No. A17-0923

SUPREME COURT
STATE OF MINNESOTA

Commissioner of Revenue,
Relator,
vs.
Associated Bank, N.A. and Affiliates,
Respondents.

BRIEF OF AMICUS CURIAE MULTISTATE TAX COMMISSION IN SUPPORT OF RELATOR

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

Regulations

Other Authorities

INTEREST OF THE *AMICUS CURIAE*[1]

The Multistate Tax Commission (the Commission) was created in 1967 by the Multistate Tax Compact (the Compact). *See RIA All States Tax Guide*, ¶ 701 *et seq*. (RIA 2005).[2] The goal of the Commission is to preserve state tax sovereignty and to promote uniformity, fairness, and efficiency in state taxation of multistate businesses. The purposes of the Compact are: (1) facilitating proper determination of state and local tax liability of multistate taxpayers, including equitable apportionment of tax bases and settlement of apportionment disputes; (2) promoting uniformity or compatibility in significant components of tax systems; (3) facilitating taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration; and (4) avoiding duplicative taxation. *See Multistate Tax Compact*, Art. I.[3] Minnesota was a signatory to the Compact from 1983 until 2013. *See generally Kimberly-Clark Corp. & Subsidiaries v. Commissioner of Revenue*, 880 N.W. 2d 844 (Minn. 2016).

Today, forty-eight states and the District of Columbia participate in various activities of the Commission including uniformity efforts, joint audits, multistate voluntary disclosure, training, and research. Sixteen states have legislatively established

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[1] No counsel for any party authored this brief in whole or in part. Only *amicus curiae* Multistate Tax Commission and its member states, through the payment of their membership fees, made any monetary contribution to the preparation or submission of this brief. This brief is filed by the Commission, not on behalf of any particular member state

[2] The validity of the Compact was upheld in *United States Steel Corp. v. Multistate Tax Commission*, 434 U.S. 452 (1978).

[3] *Available at* http://www.mtc.gov/The-Commission/Multistate-Tax-Compact (last visited July 7, 2017).

full membership. Seven additional states are sovereignty members and twenty-six are associate members.[4]

In the half-century since the Compact became effective, the Commission has researched, analyzed and developed model rules promoting fair and efficient application of state income taxes to multistate businesses. The Commission also files briefs as *amicus curiae* in significant state tax cases which present an opportunity to clarify the law and improve tax administration. The Commission submits this brief as *amicus curiae* in support of the Commissioner of Revenue (the commissioner) in order to further the Compact's goals of facilitating the proper determination of tax liability and promoting uniformity in application of common statutory provisions.

The common statutory provisions at issue in this case concern formulary apportionment, the method all states use to determine what portion of a multistate business's income can be taxed by a state in which the business operates. Minnesota's Corporate Franchise Tax employs separate statutory apportionment formulas, a general formula and one for financial institutions. *See* Minn. Stat. § 290.191. Minnesota's tax code also provides that these formulas can be modified when necessary in order to fairly reflect how much income was generated in the state. Minn. Stat. § 290.20, subd. 1, a provision found in virtually all state apportionment systems, provides for "equitable allocation" and is patterned after Section 18 of the Uniform Division of Income for Tax

[4] The Commission's current membership can be found here: http://www.mtc.gov/The-Commission/Member-States (last visited July 20, 2017).

Purposes Act (UDITPA).[5] This authority to modify the statutory formula is essential to the proper operation of any apportionment system. Without this authority, taxpayers with unconventional business structures or those engaged in new or emerging industries might either escape fair taxation, giving them an unfair advantage over competitors, or be forced to pay too much given the actual scope of their business activity within in the state.

ARGUMENT

The commissioner properly used § 290.20 to apply the financial institution allocation rules to allocate income of LLCs where that income was generated entirely by the activities of the LLCs' ultimate owner, a financial institution.

The sole question in this case is whether § 290.20 allows the state to modify the formula to so that interest income from loans made by a financial institution held in LLCs controlled by the financial institution is apportioned using the formula for financial institutions, rather than the general apportionment formula, which excludes interest.

Most corporate taxpayers are subject to what we are calling the general allocation formula. Minn. Stat. § 290.191, subd. 2. Associated Bank and Affiliates (the bank) are a unitary group of corporations treated as financial institutions under Minnesota law. As

[5] Virtually all states which impose taxes on business entities use the basic structure of UDITPA, but many states, including Minnesota, have determined that parts of the formula— developed in 1957—needed updating. *See* Laws 1987, C. 268, Art. 1, § 74. In 2014 the Commission recommended amendments to Compact Articles III and IV which reflected many of the policy choices made the Minnesota legislature almost three decades earlier. Those changes to the Compact, while significant, are not directly related to the issues in this appeal. *See generally* http://www.mtc.gov/Uniformity/Article-IV (last visited July 20, 2017).

such, the bank is subject to the separate statutory allocation formula, Minn. Stat. § 290.191, subd. 3, designed to fairly allocate the income of businesses in that specialized industry.[6] The major difference between the two formulas is the latter includes interest in the sales factor—for the obvious reason that earning interest is a significant component of many financial institutions' economic activity—while interest earnings are excluded from the measure of allocable sales for all other businesses.

Under Minnesota's franchise tax, when the earnings of an LLC, treated as a partnership for tax purposes, flow through and are taxed to a corporate owner, a proportional amount of the partnership's allocation factors also flow through. If the partnership is in the same "unitary" business with the corporate owner, the factors are then combined with the corporate owner's own allocation factors for that unitary business. The combination of the factors determines the corporate owner's allocation percentage. Minn. Stat. § 290.17, subd. 4.

The statutory definition of a "financial institution"[7] references only "corporations." Therefore, the parties agree that the LLCs are not "financial institutions." The Tax Court determined that the income generated by the LLCs, therefore, could not be allocated using the rules for financial institutions. (Add. 10.) But it is important to note that the LLCs engaged in no business activity other than holding the loans and had no employees, physical property, or other sources of income. The application of the general

[6] Minn. Stat. § 290.191, subs. 3, 6, 8, & 11 are only applicable to financial institutions; Minn. Stat. § 290.191, subds. 2 & 5 are only applicable to "general" (non-financial) businesses, while all or portions of subs. 1 (general rule), and subs. 9 (property factor), 10 (property factor) & 12 (payroll factor) apply to both.

[7] Minn. Stat. § 290.01, subd. 4a. (The statutory definition was amended in 2017.)

formula to a significant pool of income generated by the activities of a financial institution—that is the making of loans to customers in the state—has clearly triggered a misfire of the allocation system in this case, preventing the fair calculation of the bank's income earned in Minnesota. Minn. Stat. § 290.20 authorizes the tax commissioner to modify the allocation formula to correct such misfires. The tax court's ruling, that the commissioner exceed her authority under Minn. Stat. § 290.20, is therefore in error.

A. The tax court created exceptions to Minnesota's equitable allocation statute that are nowhere in the text of that statute and belong in the province of the legislature.

Minnesota statute § 290.20, sub. 1, provides that where the statutory apportionment methods "…do not fairly reflect all or any part of taxable net income allocable to this state…the commissioner may require…the use of another method, if that method fairly reflects net income." The statute further provides that the allocation methods described in § 290.191—a general formula for most businesses and a separate formula for financial institutions—are "…presumed to determine fairly and correctly the taxpayer's net taxable income allocable to this state."

The statute by its terms calls for a reviewing court to make two determinations: (1) did the party seeking to modify the formula overcome the statutory presumption that application of one of the two statutory formulas would fail to "fairly and correctly" reflect the net income that should be allocated to the state; and (2) did the moving party demonstrate that its proposed alternative method "fairly reflects net income."

A significant amount of state tax jurisprudence addresses the application of these same two determinations.[8] But this case is uncommon in that neither determination is apparently at issue on appeal. While the tax court concluded that the tax commissioner did not rebut the presumption under § 290.20, it made clear that the commissioner could not have prevailed under any set of facts. (Add. 13.) The Respondent's Statement of the Case does not take issue with the tax court's finding that the taxpayers' use of the standard apportionment for its partnership income constituted a "loophole" in Minnesota tax code. (Add. 13-14.) Nor did the tax court make any finding that the state's chosen alternative of allocating this income using the rules applicable to financial institutions would not fairly measure the bank's net income generated from its activities in Minnesota. Instead, the tax court effectively held that there are two implied exceptions to the statute, a "legislative judgments" exception and a "look-through" exception. *Id.* These exceptions precluded the court from finding in favor of the commissioner.

The first implied exception the tax court found can be traced to a misapprehension of the role of equitable allocation and apportionment statutes in the context of state corporate taxing systems, and is addressed in subsections 1-2 below. The second implied exception the court found appears to be based on an overly-broad reading of this court's decision in *HMN Financial, Inc. v. Commissioner of Revenue,* 782 N.W.2d 558 (Minn. 2010) and is addressed in Section B, below.

[8] *See* Walter Hellerstein & John Swain, *State Taxation*, ¶¶ 9.15, 9.20 (3d ed. 2012) (collecting cases).

1. Minnesota's equitable allocation statute represents the legislature's judgment that the general allocation formula will not always fairly and correctly reflect the portion of income generated in the state.

The tax court reasoned that allocating the LLCs' interest income passed through and taxed to the bank using the same financial institution allocation rules applied to the bank's other income exceeded the authority granted by Minn. Stat. § 290.20, because the definition of "financial institution" a "corporation" was the expression of an immutable legislative judgment. (Add. 13) The non-sequitur lurking in the tax court's reasoning is plain—while application of the general apportionment formula to all partnership income does express a legislative judgment, so does Minn. Stat. § 290.20. If § 290.20 can never be applied because the statutory apportionment formula represents an immutable legislative judgment, then the provision would be a nullity.[9]

The Commission does not accept the premise that there is a conflict between legislative judgments in this case. But even if that were true, that conflict must be resolved in favor of the application of § 290.20 since, as a remedial statute, it embodies the overriding legislative goal of ensuring that the state's allocation system is applied in a manner that fairly reflects the income generated in the state.

The argument that equitable apportionment provisions cannot override certain "legislative judgments" has been made before, but it has not been adopted by any appellate court to date. *See, e.g., BellSouth Advertising & Publishing Corp. v. Chumley*,

[9] Minn. Stat. § 290.20 does have a legislatively-created exception to its application, found in subdivision 2 of the statute, which prohibits the Commissioner from adjusting the "general" apportionment formula for taxpayers engaged in certain extractive industries.

308 S.W.3d. 350 (Tenn. Ct. App. 2009); *Vodafone Americas Holdings, Inc. & Subs. v. Roberts*, 486 S.W.3d 496 (Tenn. 2016)*; Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169 (Cal. 2006).

Indeed, the broad formulations of the possible modifications set out in the text of Minn. Stat. § 290.20 foreclose any interpretation that there may be implied immutable legislative judgments where the authority it grants is void. For example, there is arguably no legislative policy more fundamental to state corporate income tax than the decision to use formulary apportionment instead of the alternative—separate geographic accounting, which employs arms-length transactional accounting on a geographic basis. *See, e.g.*, *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-121 (1920). Yet, paragraph (1) of § 290.20 subd. 1 expressly authorizes the use of separate accounting if necessary to fairly determine in-state income. Similarly, paragraph (2) authorizes exclusion of one or more factors from the formula, while paragraph (3) authorizes creation of entirely new factor. Paragraph (4) goes even further and expressly provides a blanket authorization to use "some other method" to achieve fair apportionment. These broad remedial authorities cannot be reconciled with a narrow reading of the statute's reach.

There is no question of overreach here. The commissioner seeks only to use a formula that is appropriate to the income at issue. That formula for financial institutions has already been blessed by the legislature. But, in any case, the Commission does not argue that the authority granted under statutes like § 290.20 is or should be unlimited. In *Twentieth Century-Fox Film Corp. v. Department of Revenue*, 700 P.2d 1035, 1043 (Or.

1985), the court identified three criteria for determining whether an alternative formula is "reasonable" under UDITPA's § 18 (§ 290.20 uses the phrase "…fairly reflects net income" instead of "reasonable"):

> (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in [the state].

Similarly, in *Appeal of Crisa Corp*., 2002 WL 1400003 (Cal. St. Bd. Equal.), the California State Board of Equalization listed five non-exclusive circumstances in which equitable apportionment may be appropriate. Two of those potential circumstances are particularly applicable: (1) a business entity doing substantial business in the state without any in-state apportionment factors; and (2) inclusion of an apportionment factor with no numerator or denominator in any state. As discussed further below, all the circumstances identified in these decisions support the commissioner's conclusion in this case that equitable allocation was warranted.

2. The provision for equitable allocation and apportionment is an integral part of all tax systems based on formulary apportionment, ensuring that income will be fairly apportioned.

As the drafters of UDITPA noted decades ago, no one apportionment formula can possibly reflect where income generation occurs for every type of business imaginable. Two of the principal architects of UDITPA explained the need for equitable apportionment in an oft-cited 1967 law review:

> [U]nusual situations, which should be excepted from the application of general rules, frequently arise. Such situations may be impossible to anticipate or difficult to describe with sufficient precision to permit drafting of a provision in the statute setting forth precisely the rules to be applied. Accordingly, it is common in allocation statutes to include a general relief provision authorizing the administrator to depart from the general rule if necessary to obtain fair or equitable results.[10]

The inclusion of an alternative apportionment provision was intended to give "[B]oth the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved." William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 748 (Oct. 1957).

[10] Frank M. Keesling & John S. Warren, *California's Uniform Division of Income for Tax Purposes Act (Part I)*, 15 U.C.L.A. L. Rev. 156, 170 (1967).

The official comments to UDITPA, as amended in 1966, likewise make clear that the drafters expected Section 18 provisions to be invoked frequently in a variety of contexts. The comment to Section 18 provides in part:

> Section 18 is intended as a broad authority, within the principle of apportioning business income fairly among the states which have contact with the income, to the tax administrator to vary the apportionment formula and to vary the system of allocation where the provisions of the Act do not fairly represent the extent of the taxpayer's business activity in the state. The phrases in Section 18(d) do not foreclose the use of one method for some business activity and a different method for a different business activity. Neither does the phrase "method" limit the administrator to substituting factors in the formula. The phrase means any other method of fairly representing the extent of the taxpayer's business activity in the state.[11]

UDITPA's generally-applicable apportionment formula was designed for the mercantile and manufacturing economy,[12] and was never intended to apply to financial institutions, which were explicitly exempted from the Act's operation.[13] Minnesota's adoption of two statutory apportionment formulas—one for financial institutions, and a

[11]Uniform Division of Income for Tax Purposes Act, National Conference of Commissioners of Uniform State Laws, Comments Amended 1966, available at: Uniform Law Commission, http://www.uniformlaws.org/shared/docs/uditpa/uditpa66.pdf (last visited July 20, 2017).

[12] John A. Swain, *Reforming the State Corporate Income Tax: A Market State Approach to the Sourcing of Service Receipts*, 83 Tulane L. Rev. 283, 299 (2008).

[13] Uniform Division of Income for Tax Purposes Act, Section 2.

second formula applicable to all other business activities—is not unusual. Minnesota is one of twenty-two states to conclude that the "standard" method for apportioning income for businesses generally would be inappropriate for financial institutions. Some states have adopted entirely separate taxing provisions, while other states, like Minnesota, have modified their apportionment formula by statute, while still others have relied on regulations promulgated under authority of their codifications of UDITPA's Section 18.[14] In 1994, the Commission adopted what has become a widely-followed model for apportioning the income of financial institutions, in cooperation with industry representatives, state taxing authorities and the practitioner community.[15] Minnesota's statutory formula uses much of the same terminology as the Commission's model and reflects the same economic and practical judgments as to how income is earned.

There is a significant difference in the application of the general allocation formula and the financial institution formula in this case. Because interest is excluded from the sales factor under Minn. Stat. § 290.191(a)(1), the LLCs would have no sales factor at all. Moreover, the difference results here solely because LLCs hold the loans and not because their activity created the loans. It bears repeating that the LLCs had no employees or business operations of any kind. The LLC's property factor is similarly

[14] CCH Multistate Income Tax Charts, *Apportionment Formulas for Specific Industries.*(CCH, Inc. 2017); *See also* Hellerstein, *State Taxation*, ¶.10.08[3] (financial institution apportionment).

[15] Formula for the Apportionment and Allocation of Net Income of Financial Institutions Amended by the Multistate Tax Commission-July 29, 2015, *available at*: http://www.mtc.gov/getattachment/Uniformity/Adopted-Uniformity-Recommendations/Financial-Institutions-Apportionment-Rule-Amended-2015.pdf.aspx (last visited July 20, 2017).

affected. Under the general formula, the LLCs would also have no property factor. Instead of including the value of loan portfolios and assigning that property to Minnesota based on the location of real property securing those loans, the loans would be excluded. So the difference here is between apportioning the income which passes through the LLCs using sales and property factor percentages equal to 100 percent (applying the financial institutions allocation formula), or sales and property factors equal to 0.0 percent (applying the general formula).

Because the bank uses the financial institutions allocation formula for the rest of its income, there is always the possibility of distortion from the use of two different formulas. For this reason, many states prohibit the combination of financial and non-financial corporations on a single return. The authors of the leading treatise on state taxation conclude state: "Combined reporting typically is not practicable for corporations that are subject to different apportionment methods, even if they are engaged in a unitary business."[16] The statutory basis for passing through the allocation factors of the LLCs' to the bank is the same as the basis for combining the income of unitary corporations in Minnesota.[17] So using the same financial institutions allocation formula for the LLCs' income avoids distortion and leads to a fair reflection of income.

The case of *Microsoft Corp. v. Franchise Tax Bd.* is instructive even though the situation creating the distortion was somewhat reversed. In that case, the taxpayer argued

[16] Hellerstein, *State Taxation*, ¶ 10.08[06].

[17] *See Minnesota Revenue Ruling* 08-03 (2/19/2003), available at: www.revenue.state.mn.us/law_policy/revenue_notices/RN_08-03.pdf (last visited July 20, 2017).

that it was entitled to mix receipts from two different types of activity in the sales factor apportionment since both arose out of the taxpayer's unitary business. 139 P.3d 1169 (Cal. 2006). The court noted that, "[t]his situation, when one mixes apples — the receipts of low-margin sales — with oranges—those of much higher margin sales — presents a problem for the UDITPA." *Microsoft* at 768. The California Supreme Court had no difficulty in upholding the state's equitable apportionment authority to prevent taxpayers from exploiting what would otherwise be a "loophole" in the taxing system.

In short, the state clearly met its burden of demonstrating that the alternative methodology applied here more fairly reflected the income from loans, given that the Minnesota legislature has already determined that entities generating such income ought to include interest receipts and loan values in the sales and property factors. Moreover, the factors discussed in *Twentieth Century-Fox Film Corp., supra,* are met. The application of Minnesota's equitable allocation formula was necessary to fairly represent the taxpayer's business activity in the state, doing so would not result in "double taxation" (and would in fact avoid a substantial amount of income being assigned to "nowhere"), nor would it result in a lack of uniformity among the states, and it would "fairly reflect the economic reality of the business activity engaged in by the taxpayer." *Twentieth Century*, 700 P.2d at 1043.

In part, it appears the tax court did not consider these types of factors because it concluded that the commissioner "could not evade *HMN Financial's* look through provision and Minn. Stat. § 290.20's statutory presumption in in this way." Add. 13. The next section addresses this "look-through" exception.

B. The application of Minnesota's equitable allocation statute to distortion arising from intercompany transactions is not foreclosed by *HMN Financial*, and to the extent that decision could be so interpreted, this court should clarify its earlier holding.

HMN Financial does not preclude the commissioner from applying Minn. Stat. § 290.20 here simply because the amount of the bank's income subject to tax has been reduced through permissible transactions with related parties. There is no such exception in the text of the statute and *HMN Financial* did not create it. Fairly read, the opinion in *HMN Financial* held that Minn. Stat. § 290.20 could not be used to impute one entity's taxable income to another entity. Courts in other jurisdictions have reached similar conclusions regarding the inapplicability of equitable apportionment statutes to disputes over the taxable base.[18] But the commissioner is not imputing the income of the LLCs to the bank, nor is that necessary. All of the LLCs' income is income of the bank for tax purposes. That income was properly reported by the bank as part of its taxable income. The only question is whether the definition of "financial institution" should be read so as to preclude the use of the equitable allocation authority to apply the financial institution allocation formula to interest income taxed to the bank simply because the loans which generated that income were held by LLCs.

We are unable to find other any case suggesting that LLC income received by a taxable corporation is beyond the reach of equitable allocation or apportionment statutes. Such an exception, were this court to create one, would run counter to accepted principles of income apportionment. *Cf. Mobil Oil v. Commissioner of Taxes of Vermont*, 445 U.S.

[18] *See, e.g., Appeal of Crisa Corp.*, 2002 WL 1400003 (Cal. St. Bd. Equal.)

425, 440 (1980)("One must look principally at the underlying activity, not at the form of investment, to determine the propriety of apportionability.")

The tax court's determination does suggest, however, that this court may need to clarify its holding in *HMN Financial.* The proper apportionment of income earned by entities taxed on a pass-through basis is of critical importance to the states because of the explosive growth in such entities in recent years. That growth can be attributed in part to the U.S. Treasury's 1996 "check the box" regulations,[19] which greatly expanded the range of business entities entitled to "pass-through" treatment. Combining of factors of pass-through entities with the factors of taxable corporations is now a common aspect of state income tax allocation and apportionment. Any decision which suggests that taxpayers can successfully use pass-through structures to manipulate apportionment outcomes within a state is therefore, of great concern.

The tax court also reasoned that it is up to the legislature to address problems with the allocation formula that may be created by the use of pass-through structures. But it is not reasonable to expect that any legislature can or should anticipate all the various means by which corporate structures may result in misallocation of income. This is the very recognition that led to the adoption of the remedial authority embodied in UDITPA's Section 18, by which the Minnesota legislature has also provided for fair results in a variety of unforeseeable circumstances.

[19] 26 C.F.R. § 301.7701-3.

CONCLUSION

It is hard to imagine a case in which the use of equitable allocation authority is more fitting. Here, the income and the formula used to allocate it were simply mismatched. The formula applied by the commissioner is the one adopted by the legislature to be applied to such income. The failure to apply that formula results in a significant difference the income allocated to the state. And, no other state claims the income that would be allocated to Minnesota, so there would be no multiple taxation if the modification asserted here were upheld. Given these circumstances, the ruling of the tax court should be reversed.

Dated: July 20, 2017

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume limitations of Rule 132.01, subdivision 3(c)(1) because this brief contains 4,557 words, excluding the parts of the brief exempted by Rule 132.01, subdivision 3.

2. This brief complies with the typeface requirements of Rule 132.01, subdivision 1 because this brief has been prepared in a proportionally spaced typeface using Microsoft Word in 13 point Times New Roman.

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CERTIFICATE OF SERVICE

The undersigned certifies that on July 20, 2017, a copy of the foregoing brief was electronically filed via the EMACS system and caused to be served via first class mail postage prepaid addressed to the following last-known addresses of record:

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