No. A06-0468

STATE OF MINNESOTA
IN SUPREME COURT

Manpower Inc.,

Relator,

v.

Commissioner of Revenue,

Respondent.

RELATOR MANPOWER INC.'S OPENING BRIEF

MIKE HATCH
Attorney General
State of Minnesota

CATHERINE M. KEANE
Assistant Attorney General
Atty. Reg. No. 15006X

BRADFORD S. DELAPENA
Assistant Attorney General
Atty. Reg. No. 219046

445 Minnesota Street, Suite 900
St. Paul, MN 55101-2128
(651) 297-1075

ATTORNEYS FOR
COMMISSIONER OF REVENUE

FAEGRE & BENSON, LLP

WALTER A. PICKHARDT
Atty. Reg. No. 86782

LISA R. PUGH
Atty. Reg. No. 287714

2200 Wells Fargo Center
90 South Seventh Street
Minneapolis, MN 55402
(612) 766-7000

ATTORNEYS FOR
MANPOWER INC.

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LEGAL ISSUE

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- The Tax Court held that a *Société à Responsabilité Limitée* was not a "foreign entity" because it made an election to be classified as a partnership for federal income tax purposes.

  Minn. Stat. § 290.01, subdivisions 5 and 5a
  Minn. Stat. § 290.17, subdivision 4
  Caterpillar, Inc. v. Commissioner of Revenue, 568 N.W.2d 695 (Minn. 1997)

STATEMENT OF THE CASE

By Order dated December 17, 2004, the Commissioner of Revenue (the "Commissioner") assessed Minnesota corporate franchise tax against Manpower Inc. ("Manpower") for the years 1998 through 2000. On February 11, 2005, Manpower contested that Order by filing a Tax Court Notice of Appeal.

In its appeal, Manpower challenged the Commissioner's determination made for the 1999 and 2000 years (the "years in issue") that the income and apportionment factors of Manpower France ("MPF") were includible in Manpower's income and apportionment factors for Minnesota corporate franchise tax purposes.

Manpower is a Wisconsin corporation that does business and files tax returns in Minnesota. MPF is a *Société à Responsabilité Limitée* (an "SARL"), a type of business entity created and organized under the laws of France. Manpower owns 99.3068% of MPF; the remaining interest is owned by an affiliate. MPF does not do business in the United States.

Manpower and the Commissioner agreed that Manpower was engaged in a "unitary business" with MPF as that term is used in Minn. Stat. § 290.17, subd. 4. However, they disagreed on whether MPF was a "foreign entity" or a "domestic entity."

The income and apportionment factors of foreign entities must not be included in the net income and apportionment factors of a unitary business when it files a Minnesota combined corporate franchise tax return. The income and apportionment factors of domestic entities must be so included. Minn. Stat. § 290.17, subd. 4(f) and (h).

Manpower contended that MPF was created and organized under the laws of France, the country that granted MPF its charter, and therefore it was a "foreign entity." The Commissioner acknowledged that MPF was chartered under French law, but he contended that MPF became a "domestic entity" when it made an election to be classified as a partnership for federal income tax purposes.

In the Tax Court, Manpower filed a motion for summary judgment. On January 12, 2006, the Tax Court, the Honorable Sheryl A. Ramstad presiding, issued an Order denying Manpower's motion and granting summary judgment to the Commissioner. The Order was entered on January 27, 2006. Manpower then filed a petition for certiorari with this Court.

STATEMENT OF FACTS

Manpower is a corporation organized under the laws of Wisconsin. App. 76. It specializes in permanent, temporary and contract recruitment, employee assessment, and training. Manpower operates in Minnesota and is subject to franchise taxes under Minn.

Stat. § 290.02. App. 16. Affiliates of Manpower operate in 68 countries and territories. MPF is one of Manpower's affiliates. App. 17.

MPF was established in 1956 in France under French law as an SARL. App. 17. An SARL is a form of business entity. It is entitled to the same rights (including the right to own property) and has the same obligations as a physical person. App. 45. It must have more than one owner. App. 37. The owners (*associés*, or "members") have limited liability. App. 55. Its membership interests (*parts sociales*) are not negotiable and are not certificated. An SARL is a closely-held entity that cannot make a public offering. App. 73.[1]

MPF has two members. Manpower owns 99.3068% of MPF, and its wholly-owned United Kingdom affiliate, Manpower P.L.C., owns 0.6932% of MPF. App. 17.

Manpower does not operate in France. MPF does not operate in the United States. Nonetheless, they are engaged in similar lines of business and they are engaged in a "unitary business" as that term is used in Minn. Stat. § 290.17. App. 17.

For federal income tax purposes, Manpower is taxed as a corporation under Subchapter C of the Internal Revenue Code (the "Code" or "I.R.C.") App. 17. MPF's status under the Code is more complex.

As an SARL, MPF is a type of business entity that can be classified as either a corporation or a partnership for federal income tax purposes. Treas. Reg. § 301.7701-2.

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1 A publicly held company may be organized under French law as a *Société Anonyme*.

The default classification for an SARL is as an "association" (i.e., a corporation)[2] because all members of an SARL have limited liability. Treas. Reg. § 301.7701-3(b)(2)(B). However, an SARL can make an election to be classified as a partnership. Treas. Reg. § 301.7701-3(c). The election is made by checking a box on IRS Form 8832. Treas. Reg. § 301.7701-3(c)(1)(i).

MPF made an election dated September 17, 1999. On its Form 8832, MPF checked a box stating that it was "a <u>foreign</u> eligible entity electing to be classified as a partnership." (Emphasis added.) The effective date of the election was July 13, 1999. App. 17, 81.

Because MPF's tax classification changed from corporation to partnership—albeit MPF remained a "foreign eligible entity"—there were certain federal income tax consequences. Changing from the corporation classification to the partnership classification means to the Internal Revenue Service (but not to France) that the entity is "deemed" to have liquidated. Manpower so indicated on an attachment to its Form 8832, and it also indicated that the liquidation would be governed by I.R.C. § 332. App. 82. That section, which applies to liquidations of subsidiaries, provides that "no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation." Another federal income tax consequence to the

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[2] If an organization is classified as an "association," it is a "corporation" for federal income tax purposes. The term "corporation" is defined to include "associations" by I.R.C. § 7701(a)(3). For the sake of clarity, this brief will use the term "corporation" unless the context requires otherwise.

change was that a distributable share of the income and losses of MPF would flow through to Manpower under I.R.C. § 702.[3]

Manpower filed Minnesota combined corporate franchise tax returns for the years in issue. It did not include on those returns the income or apportionment factors of MPF because it understood MPF to be a "foreign entity" within the meaning of Minn. Stat. § 290.17, subd. 4(f), which provides:

> The net income and apportionment factors under section 290.191 or 290.20 <u>of foreign corporations and other foreign entities</u> which are part of a unitary business shall not be included in the net income or the apportionment factors of the unitary business. . . . .

(Emphasis added). App. 18.

The Commissioner audited Manpower's Minnesota returns for the period beginning January 1, 1998, and ending December 31, 2000. For the years in issue (1999 and 2000), the Commissioner determined that MPF was a domestic entity and therefore disallowed Manpower's exclusion of MPF's income and apportionment factors in the calculation of Manpower's Minnesota taxable income.[4] App. 18.

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3 MPF's income and losses were not reflected on Manpower's federal income tax return when MPF was classified as a corporation. Income and losses flow through foreign partnerships, but not foreign corporations.

4 For 1998, when MPF was classified as a corporation, Manpower did not include MPF's income and apportionment factors in its combined report. The Commissioner agreed that MPF was a "foreign corporation" and that its income was therefore not subject to Minnesota income taxation by reason of Minn. Stat. § 290.17, subd. 4.

ARGUMENT

The issue in this case is a legal one subject to *de novo* review. Am. Nat. Gen. Ins. Co. v. Solum, 641 N.W.2d 891, 895 (Minn. 2002). The Minnesota Supreme Court has plenary power to review an issue of law. Amoco Corporation v. Commissioner of Revenue, 658 N.W.2d 859, 865 (Minn. 2003).

I. Introduction.

This case involves the Minnesota water's edge limitation to the combined tax reporting of unitary business income. This Court had occasion to consider water's edge combined reporting in Caterpillar, Inc. v. Commissioner of Revenue, 568 N.W.2d 695 (Minn. 1997). Although that case involved a different issue than is presented here, the Court's description of Minnesota's combined reporting system provides a useful introduction to this case. The Court wrote:

> Because "a State may not tax value earned outside its borders," the income of a member of a unitary business doing business in Minnesota must be divided between Minnesota and other states. Combined reporting is an accounting device that treats separate corporations engaged in a unitary business as one for the limited purpose of properly accounting for and attributing the income of any one member to a taxing state. Under combined reporting, the income of the members of a unitary business is combined and then apportioned to a particular taxing jurisdiction by using an apportionment formula that takes into account three factors--property, payroll, and sales, see Minn. Stat. § 290.19 (1986)--which represent the three major aspects of business activity within a taxing state. Fair apportionment ensures that a "State taxes only its fair share of an interstate transaction." It is an approximation of a corporation's income that is reasonably related to the taxing state.
>
> Minnesota's combined reporting method requires each member of a unitary business engaged in business in Minnesota to file reports

> disclosing the net income of the entire unitary business. For purposes of determining the net income of the unitary business and the factors to be used in the apportionment of its net income, only the income and apportionment factors of domestic members of the unitary business are included in the combined reports. *See* Minn. Stat. § 290.19, subd. 1(2)(a) (1986). The net income of these domestic members of the unitary business remains unchanged when intragroup transfers, such as interest and royalty payments, occur. *See* id. § 290.34, subd. 2 (1986) ("All intercompany transactions between [domestic] companies which are contained in the combined report shall be eliminated."). In contrast, neither the net income nor the apportionment factors--property, payroll, and sales--of a foreign member of the unitary business are included in the combined reports; rather, foreign members of the unitary business use a "separate entity" or "arm's length" method of reporting.

Id. at 696-97 (citations omitted, emphasis added). The Court also explained the term "water's edge":

> Minnesota's reporting method includes a domestic, or water's edge, limitation. The term "water's edge" refers to the fact that this method of reporting does not extend beyond the water's edge, i.e., the geographic boundaries of the United States, in determining what activities a state will tax.

Id. at 696, n 2.

The statute imposing the water's edge limitation for the tax years in the Caterpillar case was Minn. Stat. § 290.34 which, in the 1986 version relied upon by the Court, stated in relevant part:

> The combined report shall reflect the income of the entire unitary business as provided in section 290.17, subdivision 2, clause (4). The combined report shall reflect income only from corporations created or organized in the United States or under the laws of the United States or of any state, the District of Columbia, the commonwealth of Puerto Rico, any possession of the United States, or any political subdivision of the foregoing ...

Minn. Stat. § 290.34, subd. 2(a) (1986) (emphasis added).

In 1987, the Legislature moved the water's edge limitation into Minn. Stat. § 290.17, Subd. 4(f). The Legislature also extended the water's edge limitation, which previously had applied just to foreign corporations, to "other entities organized in foreign countries."

> For purposes of determining the net income of a unitary business and the factors to be used in the apportionment of net income pursuant to section 290.191 or 290.20, there must be included only the income and apportionment factors of corporations or other entities created or organized in the United States or under the laws of the United States or of any state, the District of Columbia, the commonwealth of Puerto Rico, any possession of the United States, or any political subdivision of the foregoing ... that are determined to be part of the unitary business pursuant to this subdivision, notwithstanding that other corporations or other entities organized in foreign countries might be included in the unitary business.

1987 Minn. Laws, ch. 268, art. 1, sec. 73 (emphasis added). The 1987 extension of the water's edge limitation to include foreign entities is important for this case.

In 1988, the Legislature substantially restructured the laws relating to the taxation of foreign source income. See Hutchinson Technology, Inc. v. Commissioner of Revenue, 698 N.W.2d 1 (Minn. 2005). The water's edge limitation adopted in 1987 was preserved, but the language of Minn. Stat. § 290.17, subd. 4(f), was modified to read as follows (in relevant part):

> (f) The net income and apportionment factors under section 290.191 or 290.20 of foreign corporations and other foreign entities which are part of a unitary business shall not be included in the net income or the apportionment factors of the unitary business. A foreign corporation or other foreign entity which is required to file a return under this chapter shall file on a separate return basis. ...

1988 Minn. Laws, ch. 719, art. 2, sec. 30 (emphasis added). The Legislature also added a new subdivision, Minn. Stat. § 290.17, subd. 4(h):

> For purposes of determining the net income of a unitary business and the factors to be used in the apportionment of net income pursuant to section 290.191 or 290.20, there must be included only the income and apportionment factors of <u>domestic corporations or other domestic entities</u> other than foreign operating corporations that are determined to be part of the unitary business pursuant to this subdivision, notwithstanding that <u>foreign corporations or other foreign entities</u> might be included in the unitary business.

1988 Minn. Laws, ch. 719, art. 2, sec. 30 (emphasis added). This 1988 legislation—which in the ensuing years has not been amended—preserved the concept of the 1987 legislation that the water's edge limitation applies to both foreign corporations and other foreign entities.

The issue presented in this case is whether MPF, an SARL created and organized under the laws of France in 1956, is a "foreign entity" such that its income and apportionment factors must be excluded from the net income and the apportionment factors of Manpower's unitary business pursuant to Minn. Stat. § 290.17, subd. 4(f) and (h).

II. Under the Plain Language of the Statute, an SARL Formed Under French Law Is a Foreign Entity.

The 1988 Legislature defined the terms "domestic corporation" and "foreign corporation" as follows (in relevant part):

> **Subd. 5. Domestic corporation**. The term "domestic" when applied to a corporation means a corporation:
>
> (1) 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; ...
>
> **Subd. 5a. Foreign corporation**. The term "foreign," when applied to a corporation, means a corporation other than a domestic corporation.

1988 Minn. Laws, ch. 719, art. 2, secs. 7-8. These definitions remain in the statute. Minn. Stat. § 290.01, subds. 5 and 5a.

The Legislature did not define the terms "foreign entity" and "domestic entity." The Tax Court held (and the parties agreed) that the adjectives "domestic" and "foreign" mean the same thing when they modify "entities" as they do when they modify "corporations."

This construction is sensible and effectuates legislative intent. Within Chapter 290, the terms "domestic entities" and "foreign entities" appear only within Minn. Stat. § 290.17, subd. 4(f) and (h). They appear in tandem with the terms "domestic corporations" and "foreign corporations." Thus, the Legislature must have intended that the adjectives "domestic" and "foreign" have the same meaning when applied to "entities" as they do when applied to "corporations." Therefore, a "domestic entity" is one created or organized in the United States; all other entities are foreign.

The question in this case, then, can be restated as being whether MPF was "created or organized in the United States ... ." The plain meaning of the statute and common sense provide an obvious answer: Because MPF was created and organized as an SARL fifty years ago in France and is chartered under French law, MPF is not a "domestic entity." It is a "foreign entity."

This Court has held: "Where the statutory language is clear and unambiguous, courts must give effect to its plain meaning." Green Giant Co. v. Commissioner of Revenue, 534 N.W.2d 710, 712 (Minn. 1995); see also Hutchinson Technology, Inc. v. Commissioner of Revenue, 698 N.W.2d 1, 16 (Minn. 2005) and Minn. Stat. § 645.16. The decision of the Tax Court should be reversed because it failed to give effect to the plain meaning of an unambiguous statute.

III. Determining the Nationality of an Entity Based on Where it Was Created or Organized Is Consistent With the Legislative Purpose Underlying the Water's Edge Limitation.

A number of states, including Minnesota, adopted water's edge combined reporting in response to concerns associated with worldwide combined reporting. A leading treatise notes:

> One of the most contentious issues in the state tax field from the mid-1970s through the mid-1990s was the constitutionality of worldwide combined reporting. A number of states, including most notably California, had extended the combined reporting concept to affiliated unitary corporate groups including foreign corporations with operations abroad. Multinational corporate taxpayers, relying on Japan Line, contended that the extension of the unitary business principle to foreign corporations violated the Foreign Commerce Clause ... In Container Corp. of America v. Franchise Tax Board [463 U.S. 159 (1983)] and in Barclays Bank PLC v. Franchise Tax Board [512 U.S. 298 (1994)], the Court put an end to the constitutional controversy by sustaining the constitutionality of worldwide combined reporting ... Nevertheless, in the aftermath of Container, many states enacted so-called "water's edge" legislation that limited combined reporting to domestic corporations, tax haven corporations, and foreign corporations with a threshold of business activity in the United States.

Hellerstein, State Taxation: Corporate Income & Franchise Taxes, ¶ 8.16 (2d ed. 1993).

The Hellerstein treatise also observes:

> In one of history's ironic twists, California's victory in Container sustaining the constitutionality of worldwide combined reporting actually led to its demise in some states and to its restriction in many others. The ink was hardly dry on the Container decision in 1983 when President Ronald Reagan responded to the pressure of multinational enterprises, supported by foreign governments, by convening a Worldwide Unitary Taxation Working Group to review worldwide combined reporting. ... In its 1984 report, the Working Group recommended that the states adopt legislation or administrative action that would limit combined apportionment of both U.S. and foreign-based multinationals to a U.S. water's edge combined group. In the event "there are not sufficient signs of appreciable progress by the states" in adopting the agreed principles, Secretary of the Treasury Donald Regan stated that he would recommend federal legislation that "would give effect to a water's edge limitation." ... Responding to the threat of federal legislation and to political pressure from multinational corporations, the states acted with unusual legislative speed.

Id. at ¶ 18.17.

As discussed above, Minnesota is one of the states that responded to the concerns raised by multinational corporations, the Federal government, and by foreign governments about worldwide combination. As this Court noted in Caterpillar:

> Finally, we observe that the creation of water's edge reporting was an effort to avoid double taxation on multinational corporations, i.e., taxation by both the United States and a foreign country, as well as the problems associated with the worldwide combination reporting method. In fact, the impetus for states to utilize water's edge reporting instead of worldwide combination reporting originated from multinational companies, such as Caterpillar.

568 N.W.2d at 701.

Thus, the purpose of water's edge legislation is to treat domestic entities and foreign entities differently. The income and apportionment factors of domestic entities in a unitary business must be included on a combined report. The income and apportionment factors of foreign entities <u>must not be included</u>. See Minn. Stat. § 290.17, subd. 4(f) and (h).

Minnesota law creates a bright-line test based on whether an entity was "created or organized in the United States" to determine whether an entity is domestic or foreign. The phrase "created or organized" should be construed in a common sense manner. Minn. Stat. § 645.08. When it is so construed, an entity "created or organized" under the laws of France is clearly foreign. This result effectuates legislative intent.

The holding of the Tax Court, which treats a French entity as if it were "created or organized" in the United States, does not effectuate legislative intent. The Court's holding treats a clearly foreign entity as if it were domestic and as a result it frustrates the legislative purpose of keeping the income and apportionment factors of foreign affiliates of multinational corporations off the combined reports that must be filed by the domestic affiliates of those corporations. Not only is the Court's holding at odds with the statutory language, it is inconsistent with the concept of a water's edge limitation.

IV. Determining the Nationality of an Entity Based on Where it Was Created or Organized Is Consistent With Federal Tax Law.

The Minnesota definitions of "domestic corporation" and "foreign corporation" are parallel to these definitions in the Internal Revenue Code:

> **(4) Domestic.** The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations.
>
> **(5) Foreign.** The term "foreign" when applied to a corporation or partnership means a corporation or partnership which is not domestic.

I.R.C. § 7701(a). Thus, for both Minnesota and federal tax purposes, the nationality of a corporation (or partnership) is determined by where it is created or organized.

Perhaps because the law is so clear, these federal definitions have not been controversial. A leading treatise states the federal rule:

> Thus, 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 (if otherwise qualifying for corporate status under the entity classification rules discussed earlier in this work).

Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 15.01[3] (7^{th} ed. 2002). Under federal law, the nationality of an entity is determined by identifying the jurisdiction that grants it a charter.

This principal is so obvious that there has been virtually no litigation over what is "domestic" and what is "foreign," even though the term "domestic corporation" was defined many years ago in 1918. The "created or organized" language has been a part of the Internal Revenue Code ever since.[5]

A detailed federal legislative history appears in Private Letter Ruling 5812056040A (December 5, 1958). There, the taxpayer sought a ruling that corporations that secured charters from a foreign country were nonetheless "domestic" corporations

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5 The Revenue Act of 1918 provided that a domestic corporation or partnership was one "created or organized in the United States," and a foreign corporation or partnership was one "created or organized outside the United States." The Revenue Act of 1924 changed the definition of foreign corporation or partnership to mean "a corporation or partnership that is not domestic." See Treasury Decision 9153, 69 Fed. Reg. 49809 (Aug. 12, 2004).

because there was no difference in substance, as to operations or existence, between [the foreign corporations] and domestic corporations except for the existence of a [foreign] charter." The Internal Revenue Service ruled that a corporation having a foreign charter is foreign for federal income tax purposes.[6]

What little case law there is supports the conclusion that the determination of nationality depends upon the source of the law under which the corporation or other entity is organized. Thus, in Broadview Savings & Loan Co. v. Commissioner, 10 B.T.A. 725 (1928), the court held that because the Revenue Act of 1921 defined "domestic" as "created or organized in the United States," a bank organized under the laws of Ohio was clearly domestic. Similarly, in Barnett Banks Inc. v. Commissioner, 96 AFTR2d 2005-5595 (5th Cir. 2005)(per curiam), the court held that a building and loan was "domestic" if it was "organized as such under the law of the state of Florida (in this case) or the United States." (Emphasis in original.)

Under this Court's precedents, federal law may be relevant to the interpretation of Minnesota law:

> In cases where the state tax statute is substantially the same as the Federal statute, the construction of the Federal act prior to its adoption by the state is deemed controlling in construing the state statute. Although Federal cases subsequent to our adoption of the income tax

[6] Although private letter rulings have no precedential value according to I.R.C. § 6110, they "reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws" and may provide evidence of the proper construction of the statute. Hanover Bank v. Commissioner, 369 U.S. 672, 686 (1962); Keller v. Commissioner, 725 F.2d 1173, 1182 (8th Cir. 1984) (letter rulings are "entitled to some evidentiary weight" but are not controlling).

> laws of 1933 are not necessarily controlling on this court, they are of persuasive value where we have no decisions to the contrary.

Anderson v. Commissioner of Taxation, 93 NW2d 523, 540 (Minn. 1958). Manpower does not believe that it is necessary to resort to federal law in this case because Minnesota law is unambiguous. But if this Court finds it helpful or necessary to look to federal law, federal law strongly supports Manpower's position.

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. The Minnesota statute, like the federal statute, defines nationality by where an entity is created or organized—a determination that is made by identifying the country (or other governmental unit) that grants the entity its charter (i.e., its right to exist). Therefore, MPF is also a foreign entity for Minnesota tax purposes.

V. The Tax Court Misconstrued the Effect of the Federal Classification Election.

The Tax Court proceeded along a different path from that outlined above. It held that an election by MPF under federal tax law not only resulted in the classification of MPF as a partnership, it also resulted in its nationality changing from foreign to domestic.[7]

Although MPF's classification did change—MPF had been classified as a corporation and, as a result of its election, it became classified as a partnership—that

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[7] The Tax Court also cited federal partnership law. App. 6, 10. There isn't any federal partnership law—i.e., one cannot form a partnership under the laws of the United States. Thus, we assume that the Tax Court intended to rely solely on federal tax law.

change had no effect on MPF's nationality. MPF was foreign before the election and it was foreign after the election.

A. Nationality and Classification Are Separate Concepts for Federal Income Tax Purposes.

In the preceding Section IV of this brief, we discussed the federal tax law concept of nationality. Another important issue under federal tax law relates to classification.

Nationality has to do with the laws under which an entity is created or organized. As discussed above, an entity is either domestic or foreign depending upon the jurisdiction that issues it a charter.

Classification has to do with how a business entity is typed (i.e., classified). There are essentially three possibilities: A business entity may be a corporation, a partnership, or it may be disregarded.[8]

Federal Treasury regulations unequivocally 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, for federal income tax purposes, nationality does not affect classification, nor does classification affect nationality.

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[8] The "disregarded" classification is only applicable to entities having a single owner. Single-owner eligible entities in the United States are typically limited liability companies. These are classified as corporations or are disregarded for federal tax purposes. Minnesota follows the federal classification. Minn. Stat. § 290.01, subd. 3b. For entities such as MPF that have multiple owners, the options are corporation and partnership. Treas. Reg. § 301.7701-2(a).

B. MPF Was a Foreign Eligible Entity and Elected to be Classified as a Partnership for Federal Income Tax Purposes.

The classification of an entity for U.S. federal tax purposes is determined under the following definitions:

> **(2) Partnership and partner.** The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.
>
> **(3) Corporation.** The term "corporation" includes associations, joint-stock companies, and insurance companies.

I.R.C. § 7701(a).[9] Unlike nationality—which has never been controversial under federal law—classification was controversial for many years. See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 2.01[3] (7th ed. 2002). To resolve controversy and to simplify the law, the Treasury Department proposed new regulations in May 1996. IRS Notice 95-14, 1995-1 CB 297. The regulations became final in December 1996. Treasury Decision 8697 (December 17, 1996); see Treas. Reg. §§ 301.7701-2 through -4. The regulations are commonly referred to as the "check-the-

[9] There is no statutory definition of disregarded entities. That classification was created by Treasury Regulations, as discussed below.

box" regulations because they permit some types of entities (i.e., "eligible entities") to elect how they want to be classified by simply "checking a box" on IRS Form 8832.[10]

The classification of a business entity depends in part on how many members it has. The regulations state:

> A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.

Treas. Reg. § 301.7701-2(a). Because MPF has two members, it can be classified as either a corporation or a partnership. It cannot be disregarded.

Some types of business entities are *per se* corporations—they cannot elect to be anything else. The category of *per se* corporations includes an entity organized under a state's corporation laws. Treas. Reg. § 301.7701-2(b)(1). The category of *per se* corporations also includes some types of foreign entities. For example, a *Société Anonyme* organized under French law (i.e., a French publicly-held company) is a *per se* corporation. Treas. Reg. § 301.7701-2(b)(8). An SARL, like an American limited liability company (an "LLC"), is not a *per se* corporation.

If an entity (including an SARL) has at least two members and is not classified as a *per se* corporation, it is an "eligible entity" that "can elect its classification for federal

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[10] The validity of the check-the-box regulations, which have been amended several times, was upheld in a recent decision. Frank Littrielo v. United States, 2005 U.S. Dist. LEXIS 9813 (W.D. Ky. 2005).

tax purposes." Treas. Reg. § 301.7701-3(a). SARLs (which must have at least two members) and multi-member LLCs are eligible entities.

For a domestic eligible entity such as a multi-member LLC, the default classification is "a partnership if it has two or more members." Treas. Reg. § 301.7701-3(b)(1). For a foreign eligible entity such as an SARL, the default classifications are:

> (A) A partnership if it has two or more members and at least one member does not have limited liability;
>
> (B) An association if all members have limited liability; or ... .

Treas. Reg. § 301.7701-3(b)(2)(i).

In 1997 when the regulations took effect, MPF was a foreign eligible entity (an SARL under French law) all of whose members had limited liability. Therefore, its default classification was as a corporation. In 1999, MPF decided to change its classification from the default classification by making an election. The regulations stipulate that such an election must be made on IRS Form 8832. Treas. Reg. § 301.7701-3(c). MPF completed that form by checking two boxes: (1) a box stating that it was changing its current classification; and (2) a box stating that it was a "foreign eligible entity electing to be classified as a partnership." The election was to take effect on July 13, 1999. App. 81-82.

To summarize, MPF was a foreign corporation for federal income tax purposes before the 1999 election. After that election, MPF was a foreign partnership for federal income tax purposes. <u>Its classification for federal income tax purposes changed, but its</u>

nationality remained foreign.[11] For French law purposes, the United States tax classification had no effect. MPF continued to be chartered as an SARL under French law.

C. As a Result of the Election to Be Taxed as a Partnership, MPF Was Deemed to Be Liquidated for Tax Purposes.

Corporations and partnerships are subject to different federal (and state) income tax treatment. Corporations are subject to federal income tax. Partnerships, on the other hand, are flow-through entities—the partnership itself is not subject to tax, but the partners are. If a corporation wants to become a partnership, there is a tax cost to pay. When the shareholders take all of the assets out of a corporation to form the partnership, that is a "liquidation" for tax purposes and gain may be recognized on the appreciated assets.[12]

The check-the-box regulations allow an eligible entity classified as a corporation to be reclassified as a partnership by checking a box, but to insure that no revenue is lost they provide that certain transactions are deemed to occur:

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[11] That there was no change in MPF's nationality as foreign may be relevant for several reasons. For example, I.R.C. § 6038 requires its United States partner (Manpower) to file Form 8865, which provides information about foreign partnerships to the IRS. In addition, withholding might be required on payments to foreign partnerships. Also, transfers of property to a foreign partnership are "outbound transfers" subject to gain recognition and reporting requirements.

[12] A liquidation is treated as a sale or exchange of the assets. I.R.C. § 336. Although this means that gain is realized on any appreciated assets, in general there is no tax due if the liquidating corporation is a subsidiary that is owned at least 80 percent by another corporation, as was the case with MPF. I.R.C. §§ 332 and 337.

> 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).

The regulations also allow an entity classified as a partnership to become reclassified as a corporation by checking a box.[13] The following deemed transactions occur:

> Partnership to association. If an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association [i.e., a corporation] in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

Treas. Reg. § 301.7701-3(g)(1)(i).

Again, it should be emphasized that the classification election does not determine nationality. The 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). Thus, the transactions that are deemed to occur when a classification election is made do not affect nationality. Nationality is

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[13] An entity cannot switch back and forth on an annual basis. In general, there is a 60-month waiting period between classification elections. Treas. Reg. § 301.7701-3(c)(1)(iv).

dependent solely on where the entity is created or organized—which is a question answered by determining which country gave the entity its charter.

Therefore, the following occurred when MPF checked the box: (1) MPF was deemed to have distributed all of its assets and liabilities to its shareholders in liquidation; (2) the members of MPF were deemed to have contributed all of the distributed assets and liabilities to a newly formed partnership; (3) for classification purposes, MPF was converted from a corporation to a partnership; and (4) the nationality of the entity did not change (i.e., it was foreign before the election, and it was foreign after the election) because nothing happened to alter the fact that its charter was granted under French law.

D. Minnesota Generally Follows Federal Law With Respect to Classification.

Minnesota law provides definitions of "partnership" and "corporation" that employ the federal classification scheme:

> **Subd. 3. Partnership; partner.** The terms "partnership" and "partner" have the meanings given in section 7701(a)(2) of the Internal Revenue Code.
>
> **Subd. 4. Corporation.** The term "corporation" shall include every entity which is a corporation under section 7701(a)(3) or is treated as a corporation under section 851(g) or 7704 of the Internal Revenue Code and financial institutions.

Minn. Stat. § 290.01. These statutes incorporate by reference a business organization's classification under federal law.

In response to the adoption of the check-the-box regulations, the Commissioner of Revenue in 1997 issued a revenue notice that stated:[14]

> The Department feels a need to clarify how Treasury Decision (T.D.) 8697, I.R.C. Reg. § 301.7701-2 (Dec. 17, 1996), effective January 1, 1997, will impact the classification of Minnesota business entities under Minn. Stat. § 290.01, subds. 3, 4, and 31. Treasury Decision 8697 simplifies the process of classifying business organizations by allowing businesses to indicate how they would like to be classified. The Department will follow T.D. 8697 with respect to its "check the box" regulation. This will make it easier for entities to classify their business for income and franchise tax purposes.

Revenue Notice 97-03 (March 17, 1997). A year later, the Commissioner issued a revised notice that stated, in relevant part:

> The Minnesota Department of Revenue will follow the "check the box" elections made by either a domestic or foreign eligible entity that is electing to be classified either as an association taxable as a corporation or as a partnership.
>
> The Minnesota Department of Revenue will also follow a "check the box" election made by a domestic eligible entity with a single owner electing to be disregarded as a separate entity.
>
> The Minnesota Department of Revenue cannot recognize the "check the box" election made by a foreign eligible entity with a single "C" corporation owner which is electing to be disregarded as a separate entity for federal tax purposes. Minnesota Statutes, § 290.17, subdivision 4(f), does not permit the net income or the apportionment factors of foreign corporations or foreign entities to be included in a combined report even though they may be part of a unitary business. A foreign corporation that is required to file a return in Minnesota must file on a separate return basis.

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[14] Revenue notices are policy statements of the Commissioner that are published for informational purposes. Unlike tax rules and regulations, revenue notices do not have the force and effect of law and do not have precedential effect, but they may be relied on by taxpayers until revoked or modified. Minn. Stat. § 270C.07.

Revenue Notice 98-08 (May 26, 1998). Thus, the Commissioner recognizes that the Minnesota classification rules follow the federal classification rules, with the sole exception of single-member foreign entities, wholly-owned by C corporations, that elect to be disregarded.

As discussed above, when MPF checked the box on IRS Form 8832, it became classified as a partnership for both federal and Minnesota purposes. For federal purposes, that classification election had no effect on MPF's nationality. MPF was still foreign because it was not "created or organized in the United States or under the laws of the United States or of any State." But the Tax Court found that Minnesota law should be construed differently. We will next examine the flaws in the Tax Court's logic.

E. The Tax Court Wrongly Held that Under Minnesota Law, MPF's Nationality Changed as a Result of its Classification Election.

The Tax Court reasoned as follows. When MPF checked the box on IRS Form 8832, there was a deemed liquidation of MPF as a corporation and a deemed formation of MPF as a partnership. Under Minnesota law, a domestic entity is one "created or organized in the United States or under the laws of the United States or of any State … ." MPF was created or organized in France as an SARL. However, according to the Tax Court, when MPF checked the box, MPF became created or organized under United States tax law because of the deemed liquidation of the corporation and deemed formation of a partnership. App. 23-25.

The Relator does not dispute that the deemed transactions occurred for Minnesota tax purposes as well as for federal tax purposes, but the Tax Court misinterpreted the regulation. The regulation states: "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). The Tax Court erroneously assumed that the "newly formed partnership" would be one "created or organized" under federal law, even though the regulation does not say that.

The Tax Court would have been more accurate if it said that the "newly formed partnership" results as a consequence of federal tax law. But that is not the relevant question. Nationality depends on whose laws the entity in question—whether classified as a corporation or "newly formed partnership"—is created or organized under. Treas. Reg. § 301.7701-3(g)(1), which the Tax Court relied upon, says nothing about the created-or-organized issue.

Why doesn't that regulation address that issue? Because the regulation is a classification regulation, and "[t]he 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).

Treas. Reg. § 301.7701-5(b) contains two examples that, although they involve the unusual circumstance of a dually-chartered entity, may shed some light on the meaning of nationality. In each example, an entity is both (1) created or organized under the laws of a foreign country, and (2) created or organized under the laws of a state.[15] Federal law (like Minnesota law) says that the term "domestic" applies if the entity is created or organized in the United States or under the laws of the United States. All others are foreign. The examples show that an entity created or organized under the laws of a state is domestic, even if it has a second charter that is foreign:

> Example (1). (i) Facts. Y is an entity that is created or organized under the laws of Country A as a public limited company. It is also an entity that is organized as a limited liability company (LLC) under the laws of State B. Y is classified as a corporation for Federal tax purposes under the rules of §§ 301.7701-2, and 301.7701-3.
>
> (ii) Result. Y is a domestic corporation because it is an entity that is classified as a corporation and it is organized as an entity under the laws of State B.
>
> Example (2). (i) Facts. P is an entity with more than one owner organized under the laws of Country A as an unlimited company. It is also an entity that is organized as a general partnership under the laws of State B. P is classified as a partnership for Federal tax purposes under the rules of §§ 301.7701-2, and 301.7701-3.
>
> (ii) Result. P is a domestic partnership because it is an entity that is classified as a partnership and it is organized as an entity under the laws of State B.

Treas. Reg. § 301.7701-5(b). For purposes of this case, what is noteworthy is that the only factor relevant to determining nationality is whether the entity is organized under

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15 The phenomenon of dually-chartered entities is a relatively new one. When it adopted temporary regulations to address the issue, the IRS noted: "Several jurisdictions have recently enacted provisions (generally referred to as either continuance or domestication statutes) that make it possible for a business entity to be treated as created or organized under the laws of more than one jurisdiction at the same time (a dually chartered entity)." Treasury Decision 9153, 69 Fed. Reg. 49809 (Aug. 12, 2004). MPF is not dually chartered. It is chartered only in France.

United States or state law. In example (1), an entity "organized as a limited liability company (LLC) under the laws of State B" is domestic. In example (2), an entity "organized as a general partnership under the laws of State B" is domestic. The examples don't talk about whether a check-the-box election had been made, because such an election is irrelevant to the issue of nationality.[16]

Minnesota law is parallel to federal law and should be similarly construed. Simply because a "newly formed partnership" results <u>as a consequence</u> of a federal election, that does not mean that the entity has a new nationality. If its charter has not changed—if a French SARL remains a French SARL after making the classification election—then it remains a foreign entity.[17]

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16 Treas. Reg. § 301.7701-5 technically does not apply to the years in issue. However, when the regulation was first proposed, the Treasury Department stated that the regulations "clarify current law and do not change the outcome that would result under a proper application of the existing rules as they apply to dually chartered entities." Treasury Decision 9153, 69 Fed. Reg. 49809, at 49810 (Aug. 12, 2004). It also noted:

> 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.

Id. at 49809. Thus, federal law applicable to the years in issue was that nationality was determined separately from classification.

17 It is important to emphasize that one cannot charter a business entity, such as a corporation or a partnership, under federal tax law. Also, there is no federal corporation or partnership statute of general application. There are federal statutes for chartering certain types of business entities, such as national banks. See Title 12 of the United States Code. However, most business entities in the United States are established under state law.

F. The Tax Court's Holding, if Affirmed, Would Erode the Water's Edge.

If the Tax Court were correct, many eligible entities organized under the laws of foreign countries would be considered domestic for Minnesota tax purposes. Over time, an increasing number of such entities would be so classified. As a consequence, the water's edge would be severely eroded.

Why is this so? As noted above, each foreign-chartered eligible entity (with more than one member) has a default classification: corporation if all members have limited liability; partnership if at least one member does not have limited liability. Treas. Reg. § 301.7701-3(b)(2)(i). Under the Commissioner's theory if pushed to its logical limit, every entity created under foreign law might be considered domestic because (1) every such entity became classified under the federal tax law default rule on January 1, 1997 (or on the day it was organized, if later), and (2) the entities might, as a result, be considered "formed" under federal law. The Commissioner has not pushed his theory to the logical limit, at least not yet. Therefore, every foreign-chartered entity presumably started out foreign when the check-the-box regulations were adopted.

However, if a foreign entity did not like its default classification and if it elected to change, then the deemed transaction rules would apply. Many foreign entities have made such elections. Under the holding of the Tax Court, such an election transforms the foreign entity into a domestic one. Under the federal regulations, an entity can make a new election every 60 months. Suppose that an entity decides to change back to the default classification—would it once again become foreign under the Tax Court's analysis? No, because every election—partnership to corporation, or vice versa—

involves deemed transactions. Therefore, once an initial election is made, the entity would be forever domestic under the Tax Court's holding. Over time, assuming that most entities will want to make an election at some point, most foreign eligible entities will become domestic for Minnesota income tax purposes.

As discussed above, the water's edge limitation is supposed to exclude foreign entities from Minnesota combined reporting. The Tax Court's holding, if affirmed, will substantially undermine the water's edge limitation and, over time, may almost completely eviscerate it for eligible entities.

G. The Tax Court's Holding Is Inconsistent With Revenue Notice 98-08.

As noted above, Revenue Notice 98-08 states that if a single member foreign eligible entity, that is wholly-owned by a domestic C corporation, makes an election to be disregarded as a separate entity, the Commissioner cannot recognize the election. The reason why he cannot recognize the election is: "Minnesota Statutes, § 290.17, subdivision 4(f), does not permit the net income or the apportionment factors of foreign corporations or foreign entities to be included in a combined report."

When an entity is disregarded for tax purposes, it is as if it did not exist. Instead of being a separate wholly-owned entity (in the nature of a subsidiary), it is treated as if it were just a division (i.e., not an entity at all). In its revenue notice, the Department recognized that if a foreign-chartered entity were disregarded, its income and factors would be taken into account by the domestic parent. It also recognized that this would be contrary to Minn. Stat. § 290.17, subd. 4(f), presumably because: (1) the entity is still an entity, even if United States tax law treats it as disregarded; (2) the entity is still foreign, even though the disregard election is a deemed liquidation into a domestic C corporation under Treas. Reg. § 301.7701-3(g)(1)(iii); and (3) Minnesota law states that the income and apportionment factors of foreign entities must be excluded from the combined report of a unitary business.

If the Tax Court's holding were correct, then Revenue Notice 98-08 would have to be rescinded. The Court's holding, which treats the deemed transactions as controlling for determining nationality, is inconsistent with the revenue notice, which does not treat the deemed liquidation of the disregarded entity to be controlling for purposes of nationality. In other words, if the deemed liquidation of the single-member foreign entity were controlling, then the income and apportionment factors of that entity would have to be included on its C corporation parent's combined report.

H. The Tax Court Drew a False Analogy to Federal Consolidated Returns.

The Tax Court observed, in support of its holding, that treating MPF as a domestic entity would result in treatment under Minnesota law parallel to treatment under the "United States system of consolidated reporting with respect to the taxation of foreign entities." App. 26. It noted that foreign corporations are excluded from federal consolidated returns and from Minnesota combined reports, so MPF was excluded from both when it was classified as a corporation. It also noted that income from a foreign partnership was included in Manpower's federal consolidated return, so it was "consistent that it is similarly included in Manpower's combined Minnesota return." App. 26.

One problem with this reasoning is that it assumes that Minnesota has adopted the same tax policies as the United States. That assumption is incorrect. Minnesota, like many states, employs the unitary business principal which has been modified by the water's edge limitation (i.e., the unitary business stops at the water's edge). Minnesota does not tax the income of foreign corporations or other foreign entities unless they are doing business in Minnesota. The United States does not employ the unitary business principal and thus does not have a water's edge limitation.

Thus, the United States and Minnesota take different approaches to the taxation of foreign partnership income. For federal income tax purposes, income from a foreign partnership flows through to a United States partner who reports the income on its return. Although Minnesota net income is initially defined by reference to federal taxable income pursuant to Minn. Stat. § 290.01, subd. 19, income from a foreign entity (which would include a foreign partnership) must not be included in unitary business income. Minn. Stat. § 290.17, subd. 4(f) and (h). The water's edge limitation, which doesn't exist under federal law, keeps the foreign partnership income off the Minnesota return. Federal tax law and Minnesota tax law are not consistent in this respect.

A second problem with the Tax Court's reasoning is that it assumes that the Legislature intended Minnesota combined reporting to be parallel to federal consolidated reporting. That is also a false assumption.

Combined reporting is required (as the Commissioner determines) by corporations engaged in a unitary business. Minn. Stat. § 290.17, subd. 4(j). Consolidated return filing is not required under federal law—it is a privilege granted by the Code that may be exercised if all members of an affiliated group consent. I.R.C. § 1501.

Combined reporting is a way for Minnesota to tax (and properly apportion) the entire income of a unitary business, a term that refers to "business activities or operations which result in a flow of value between them." The term "unitary business" may be "applied within a single legal entity or between multiple entities and without regard to whether each entity is a sole proprietorship, a corporation, a partnership or a trust." Minn. Stat. § 290.17, subd. 4(b). Federal tax law has no "unitary business" concept and consolidated returns have nothing to do with properly apportioning income.

A unitary business requires unity of ownership, which is not deemed to exist unless a corporation is a member of a group of two or more business entities and more than 50 percent of the voting stock of each member of the group is directly or indirectly owned by a common owner or by common owners. Minn. Stat. § 290.17, subd. 4(e). The 50 percent test can be met in a parent-subsidiary or in a brother-sister relationship. Under federal law, there must be a common parent corporation for consolidated returns to be filed (i.e., brother-sister companies may not file consolidated returns unless they are owned by a common parent company). Also, there is an 80 percent test measured not only by vote, but also by value. I.R.C. § 1504(a).

Foreign corporations cannot be included on a Minnesota combined report. Minn. Stat. § 290.17, subd. 4(f) and (h). Although in general foreign corporations are not included on federal consolidated returns either, some foreign corporations are includible. I.R.C. § 1504(d).

Under Minnesota law, a domestic corporation qualifying as a "foreign operating company" (i.e., at least 80 percent of its property and payroll is foreign) is not includible on a combined report. Minn. Stat. § 290.17, subd. 4(f) and (h). A "foreign operating company" generally will be includible on a federal consolidated return because it is domestic. I.R.C. § 1504.

The differences between Minnesota combined reports and federal consolidated returns are simply too numerous to elucidate here. Combined reports and consolidated returns have different membership rules, compute income differently, and exist for different purposes. The Tax Court therefore improperly relied upon "parallelism" to buttress its erroneous holding.

CONCLUSION

The United States Supreme Court once observed:

> After thirty years of income tax history the volume of tax litigation necessary merely for statutory interpretation would seem due to subside. That it shows no sign of diminution suggests that many decisions have no value as precedents because they determine only fact questions peculiar to particular cases. ... No other branch of the law touches human activities at so many points. It can never be made simple, but we can try to avoid making it needlessly complex.

Dobson v. Commissioner, 320 US 489, 494-495 (1943). Manpower respectfully suggests that the question of nationality is a relatively simple one (as tax issues go), but that the Tax Court made the question needlessly complex.

For federal tax purposes, the rule of law is that nationality depends on which government granted an entity its charter. Minnesota's statute is parallel to the federal statute in establishing nationality by where an entity is created or organized. Therefore, the rule in Minnesota should also depend on which government granted an entity its charter. That rule is compelled by the plain language of the statute, and it also effectuates the legislative purpose underlying the water's edge limitation.

For the foregoing reasons, Manpower respectfully asks this Court to reverse the Tax Court's holding that MPF became a domestic entity when it checked the box to be classified as a partnership. MPF was a foreign entity before and after it checked the box. Pursuant to Minn. Stat. § 290.17, subd. 4(f) and (h), the income and apportionment factors of MPF must not be included on the combined report filed by Manpower.

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Walter A. Pickhardt, #86782
Lisa R. Pugh, #287714
Faegre & Benson, LLP
2200 Wells Fargo Center
90 South Seventh Street
Minneapolis, Minnesota 55402
(612) 766-7000

Attorneys for Manpower Inc.

M1:1309492.13

CERTIFICATE OF COMPLIANCE

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

The undersigned certifies that the Brief submitted herein contains 9,673 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.

Walter A. Pickhardt