classified as a corporation or “newly formed partnership”—is created or organized under.

Mpr-Br. 26 (emphasis added). To be perfectly clear, Manpower’s position is that MPF is a foreign entity because it was created and organized under the laws of France. MPF exists as a legal entity solely because France, under its laws, conferred legal personality on MPF by granting it a charter. Therefore, it was not “created or organized ... under the laws of the United States.”

An interesting question might be raised if MPF had arguably been created in the United States but under the laws of France—if, for example, its “incorporator” was in the

United States and the organizational documents were created here.<sup>1</sup> Even in such a case, federal law would consider such an entity to be foreign because the entity obtained its legal personality under foreign law.<sup>2</sup> The instant case does not raise this issue because, as the Tax Court found, MPF “was established in 1956 in France under French law.” App. 17. So, both as a geographical matter and as a “whose laws” matter, MPF was created or organized in, and under the laws of, France.

### **III. The Commissioner Misinterprets Treas. Reg. § 301.7701-3(g)(1)(ii).**

The Commissioner does not dispute that MPF “was established in 1956 in France under French law,” or that MPF continues to be an SARL whose legal personality derives from the laws of France. However, the Commissioner argues that “created or organized ... under the laws of” refers in this case to federal tax law, even though it is literally not possible to “create or organize” any kind of entity (corporation, partnership, LLC, etc.) under federal tax law. Mpr-Br. 28, n. 17.

The linchpin of the Commissioner’s argument is a federal tax regulation providing that when MPF checked the box to become classified as a partnership, there was a deemed liquidation of MPF as a corporation and a deemed contribution of assets to MPF as a new partnership. Com-Br. 12. See Treas. Reg. § 301.7701-3(g)(1)(ii). The

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<sup>1</sup> We say “arguably created “in the United States” because we do not understand the phrase “created or organized” to refer to the physical act of preparing organizational documents. “Created or organized” refers to the conferring of legal personality through the granting of a charter. That can only happen in one country—the one that grants the charter. See Mpr-Br. 13-16.

<sup>2</sup> This “interesting question” was addressed by the Internal Revenue Service in Private Letter Ruling 5812056040A (December 5, 1958). After reviewing the legislative history, the Service ruled that the nationality of a corporation was determined solely by which country’s laws granted the corporation its charter.

Commissioner concludes (from the “deeming” of the transactions) that MPF was “created or organized” under United States tax law. Com-Br. 12. That logic is fatally flawed.

In the first place, if the Commissioner’s argument were correct for Minnesota income tax purposes, one would think it would also be correct for federal income tax purposes. The Minnesota and federal statutes defining nationality are parallel. Both define a “domestic” entity as one created or organized in, or under the laws of, the United States. Mpr-Br. 13-14, 28. Under federal law, however, MPF is a foreign entity because it was chartered under French law. Mpr-Br. 13-16.

Why then does the Commissioner argue that the deemed transactions make MPF a domestic entity? Because the Commissioner reads language into the regulation that is not there. The regulation provides:

If an eligible entity classified as an association [i.e., a corporation] elects under paragraph (c)(1)(i) of this section to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

Treas. Reg. § 301.7701-3(g)(1)(ii) (emphasis added). The Commissioner notes that there is a “newly formed partnership” and then assumes that the partnership is “created or organized” under federal tax law. However, the regulation does not say that. It says nothing about whose laws the “newly formed partnership” is created or organized under.

The question may reasonably be asked: Why is the regulation silent about whose laws the “newly formed partnership” is “created or organized” under? The answer is that the regulation is a classification regulation. It has nothing to do with nationality. Classification and nationality are determined separately.

Classification solves the problem of how to tax the many different kinds of business entities that exist around the world. As a practical matter, federal (and Minnesota) law cannot have separate and distinct rules for how to tax each kind of entity. There cannot be one rule governing Minnesota limited liability companies, another for French SARLs, another for Swedish *publika aktiebolags*, etc. Therefore, tax law classifies the different kinds of entities into three categories: corporation, partnership, and disregarded entity. Nationality, by contrast, organizes all entities into two categories: domestic or foreign.

Federal tax regulations state: “The determination of whether an entity is domestic or foreign is made independently from the determination of its corporate or non-corporate classification.” Treas. Reg. § 301.7701-5(a) (emphasis added). Thus, classification and nationality are not interdependent. This explains why the classification regulation that the Commissioner relies upon, which deems there to be a “newly formed partnership,” does not say a word about nationality—i.e., whose laws the “partnership” is “created or organized” under.

Nationality is addressed in another regulation which states, in relevant part:

(a) *Domestic and foreign business entities.* A business entity (including an entity that is disregarded as separate from its owner under § 301.7701-2(c)) is domestic if it is created or organized as any type of entity (including, but not limited to, a corporation, unincorporated association, general partnership, limited partnership, and limited liability company) in the United States, or under the law of the United States or of any State. Accordingly, a business entity that is created or organized both in the United States and in a foreign jurisdiction is a domestic entity. A business entity (including an entity that is disregarded as separate from its owner under § 301.7701-2(c)) is foreign if it is not domestic. The determination of whether an entity is domestic or foreign is made independently from the determination of its corporate or non-corporate classification. See

§§ 301.7701-2 and 301.7701-3 for the rules governing the classification of entities.

Treas. Reg. § 301.7701-5(a) (emphasis added). Contrary to the suggestion of the Commissioner, although this regulation addresses dually chartered entities, it is not limited to such entities.<sup>3</sup>

The Commissioner asks the Court to disregard Treas. Reg. § 301.7701-5 because it was not cited in the Tax Court. Com-Br. 15-16. The regulation was not adopted until January 27, 2006. Because that was after the Tax Court issued its decision, Manpower did not cite the regulation in the Tax Court. However, Manpower did argue to the Tax Court that the federal classification regulations do not govern nationality. The Tax Court expressly considered the argument and rejected it. App. 24 (note 7).

Thus, contrary to the Commissioner's claim, Manpower is not arguing a "new issue" within the meaning of Thiele v. Stich, 425 N.W.2d 580, 582 (Minn. 1988). Thiele may preclude the raising of new issues, but it does not preclude citations to new authorities. Indeed, a new authority may be cited in this Court even after oral argument. Minn. Rule App. Proc. 128.05.<sup>4</sup>

The Commissioner also argues that the Court should not apply Treas. Reg. § 301.7701-5 retroactively. Com-Br. 16. We are not asking the Court to do so. As we

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<sup>3</sup> This is also clear from the fact that the regulation has two effective dates, one for business entities generally and another for dually chartered entities. Treas. Reg. § 301.7701-5(c).

<sup>4</sup> Moreover, even if an issue is new, this Court will consider it where there is no prejudice to the opposing party, as in this case. Cf. Zip Sort, Inc. v. Comm'r of Revenue, 567 N.W.2d 34, 39 (Minn. 1997) (allowing argument of a theory not presented to the trial court where there was no possible advantage or disadvantage to either party in not having had a prior ruling on the question by the trial court).

noted in our opening brief, the regulation's effective date means that it is technically not applicable to the check-the-box election made by MPF in 1999. Mpr-Br. 28.

Nonetheless, the regulation was intended to “clarify current law” and—despite what the Commissioner argues—not just for the unusual case of a dually chartered entity. The preamble to the Treasury Decision stated:

Under the existing rules, the characterization of a business entity for Federal tax purposes is established in two separate and independent steps. The first involves a determination of whether the entity is a corporation or a non-corporate entity (e.g., a partnership). The second involves a determination of whether the entity is foreign or domestic.

Treasury Decision 9153, 69 Fed. Reg. 49809, at 49810 (Aug. 12, 2004). The “existing rules” that are described here are not limited to the dually chartered entity situation.

#### **IV. Manpower's Position Is Consistent with Giving Effect to the Deemed Transactions.**

The Commissioner argues that Manpower's position is at odds with Hutchinson Technology, Inc. v. Commissioner of Revenue, 698 N.W.2d 1 (Minn. 2005). Hutchinson involved a statute that denied an otherwise applicable dividends received deduction “if the dividends are paid by a FSC.” Minn. Stat. § 290.21, subd. 4(e) (emphasis added). Another statute provided that the “adjusted net income of a foreign operating corporation shall be deemed to be paid as a dividend,” and that “such deemed dividend shall be treated as a dividend” for purposes of the dividends received deduction. Minn. Stat. § 290.17, subd. 4(g) (emphasis added). Hutchinson's subsidiary was both a FSC and a foreign operating company. The Court held that the denial of the dividends received deduction applied to deemed dividends as well as actual dividends.

In Hutchinson, the “deeming” was dictated by a Minnesota statute, and the statute said explicitly that the “deeming” was effective for purposes of another Minnesota statute. Here, by contrast, the “deeming” occurs by operation of a federal tax regulation. Not only is that regulation not explicit in saying that the “deeming” is effective in determining nationality, the opposite is true. Federal regulations are explicit in saying that the classification regulations have no effect on nationality. That, in itself, provides a basis for distinguishing Hutchinson.

We do not, however, take the position that the federal deemed transactions are totally irrelevant for Minnesota purposes. In fact, we agree entirely that the deemed transactions have parallel consequences for federal and Minnesota purposes.

Under Minnesota law, the term “net income” means federal taxable income, incorporating any elections made by the taxpayer in determining federal taxable income. Minn. Stat. § 290.01, subd. 19. Accordingly, we agree that there was a deemed liquidation of MPF under Treas. Reg. § 301.7701-3(g)(1)(ii). We agree that MPF is treated as if it actually liquidated for purposes of determining both federal taxable income and Minnesota net income.<sup>5</sup> We agree that Manpower is treated as if it actually contributed the assets of MPF to a partnership, again for purposes of determining both federal taxable income and Minnesota net income.<sup>6</sup>

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<sup>5</sup> A liquidation of a corporation that is owned at least 80 percent by another corporation generally does not result in the recognition of taxable gain. I.R.C. § 332 and 337. Had Manpower owned less than 80 percent of MPF, however, the liquidation would have been taxable.

<sup>6</sup> In general, a contribution by a partner to a partnership is not a taxable transaction. I.R.C. § 721.

Under Minnesota law, the terms “corporation” and “partnership” are defined by reference to federal law, specifically I.R.C. § 7701(a). See Minn. Stat. § 290.01, subs. 3 and 4. Therefore, we agree that the check-the-box election resulted in a change of MPF’s classification from corporation to partnership for both federal and Minnesota purposes.

Under Minnesota law, nationality is determined pursuant to the “created or organized” test discussed above. Minn. Stat. § 290.01, subs. 5 and 5a. Minnesota’s law is virtually identical to federal law. I.R.C. § 7701(a)(4) and (5). But with respect to the issue of nationality, the Commissioner does not want to follow parallel federal law.

We disagree with the Commissioner when he leaps to the unfounded conclusion that the “newly formed partnership” was “created or organized” under United States tax law. Although a “newly formed partnership” results as a consequence of United States tax law, the regulation does not say that the partnership is “created or organized” under the laws of any particular jurisdiction (because it does not deal with nationality).

In fact, the regulation doesn’t use the phrase “created or organized” at all. It says only that “the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.” The phrase “created or organized” has been long understood to mean the granting of legal personality through the issuance of a charter. See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 15.01[3] (7<sup>th</sup> ed. 2002) (“... an entity is a domestic corporation if it is treated as a corporation for U.S. tax purposes and has a charter or similar document creating it from either the United States, one of the fifty states, or the District of Columbia; all others are “foreign”

corporations ...”). The omission of that phrase from the regulation is yet another indication that the regulation has nothing to do with nationality.

We believe the proper analysis under the federal regulations (and Minnesota law) is as follows. Nationality is determined independently of classification. Therefore, taxpayers should not take the classification regulation (and the deemed transactions) into account in determining nationality. “Created or organized” refers to the country (or state, etc.) that grants a charter to the entity. MPF was “created or organized” under the laws of France. This occurred in 1956—checking the box in 1999 did not change this. MPF is, therefore, not a domestic entity. It is French and therefore foreign.

To put it succinctly: The transactions that are deemed to occur under Treas. Reg. § 301.7701-3(g)(1)(ii) are relevant for determining the classification of an entity and determining net income, but they are not relevant for determining nationality.

However, if the Court decides that the deemed transactions (under the classification regulations) are relevant for determining nationality, then we submit that Manpower still should prevail under the following analysis. Treas. Reg. § 301.7701-3(g)(1)(ii) says that the shareholders are deemed to “contribute all of the distributed assets and liabilities to a newly formed partnership.” If (contrary to the above) one concludes that a new partnership is “created or organized,” then the regulation is ambiguous because it does not identify under whose laws that is deemed to occur.

The logical construction is that the new partnership is deemed “created or organized” under the laws of the jurisdiction where it was actually “created or organized.” The Commissioner’s alternative construction that it is organized under

federal tax law makes no sense because one cannot create or organize any kind of entity under federal tax law. French law provides rules regarding an array of issues such as membership, meetings, voting, management, liability, etc. App. 55-75. Federal tax law provides no such rules. It is absurd to say that a French SARL is organized under a United States tax law that has absolutely no rules pertaining to entity governance.

Furthermore, if Minnesota law and the federal regulation are ambiguous, then this Court's precedents hold that they should be construed in favor of the taxpayer. See BCBSM, Inc. v. Commissioner of Revenue, 663 N.W.2d 531, 533 (Minn. 2003) ("... we construe ambiguous taxation provisions in favor of the taxpayer where the ambiguous term is crucial to the applicability of the tax"); Northland Country Club v. Commissioner of Taxation, 241 N.W.2d 806, 807 (Minn. 1976) (where "crucial but undefined terms" exist in a statute imposing a tax, the statute should be construed strictly against the Commissioner, even though the Commissioner's theory "may be a rational one"); Busch v. Commissioner of Revenue, 2006 WL 1278705 (Minn. 2006) ("tax statutes must be strictly construed against the taxing authority when ambiguous").

**V. Revenue Notice 98-08 Was Correct When Issued, Is Still Correct, and Demonstrates the Inconsistency of the Commissioner's Position in This Case.**

Manpower discussed Revenue Notice 98-08 merely to point out that the Commissioner was being inconsistent. The Commissioner recognized that a foreign-chartered entity treated as disregarded under federal tax law was foreign, despite a deemed liquidation, yet he refused to recognize that a foreign-chartered entity treated as a partnership under federal tax law was foreign. The Commissioner, in his brief, admits that he has been inconsistent.

Now, to achieve a modicum of consistency, the Commissioner seems to say: (1) that his revenue notice was wrong when it was issued; (2) that he reaches that conclusion with “significant reluctance” because the notice represented good tax policy; (3) that he would prefer a “neutral rule whereby nationality and classification are independent;” (4) that Treas. Reg. § 301.7701-5 states just such a rule; and (5) he will apply that regulation beginning August 12, 2004 (i.e., its effective date), thus preserving the validity of the revenue notice from that point forward. Com-Br. 16-20.

This court does not have to (and should not) address the validity of Revenue Notice 98-08, which both parties agree is not applicable to this case. Again, Manpower cited it simply to show the Commissioner’s inconsistency. However, we feel constrained to note that the Commissioner’s decision to abandon the revenue notice and then resurrect it on August 12, 2004, is completely unnecessary because Treas. Reg. § 301.7701-5 restated longstanding law that nationality and classification are independent determinations.

### CONCLUSION

An entity is “created or organized in the United States, or under the laws of the United States or of any state,” and is domestic, if the United States or a state confer legal personality on the entity by granting it a charter. Otherwise, the entity is foreign. MPF was chartered under French law. Therefore, it is “foreign.”

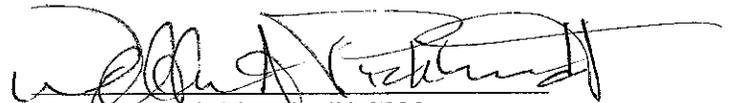
Even though MPF checked the box to be classified as a partnership for federal and Minnesota income tax purposes, that reclassification had no effect on nationality. The deemed transactions that resulted from the federal classification regulations were relevant

in determining net income for both federal and Minnesota purposes. They were not relevant in determining nationality because nationality is determined independently from classification.

In the alternative, if the deemed transactions were relevant in determining nationality, Manpower still prevails because the federal regulation is ambiguous—it does not say whose laws the “newly formed partnership” is created or organized under. Ambiguous statutes must be construed in favor of the taxpayer. Moreover, the only sensible result is that the “newly formed partnership” is created or organized under French law, especially inasmuch as it is not possible to organize any type of entity under federal tax law.

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

Dated: June 1, 2006

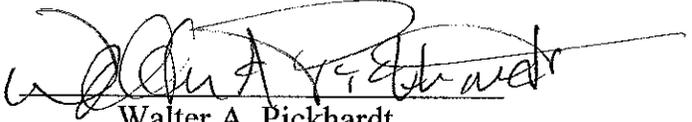


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**CERTIFICATE OF COMPLIANCE**  
**WITH MINN. R. APP. P 132.01, Subd. 3**

The undersigned certifies that the Brief submitted herein contains 3,599 words and complies with the type/volume limitations of the Minnesota Rules of Appellate Procedure 132. This Brief was prepared using a proportional spaced font size of 13 pt. The word count is stated in reliance on Microsoft Word 2003, the word processing system used to prepare this Brief.

  
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