
STATE OF MINNESOTA
IN SUPREME COURT

John & Deborah Billion,

Relators,

vs.

Commissioner of Revenue,

Respondent.

RELATORS JOHN AND DEBORAH BILLION'S
BRIEF

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LEGAL ISSUE

When the Legislature prescribes how a non-resident is to be taxed, can the Commissioner impose a different treatment? The Tax Court held the Commissioner could disregard the treatment proscribed by Minnesota Statutes

Minn. Stat. 290.03

Minn. Stat. 290.01 subd. 22 (2),

Minn. Stat. 290.06 subd. 2c (e).

STATEMENT OF THE CASE

By Order dated August 27, 2010, the Commissioner assessed additional Minnesota individual income tax against John and Deborah Billion for tax year 2007. On October 20, 2010 the Billions contested that Order by filing a Tax Court Notice of Appeal. Addn. 1.

The parties filed cross motions for Summary Judgment. On November 7, 2011 the Honorable Kathleen H. Sanberg, Judge of the Minnesota Tax Court, denied the Billions' Motion for Summary Judgment and granted the Commissioner's Motion for Summary Judgment. Addn. 2. Entry of the order was stayed 15 days. Addn. 2. The order was entered on November 22, 2011. Addn. 2. The Billions then timely filed a petition for certiorari with this Court on December 28, 2011.

The issue in this case was whether John Billion's Minnesota Subchapter S

losses from 2005 could be carried forward and offset Minnesota income realized in 2007. The Tax Court ruled that the losses could not be carried forward. The Billions appeal that ruling.

STATEMENT OF FACTS

The Appellants were South Dakota residents for calendar years 2005-2007.¹ During the calendar years 2005-2007, inclusive, John Billion owned stock in Dignified Assisted Living (“DAL”) (EIN 41-1900267).² DAL is a Subchapter S corporation.³ DAL’s income and losses are 100% Minnesota sourced.⁴ DAL, since its inception, has conducted its business solely in Minnesota.⁵ During the calendar years 2005-2007, inclusive, John Billion did not participate in the operations of DAL.⁶ During the calendar years 2005-2007, inclusive, Deborah Billion owned stock in Kelly Inns, Inc. (“Kelly”) (EIN 46-0379828).⁷ Kelly is a Subchapter S corporation.⁸ Kelly conducts business both in and outside of Minnesota.⁹ Deborah Billion’s Minnesota income is her allocable share of income from Kelly’s operations in Minnesota.¹⁰ During the calendar years 2005-2007, inclusive,

¹Affidavit of John Billion. Affidavit of Deborah Billion.

²Affidavit of John Billion.

³Exhibits 1, 2, & 3.

⁴Affidavit of John Billion; Exhibits 1, 2, & 3.

⁵Affidavit of John Billion.

⁶Affidavit of John Billion.

⁷Affidavit of Deborah Billion.

⁸Exhibits 4, 5, & 6.

⁹Affidavit of Michael M. Billion #21; Exhibits 4, 5, & 6.

¹⁰Exhibits 4, 5, & 6 (Schedule KS).

Deborah Billion did not participate in the operations of Kelly.¹¹

Federal Income from DAL and Kelly and their reporting

For calendar year 2005, John Billion realized a \$75,915 federal “Ordinary Business Loss” from DAL.¹² For Kelly’s fiscal year ended September 30, 2005, Deborah Billion realized \$8,581 of federal “Ordinary Business Income”.¹³ Of that, \$2,217 was “Ordinary Minnesota Source Income From Trade or Business Activities.”¹⁴ During the calendar years 2005, the Billions also reported income from investments in other passive activities.¹⁵ In the Billions’ federal tax return for calendar year 2005 \$49,867 of the DAL loss was applied against passive income in the Appellants’ joint federal tax return.¹⁶ That passive income included the Kelly Ordinary Business Income.¹⁷ The Billions reported their federal adjusted gross income (“AGI”) which included their passive activity income net of the \$49,867 DAL PAL.¹⁸ A \$22,048 unallowed DAL loss was calculated on Form 8582.¹⁹

For calendar year 2006, John Billion realized a \$12,696 federal “Ordinary

¹¹Affidavit of Deborah Billion.

¹²Exhibit 1.

¹³Exhibit 4.

¹⁴Exhibit 4, Schedule KS line 15.

¹⁵Exhibit 10 Form 8582, p. 2, Worksheet 3.

¹⁶Affidavit of Michael M. Billion #29.

¹⁷Exhibit 10 Form 8582, p. 2, Worksheet 3.

¹⁸Exhibit 10 Statement 1 supporting reported income on Schedule E line 28A. Form 1040 line 17.

¹⁹Exhibit 10 Form 8582, p. 3, Worksheet 6 column (b).

Business Income” from DAL.²⁰ John Billion also realized a \$8,877 Section 179 deduction.²¹ For Kelly’s fiscal year ended September 30, 2006, Deborah Billion realized \$11,861 of federal “Ordinary Business Income”²² Of that, \$3,154 was “Ordinary Minnesota Source Income From Trade Or Business Activities”²³. During the calendar years 2006, the Billions also reported income from investments in other passive activities.²⁴ The Billions’ federal joint tax return for calendar year 2006 applied \$14,214 of the 2005 \$22,048 carryover loss against passive income.²⁵ That passive income included the Kelly Ordinary Business Income and the DAL Ordinary Business Income.²⁶ The Billions reported their federal adjusted gross income (“AGI”) which included \$14,214 of the DAL carryover PAL applied against passive income.²⁷ A \$7,834 unallowed DAL loss was calculated on form 8582.²⁸

For calendar year 2007, John Billion realized \$198,141 federal “Ordinary Business Income” from DAL.²⁹ For Kelly’s fiscal year ended September 30, 2007,

²⁰Exhibit 2 number 1.

²¹Exhibit 2 number 11.

²²Exhibit 5, number 1.

²³Exhibit 5, Schedule KS line 15.

²⁴Exhibit 11 Statement 1 supporting reported income on Schedule E line 28A. Form 1040 line 17.

²⁵Exhibit 11 Form 8582 p. 3 Worksheet 6, column (c).

²⁶Exhibit 11 Form 8582 p. 2 Worksheet 3.

²⁷Exhibit 11 Statement 1 supporting reported income on Schedule E line 28A. Form 1040 line 17.

²⁸Exhibit 11 Form 8582 p. 3 Worksheet 6, column (b).

²⁹Exhibit 3 number 1.

Deborah Billion realized \$14,415 of federal “Ordinary Business Income”.³⁰ Of that, \$3,897 was “Ordinary Minnesota Source Income from Trade or Business Activities.”³¹ During the calendar years 2007, the Billions also reported income from investments in other passive activities.³² The Billions’ federal joint tax return for calendar year 2007 applied \$7,834 of the 2005 carryover loss against passive income.³³ That passive income included the Kelly Ordinary Business Income and the DAL Ordinary Business Income.³⁴ The Billions reported their federal adjusted gross income (“AGI”) which included \$7,834 of the DAL carryover PAL.³⁵

Minnesota Income from DAL and Kelly and their reporting

In 2005 John Billion had a \$76,916 Ordinary Minnesota Source Loss From Trade Or Business Activities (“OMSL”) from DAL.³⁶ In 2005 Deborah Billion had a \$ 2,217 Ordinary Minnesota Source Loss From Trade Or Business Activities (“OMSI”) from Kelly.³⁷ The Billions’ 2005 Minnesota return reported federal taxable income in the same amount as reported on the federal return, \$116,625³⁸. The Billions federal gross income was \$171,437.³⁹ This included the passive

³⁰Exhibit 6 line 1

³¹Exhibit 6, Schedule KS line 16.

³²Exhibit 11 Statement 1 supporting reported income on Schedule E line 28A. Form 1040 line 17.

³³Exhibit 12 Schedule E line 28A Statement 1.

³⁴Exhibit 10 Form 8582 p. 2 Worksheet 3.

³⁵Exhibit 10 Statement 1 supporting reported income on Schedule E line 28A. Form 1040 line 17.

³⁶Exhibit 1 MN Schedule KS line 15.

³⁷Exhibit 10 Form 8582, p. 2, Worksheet 3.

³⁸Exhibit 7 Form M1 line 1. Ex. 10 Form 1040 line 43.

³⁹Exhibit 10 Form 1040 line 22.

activity losses reported on Schedule E.⁴⁰ In Column A Minnesota Schedule M1NR, the Billions reported their federal gross income increased by tax exempt interest, \$279.⁴¹ In column B the Billions reported Minnesota sourced interest income and gains from Kelly and DAL.⁴² Zero income was reported on the 2005 Schedule M1NR line 6 as the return was prepared applying \$2,217 of John Billion's 2005 DAL OMSL against the 2005 fiscal year OMSI reported by Kelly, \$2,217.⁴³ For 2005 column B line 22 was reported as zero because they did not have a filing requirement.⁴⁴ For the calendar year 2005, the Appellants' OMSL from trade or business activities was \$69,699 (the net of OMSI \$2,217 and OMSL -\$71,916.00).⁴⁵

For the calendar year 2006, John Billion had \$10,641 OMSI from DAL;⁴⁶ Deborah Billion had \$3,154 of OMSI from Kelly.⁴⁷ The Billions' 2006 Minnesota return reported federal taxable income in the same amount as reported on the federal return as \$158,271.⁴⁸ The Billions federal Gross Income was \$261,190.⁴⁹

⁴⁰Exhibit 10 Form 1040 Schedule E line 29b column (f).

⁴¹Exhibit 7 MN Schedule M1NR Column A line 9.

⁴²Exhibit 7 MN Schedule M1NR Column B lines 2 and 4. Ex. 1 MN Schedule KS line 17 interest \$86; Ex. 4 MN Schedule KS line 17 interest \$48 and line 22 Section 1231 net gain \$156.

⁴³Affidavit of Michael M. Billion #16.

⁴⁴Exhibit 7 MN Schedule M1NR Column A line 22.

⁴⁵Affidavit of Michael M. Billion #15; Exhibits 1 (Schedule KS line 15) & 4 (Schedule KS line 15).

⁴⁶Exhibit 2 schedule KS line 16 less Minnesota Allowed Section 179 expense Exhibit 2 page 2, \$2055.

⁴⁷Exhibit 5 Schedule KS line 15.

⁴⁸Exhibit 8 Form M1 line 1. Ex. 11 Form 1040 line 43.

⁴⁹Exhibit 11 Form 1040 line 22.

This included the passive activity losses reported from Schedule E on their form 1040 line 29b column (f).⁵⁰ In Column A Minnesota Schedule M1NR, the Billions reported their federal Gross Income increased by tax exempt interest, \$11,525.⁵¹ Self-employed health insurance from line 29 of federal return was deducted at line 16. The net at line 23 was \$258,755. The federal AGI was \$247,230⁵². The difference between the federal AGI and line 23 is \$11,525 – the amount of tax exempt interest. In column B the Billions reported Minnesota sourced interest income and gains from Kelly and DAL.⁵³ Zero income was reported on the 2006 Schedule M1N line 6 as the return was prepared applying \$13,795 of John Billion’s 2005 DAL OMSL against the 2006 fiscal year OMSI reported by DAL - \$ 10,641 and by Kelly, \$3,154.⁵⁴ The Minnesota tax on the taxpayers’ Minnesota adjusted federal taxable income was \$11,915.⁵⁵ The allocated Minnesota income tax was \$10.⁵⁶

As of the end of the calendar year 2006, John Billion’s OMSL from DAL, which had not been netted against OMSI, was \$55,903 (the net of -\$71,915 OMSI and \$2,217 (2005) and \$13,795 (2006)).⁵⁷

⁵⁰Exhibit 11 Form 1040 Schedule E line 29b column (f)

⁵¹Exhibit 8 MN Schedule M1NR Column A line 9.

⁵² Exhibit 11 line 37.

⁵³Exhibit 8 MN Schedule M1NR Column B lines 2 and 4. Ex. 2 MN Schedule KS line 18 interest \$190; Ex. 5 MN Schedule KS line 17 interest \$17 and line 22 Section 1231 net gain \$13.

⁵⁴Affidavit of Michael M. Billion #18.

⁵⁵Exhibit 8 M1 line 13; Ex. 8 M1NR line 25.

⁵⁶Exhibit 8 M1NR line 26.

⁵⁷Affidavit of Michael M. Billion #19.

John Billion's 2007 DAL's OMSI was \$198,142.⁵⁸ Deborah Billion had \$3,897 of OMSI from Kelly.⁵⁹ On their federal return, the Billions applied the remainder of John Billion's 2005 Ordinary Business Loss, \$7,834 against their passive income, \$215,959.⁶⁰ The Billions federal Gross Income was \$575,057.⁶¹ Their federal 2007 AGI was \$563,945.⁶² Their 2007 taxable income was \$484,387.⁶³ The Billions' 2007 Minnesota return reported federal taxable income in the same amount as reported on the federal return, \$484,387.⁶⁴ After increases for state income tax deducted; tax exempt interest and allowance of \$82 additional depreciation, the Billions' Minnesota taxable income was \$508,236. On audit the Commissioner determined Minnesota taxable income in the same amount.⁶⁵ The tax determined by the Billions and the Commissioner on that Minnesota taxable income was \$38,377.⁶⁶ Likewise, the Commissioner and the Billions reported the same Minnesota Gross income, \$582,379⁶⁷, and the same Schedule M1NR line 23 amount, \$571,267.⁶⁸ The difference between the federal AGI, \$563,945 and line 23 is \$7,322 – the amount of their tax exempt interest.⁶⁹ In column B Schedule

⁵⁸Exhibit 3 Schedule KS line 16.

⁵⁹Exhibit 6 Schedule KS line 16.

⁶⁰Exhibit 12 Schedule E line 29b column (f); line 29a column (g)

⁶¹Exhibit 12 Form 1040 line 22.

⁶²Exhibit 1 Form 1040 Line 37.

⁶³Exhibit 12 Form 1040 line 43.

⁶⁴Exhibit 9 Form M1 line 1. Ex. 12 Form 1040 line 43.

⁶⁵Audit Report Addn. 5 p. 1 lines 1 and 3.

⁶⁶Addn 4 p 1, line 11; Addn 5, p 2 line 25.

⁶⁷Addn 4 p 3 line 11, Audit report Addn 5 p 2 line 11.

⁶⁸Addn 4 p 3 line 23; Audit report Addn 5 p 2 line 23.

⁶⁹Exhibit 12 Form 1040 line 8b.

M1NR the Billions reported Minnesota sourced interest income from DAL and Kelly and DAL, \$1,929.⁷⁰ On audit, this was not adjusted.⁷¹ The Billion's 2007 Schedule M1N line 6 reported \$146,135.⁷² The return was prepared applying \$55,903 of John Billion's 2005 DAL OMSL against the 2007 year OMSI reported by DAL - \$ 198,142 and by Kelly, \$3,897.⁷³ As reported by the Billions, the allocated Minnesota income tax was \$9,947.⁷⁴ On audit, the Commissioner disallowed the remainder of John Billion's 2005 DAL OMSL deduction, \$55,903, and determined the Billions 2007 Minnesota income tax at \$13,702.⁷⁵

ARGUMENT

This is a tax case. The legal issue is whether the carry forward and application of John Billion's losses (PAL's) from DAL's 2005 year complied with Minnesota law. The issue presented is an issue of law that is entitled to *de novo* review by this Court. *Hutchinson Technology, Inc. v. Comm'r of Revenue*, 698 N.W. 2d 1, 6 (Minn 2005). It is a case of first impression.

I. The Billions reported their income consistent with Minnesota law.

This case involves provisions of Minnesota law relating to the income taxation of non-residents. The Billions reported their income in compliance with those statutes.

⁷⁰Addn 4 p 3 line 2; Audit report Addn 5 p 2 line 2

⁷¹Audit Report Addn 5 p 2 line 2

⁷²Addn 4 p 3 line 6

⁷³Affidavit of Michael M. Billion #20.

⁷⁴Addn 4 p 3 line 26.

⁷⁵Audit report Addn 5 p 2 line 6 and line 26.

A. The applicable Minnesota Statutes.

Minnesota law imposes an income tax on resident and nonresident individuals annually on their taxable income. The governing statutes are Minn. Stat. 290.01 subd. 29, defining “taxable income,” subd. 22, defining “taxable net income” and subd. 19, defining “net income”. The statutory scheme is two pronged. First taxable income is determined. Minn. Stat. 290.03. Then income tax is determined by applying the tax rate schedule to the taxable income. Minn. Stat. 290.06 Subd. 2c.

Mn. Stat. 290.03 imposes the Minnesota income tax. It provides in relevant part:⁷⁶

An annual tax for each taxable year, computed in the manner and at the rates hereinafter provided, is hereby imposed upon the taxable income for such year of the following classes of taxpayers:(1) Resident and nonresident individuals; Minn. Stat. 290.03(1). *Emphasis added.*

First, the term ‘taxable income’ is defined. The term “taxable income” means: (1) for individuals, estates, and trusts, the same as taxable net income; Minn. Stat. 290.01 Subd. 29 *Emphasis added.*

“Taxable net income is” defined:

For tax years beginning after December 31, 1986, the term ‘taxable net income’ means: (1) for resident individuals the same as net income; (2) for individuals who were not residents of Minnesota for the entire year, the same as net income except that the tax is imposed only on the Minnesota apportioned share of that income as determined pursuant to section 290.06, subdivision 2c, paragraph (e); Minn. Stat. 290.01 Subd. 22.

⁷⁶ The statutory language is the same in years 2005, 2006, 2007.

The term "net income" is also defined.

The term "net income" means the federal taxable income, as defined in section 63 of the Internal Revenue Code of 1986, as amended through the date named in this subdivision,⁷⁷ incorporating the federal effective dates of changes to the Internal Revenue Code and any elections made by the taxpayer in accordance with the Internal Revenue Code in determining federal taxable income for federal income tax purposes, and with the modifications provided in subdivisions 19a to 19f. Minn. Stat. 290.01 Subd. 19.

In summary, Minnesota income tax, for both a resident or non resident taxpayer, is based on the taxpayer's federal taxable income [IRC §63] adjusted by Minn. Stat. 290.01 subdivisions 19a to 19f. Once the tax is determined, for non resident taxpayers, Minnesota law allocates the tax based on the ratio of the Minnesota adjusted gross income as determined according to IRC §62 to the federal adjusted gross income . Minn. Stat. 290.01 Subd. 22(2); Minn. Stat. 290.06 subd.2c.(e).

B. On Audit the Commissioner accepted the Billions' Minnesota Taxable Income as filed.

On audit, the Commissioner determined that the 2007 Minnesota taxable income as returned by the Billions was the correct Minnesota taxable income. Addn. 5 Lines 1 and 3.

C. On Audit the Commissioner accepted the Billions' Minnesota Federal Income as filed

The Billions reported \$582,379 as their Minnesota gross income on

⁷⁷ For 2005, the Internal Revenue Code of 1986 as amended through April 15, 2005. For 2006 and 2008, the Internal Revenue Code of 1986 as amended through May 18, 2006. Minn. Stat. 290.01 Subd. 19.

Schedule M1NR line 11 and reported \$571,267 as their Minnesota Adjusted Gross income. (Schedule M1NR line 23). Addn 4. On audit the Commissioner accepted these determinations as filed. Addn. 5 p 2 lines 11 and 23. The Commissioner determined that the Billions' Minnesota income tax, determined as though the Billions were residents was as returned, \$ 38,377. Addn 4 p 3 line 25; Addn 5 line 25.

D. The Billions' returns complied with Minnesota Law relating to the taxation of non residents.

A non-resident income taxpayer's taxable income is allocated. The relevant statute provides:

For tax years beginning after December 31, 1986, the term 'taxable net income' means: (1) for resident individuals the same as net income; (2) for individuals who were not residents of Minnesota for the entire year, the same as net income except that the tax is imposed only on the Minnesota apportioned share of that income as determined pursuant to section 290.06, subdivision 2c, paragraph (e); Minn. Stat. 290.01 Subd. 22. *Emphasis added.*

The allocation statute, Minn. Stat. 290.06 subd.2c.(e) states:

An individual who is not a Minnesota resident for the entire year must compute the individual's Minnesota income tax as provided in this subdivision. After the application of the non-fundable credits provided in this chapter, the tax liability must then be multiplied by a fraction in which:

(1) the numerator is the individual's Minnesota source federal adjusted gross income as defined in section 62 of the Internal Revenue Code and increased by the additions required under section 290.01, subdivision 19a, clauses (1), (5), (6), (7), (8), and (9), and reduced by the Minnesota assignable portion of the subtraction for United States government interest under section 290.01,

subdivision 19b, clause (1), and the subtractions under section 290.01, subdivision 19b, clauses (9), (10), (14), (15), and (16), after applying the allocation and assignability provisions of section 290.081, clause (a), or 290.17; and

(2) the denominator is the individual's federal adjusted gross income as defined in section 62 of the Internal Revenue Code of 1986, increased by the amounts specified in section 290.01, subdivision 19a, clauses (1), (5), (6), (7), (8), and (9), and reduced by the amounts specified in section 290.01, subdivision 19b, clauses (1), (9), (10), (14), (15), and (16). *Emphasis added.*

1. Passive activity income is a component of Federal Gross Income. It is includable in the denominator of the allocation fraction in Minn. Stat. 290.06 subd.2c.(e)

Federal Adjusted Gross Income as defined in IRC §62, is Gross Income, IRC §61, less listed deductions of which only the self-employed health insurance is applicable. Gross income is all income from whatever source derived. IRC §61. A S corporation shareholder must include the shareholder's ratable share of the nonseparately computed income or loss in Gross Income. Treas. Reg. 1.1366-1(a)(3); IRC §1366(a) (1)(B). "Nonseparately computed income or loss" means gross income less allowable deductions. Treas. Reg. 1.1366-1(a)(3); IRC §1366(a) (2). An S corporation NOL is treated as an ordinary loss by the shareholders and thus, fully deductible, except to the extent that deduction limitations apply. U.S. Income Portfolios, Portfolio 371-2d: S Corporations I.A.5.a. IRC §469 is such a limitation. An S corporation must report and an S corporation shareholder must include its share of S corporation income, loss, deduction and credit for each of the corporation's IRC §469 activities. Treas. Reg. 1.1366-1(a)(4).

The Passive Activity Loss “PAL” statute IRC §469 is an accounting method which eliminates the application of PAL’s to shelter other income. The PAL statutes were codified to ensure that salary and portfolio income and gains from property held for investment, elements of Sec. 61 Gross Income, cannot be offset by losses from passive activities.⁷⁸ Joint Committee on Taxation, *Summary of H.R. 3838 (Tax Reform Act of 1986) as Passed by the Senate* (JCS-14-86), (July 14, 1986) page 32.

Internal Revenue Code Subchapter E Part II codifies the methods of accounting – IRC §§ 446-475. IRC Subpart C §§ 461-470 determines the taxable year in which deductions may be taken. The accounting statutes for passive activities are codified at IRC § 469. A passive activity is an activity which (1) involves the conduct of a trade or business in which (2) the taxpayer does not materially participate. IRC §469 (c).

John Billion did not materially participate in the DAL operations. DAL conducted its business solely in Minnesota. The DAL losses were losses from a passive activity.⁷⁹ Deborah Billion did not participate in the Kelly operations.⁸⁰ The Kelly income was income from a passive activity. IRC § 469.

⁷⁸ The exception to this general rule is that unapplied PAL’s are allowed on a fully taxable disposition of the passive activity. IRC § 469(g)(1). This is not the case here.

⁷⁹ As identified on the Minnesota KS, the DAL income or losses were Ordinary Minnesota Source Income (Loss) from trade or business activities.

⁸⁰ Kelly conducted its business in several states including Minnesota. The Kelly Minnesota income was identified as Ordinary Minnesota Source Income from trade or business activities.

A Passive Activity Loss (“PAL”) is the amount by which the aggregate losses from all passive activities exceed the aggregate income from all passive activities. IRC §469(d)(1). A loss from a passive activity disallowed under IRC §469(a) is a deduction allocable to the activity in the following year. IRC §469(b). It is included in the following year’s determination of PAL’s. IRC §469(d).

PAL’s can only be applied to reduce gross income from passive activities, either currently (IRC §469(d)) or in the future (IRC § 469(b)). IRC §469(a). Aggregate PAL’s reduce the aggregate gross income from all passive activity for the year to reduce the Passive Activity Income component of gross income to zero or greater. IRC §469(a), 469(d).

During the calendar years 2005-2007, the Billions’ federal returns also reported income from investments in non-Minnesota passive activities as defined by IRC §469.⁸¹ The Appellants’ 2005, 2006, and 2007 federal returns reported passive activity income and PALs in accordance with IRC §469. Affidavit of Michael Billion #28.

In 2005 DAL had a net operating loss (“NOL”) . Its character carried through to its shareholder. IRC § 1366(b). The character of a loss is determined at the entity level; the treatment of a loss is determined at the shareholder level. BNA U.S. Income Portfolio 527-3rd: Loss Deductions III.A. A C corporation is not restricted by the IRC §469 Rules. IRC §469(e)(2). A NOL is deductible in computing Adjusted Gross Income. Treas. Reg. 1.62-1T(c) (1). Had John Billion

⁸¹ Statement 1; Exhibits 10, 11, & 12.

been an active participant in DAL, his loss would have been a deduction in determining the Billion's Adjusted Gross Income. Because John Billion did not materially participate in DAL's operations, his deductible loss against AGI resulting from DAL was limited by the "passive activity loss" rules. IRC §469. In 2005 Deborah Billion had Minnesota sourced income from a Subchapter S corporation. The Billions had passive income from non-Minnesota sources and Deborah Billion had passive income from a Minnesota S corporation, Kelly.

Gross Income means all income from whatever source derived, including (but not limited to) elaborated items. IRC §61 includes partnership income IRC 61(a)(13). Per the Subchapter S Revision Act of 1982, the taxation of income earned by a S corporation follows the partnership rules. S. Rep. No. 640, 97th Cong., 2d Sess. (1982) In each year 2005, 2006, and 2007 the Billion's had gross income from S corporations; it was includable in their Gross Income IRC §§1366(a)(1), 61(a)(13). However, because it was passive activity income, it was reduced by passive activity losses. IRC §469.

The Billions' federal Gross Income for 2007 reports the balance of the DAL PAL carryforward which is applied against passive income from other sources including the DAL passive activity income. The Commissioner does not challenge the propriety of that reporting position. On audit, the Commissioner determined that the 2007 federal Gross Income, which included passive activity income reduced by passive activity losses, was as the Billions returned (\$582,379) and that the federal Adjusted Gross income was as the Billions returned

(\$571,267). Audit Report of Individual Income Tax Changes – Return p2 . Addn.

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In summary, Gross Income, IRC §61, is defined as all income from all sources and includes Passive Activity Income after the application of IRC §469. Thus, Adjusted Gross Income includes Passive Activity Income as it is Gross Income, IRC §61, less allowable deductions. IRC §62.

2. **The Billions correctly determined their allocable Minnesota income.**

Once the Minnesota tax is determined, it must be allocated according to the ratio of Minnesota Adjusted Gross income to the federal Adjusted Gross income. Given the plain meaning of the statutory language of Minn. Stat. 290.06 subd.2c.(e) (2) Minnesota Adjusted Gross income is Minnesota sourced income determined in accordance with IRC §62. The federal statutes limit a passive loss to passive income with a carryover of the balance of the PAL to the subsequent years. The Billions determined their Minnesota Gross Income accordingly. They applied IRC §469 rules to their Minnesota passive income. In 2005 and 2006, their Minnesota passive income was reduced to zero after application of the Minnesota DAL loss (2005) or by the DAL carryforward (2006). The Billions properly reported their Minnesota tax liability in 2007. In 2007 their Minnesota

⁸² The Commissioner did not audit the Billions' 2005 and 2006 Minnesota returns. They are referenced because the amount of the DAL carryforward to 2007 is contingent upon the DAL PAL applied in these years.

sourced federal adjusted gross income as defined in section 62 of the Internal Revenue Code was \$202,039 less the DAL PAL, \$55,903, carryforward plus interest, \$1,929 which is not at issue.

In summary, federal AGI includes passive income net of passive activity losses. Determining Minnesota Adjusted Gross income in accordance with the definition of federal AGI which applies IRC §469, it follows that the calculation of Minnesota AGI includes the application of the federal passive activity statutes, IRC §469 which allow the carryforward of PAL's to subsequent years, in this case the 2007 tax year. The Billions' Minnesota tax return is correct as filed.

II. The Tax Court erred when it failed to address Relators' argument construing the taxable income of a non-resident.

The Tax Court erred when it did not determine the Billions' 2007 Minnesota taxable income in accordance with Minn. Stat. 290.03 (1) and 290.01 Subd. 22 (2). The issue was briefed for the Tax Court. However, the Tax Court did not address the issue in its Order below.

III. The Tax Court erred when it failed to make findings of fact regarding material participation in order to ground the conclusion of law that the DAL losses were PAL's.

The Tax Court presumed that the DAL loss was a Passive Activity loss but did not make findings of fact explicit enough to support that conclusion. There, however, can be no dispute that the losses are in fact PAL's and that the PAL's reported on the federal returns are correct as filed.

IV. The Tax Court erred in construing Minn. Stat. § 290.095

The Tax Court determined that the DAL passive loss is a NOL the deduction of which is governed by Minn. Stat § 290.095. The Tax Court stated that Minn. Stat. §290.095, subd. 2 defines NOL as stated in IRC §172(c) as “[T]he excess of the deductions allowed by Chapter 1 of the Internal Revenue Code over the gross income.” *Emphasis theirs*. The Court reasoned that a PAL is “a deduction allowed under Chapter 1 of the Internal Revenue Code” and thus is a NOL.

The error of the Tax Court’s analysis results from parsing the statute and extracting the selected language from the statute omitting the language, “[T]he excess of the” and “over the gross income” and, thus, not considering the entire statute. This is contrary to Minnesota law which requires every law shall be construed, if possible, giving effect to all its provisions. Mn. Stat. 645.16. *Emphasis added*. A court is not allowed to extend the scope of a tax-levying schedule beyond the clear meaning of the statutory language. *Northfield Country Club v. Comm’r*, 241 N.W. 2d. 806, 807 (Mn.1976).

The Tax court erred. The extent of its error is apparent upon reviewing the deductions allowed under Chapter 1 of the Internal Revenue Code:

- § 162. Trade or business expenses.
- § 163. Interest.
- § 164. Taxes.
- § 165. Losses.
- § 166. Bad debts.
- § 167. Depreciation.
- § 168. Accelerated cost recovery system.
- § 169. Amortization of pollution control facilities.
- § 170. Charitable, etc., contributions and gifts.

- § 171. Amortizable bond premium.
- § 172. Net operating loss deduction.
- § 173. Circulation expenditures.
- § 174. Research and experimental expenditures.
- § 175. Soil and water conservation expenditures; endangered species recovery expenditures
- § 176. Payments with respect to employees of certain foreign corporations.
- § 178. Amortization of cost of acquiring a lease.
- § 179. Election to expense certain depreciable business assets.
- § 179A. Deduction for clean-fuel vehicles and certain refueling property.
- § 179B. Deduction for capital costs incurred in complying with Environmental Protection Agency Sulfur regulations.
- § 179C. Election to expense certain refineries.
- § 179D. Energy efficient commercial buildings deduction.
- § 179E. Election to expense advanced mine safety equipment.
- § 180. Expenditures by farmers for fertilizer, etc.
- § 181. Treatment of certain qualified film and television productions.
- § 183. Activities not engaged in for profit.
- § 186. Recoveries of damages for antitrust violations, etc.
- § 190. Expenditures to remove architectural and transportation barriers to the handicapped and elderly.
- § 192. Contributions to black lung benefit trust
- § 193. Tertiary injectants.
- § 194. Treatment of reforestation expenditures.
- § 194A. Contributions to employer liability trusts.
- § 195. Start-up expenditures.
- § 196. Deduction for certain unused business credits.
- § 197. Amortization of goodwill and certain other tangibles.
- § 198. Expensing of environmental remediation costs.
- § 198A. Expensing of qualified disabled expenses.
- § 199. Income attributable to domestic production activities.

TITLE 26. INTERNAL REVENUE CODE
 SUBTITLE A. INCOME TAXES
 CHAPTER 1. NORMAL TAXES AND SURTAXES
 SUBCHAPTER B. COMPUTATION OF TAXABLE INCOME
 PART VI. ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

And

- § 212. Expenses for production of income.
- § 213. Medical, dental, etc., expenses.
- § 215. Alimony, etc., payments.
- § 216. Deduction of taxes, interest, and business depreciation by cooperative housing corporation.
- § 217. Moving expenses.
- § 219. Retirement savings.
- § 220. Archer MSAs.
- § 221. Interest on education loans.
- § 222. Qualified tuition and related expenses.
- § 223. Health Savings accounts.

TITLE 26. INTERNAL REVENUE CODE
SUBTITLE A. INCOME TAXES
CHAPTER 1. NORMAL TAXES AND SURTAXES
SUBCHAPTER B. COMPUTATION OF TAXABLE INCOME PART
VII. ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUAL.

Applying the Tax Court’s reasoning, a charitable donation, a deduction allowed by IRC §170 is a Net Operating Loss as is among others in the list above, moving expenses, alimony, and medical expenses, a NOL.

V. The Tax Court erred as to the Standard of Review.

The tax court below ruled that the Billions had the burden to prove that the Passive Activity Loss deduction was allowed under a strict construction of the statute citing *Northern Natural Gas v. Comm’r*, 251 NW. 2d. 125, 128 (Mn. 1977). The statutes at issue, namely, Mn. Stat. 290.03 (imposing income tax on taxable income) and Minn. Stat. 290.01 Subd. 22 (2), and Minn. Stat. 290.06 subd. 2c(e) (defining taxable income) are taxing statutes. Stat. 645.44 Subd. 19. Minn. Stat. 290.06 subd. 2c(e) is mandatory – a non-resident must compute its individual Minnesota tax liability in accordance with this subdivision.

A court is not allowed to extend the scope of a tax-levying schedule beyond the clear meaning of the statutory language. *U.S. Sprint Communications v. Comm'r 1997 Minn. Tax Lexis 51*. Tax statutes are construed strictly as they deprive the citizen of his property. *Concord Property Co. v. County of Otter Tail*, 1987 Minn. Tax Lexis 48. Doubt in the meaning of a taxing statute is resolved in the taxpayer's favor. *Northfield Country Club v. Comm'r*, 241 N.W. 2d. 806, 807 (Mn. 1976). A court is not allowed to extend the scope of a tax-levying schedule beyond the clear meaning of the statutory language. *Id.* When the words of a law in their application to an existing situation are clear and free from all ambiguity, the letter of the law shall not be disregarded under the pretext of pursuing the spirit. Minn. Stat. 645.16.

VI. The Tax Court Judgment affirming the Commissioner's Assessment is not consistent with its decision.

The Tax Court granted Summary Judgment for the Commissioner. The Commission's motion was that the Commissioner's order be upheld in its entirety. The Commissioner's order did not allow the application of any of the DAL PAL carryforward in 2007. The Commissioner's assessment was on \$202,039 of S corporation income. In their 2007 Minnesota tax return, the Billions reported \$146,135 which was \$198,142 from DAL and \$3,897 from Kelly, a total of \$202,038 less the DAL carryforward, \$55,903. The Tax Court decision held that the Commissioner correctly allowed the Billions to carryover \$7,834 of their DAL loss on their Minnesota tax return and affirmed the Commissioner's denial of the

\$55,903 deduction claimed on their tax return . Had the Commissioner allowed the Billions a \$7,834 loss, the loss denied would be \$55,903 less \$7,834, or \$48,069 or stated another way, the assessment would be based on \$194,192 of Minnesota Subchapter S source income. The Tax Court's allowance of this loss carryforward is inconsistent with its decision to sustain the Commissioner's assessment.

ALTERNATE ARGUMENT

VII. The Tax Court erred in denying the Billions a NOL Carryforward pursuant to Minn. Admin. R. 8002.0200

The character of an item of income, gain, loss or deduction included in shareholder's income for the period of time that a shareholder is not a Minnesota resident is determined as if it were realized directly from the corporate source or incurred in the same manner as incurred by the S corporation. Minn Stat. 290.9726 subd. 2 (2007); IRC §1366(b). A NOL is the excess of deductions allowed under IRC Chapter 1 over gross income. IRC §172(c). In plain language, DAL's 2005 loss retained its character as an NOL when it was passed through to John Billion. At the beginning of 2007, after having applied part of his DAL NOL against 2006 Minnesota operating income, he had \$55,903 of his Minnesota NOL from DAL from its 2005 business operations which was unconsumed. The Billions then sought to offset the 2007 gain realized by their unused remaining DAL loss.

The Commissioner erred in refusing to allow the taxpayers the claimed NOL deduction. The assessment is contrary to Minnesota Administrative Rule

8002.0200 subpart 8C. Subsection C of subpart 8 provides that a taxpayer who is not a resident of Minnesota and who does not have income assignable to Minnesota in the taxable year, cannot apply a loss carryback or carryover in that taxable year. Rather, the NOL carryover or carryback is carried to the next consecutive taxable year, less amounts previously applied. It further provides that a NOL carryback or carryforward that was allowed to offset federal income in an earlier year is then available to offset Minnesota income and shall be allowed to offset Minnesota income. That is the case here. In 2007, the taxpayers' Minnesota source income from DAL was \$198,141. In accordance with Minnesota Rule 8002.0200 subpart 8C, Relators applied their 2005 NOL against that income.

Minnesota allows an Operating Loss Deduction. Minn. Stat. 290.095 subd. 1 (2005). Minnesota Accounting rules codified at Minn Stat. 290.07 subd. 7 (2007) provide that deductions are to be taken in the year paid or accrued unless "in order to clearly reflect the income the deductions . . . should be taken as of a different period." Such was the case here. In order to clearly reflect Minnesota source income, the taxpayer returned the NOL deduction in 2007.

"Income" is defined as "the true increase in amount of wealth which comes to a person during a stated period of time." Black's Law Dictionary 763 (6th ed. 1990). When John Billion had operating income from DAL in 2007, he had a financial gain above those previous losses incurred. The prior losses were a reduction in his capital. The gain reported was a restoration of his previous

reduction of capital (a diminution of wealth) and after restoration of that capital, an increase in wealth which he reported and upon which he paid Minnesota income tax. The Commissioner's assessment taxes the return of Billions' initial capital. The Legislature did not intend to tax capital; it intended rather to tax income. Minn. Stat. 290.9726; Minn. Stat 290.014 subd 2(5).

The position taken by the taxpayers in their 2007 return reflects this intent. IRC §172. The purpose of loss carryforwards is described in *Vreeland v. United States*, 289 F2d. 941 (Ct. Cl. 1961). The United States Court of Claims observed that computing income on an annual basis lays such heavy emphasis on the timing of the receipt of income that an inequity in the tax burden may result among those with equal income. *Id.* at 944. The United States Congress recognized this problem and provided relief through the NOL carryover and carryback rules. *Id.* at 945. Where the state statute and the federal statute are substantially the same, the prior construction of the federal statute is controlling on the state statute. *Drew v. Comm'r.* 23 N.W. 2d 565, 567 (Minn. 1946) quoting *State v. Stickney* 5 N.W. 2d 351,352 (Minn. 1942). As in the case of the federal provision, the purpose of the Minnesota loss carryover statute is to ameliorate the inequity which results from strict adherence to the annual accounting rules. The Commissioner's interpretation of the NOL rules regarding the Appellants' losses does not ameliorate the inequity in the tax burden; it creates a \$3,736 tax burden. The tax so imposed is greater than their actual net economic gain. Given the Commissioner's interpretation of the NOL rules and the federal accounting rule

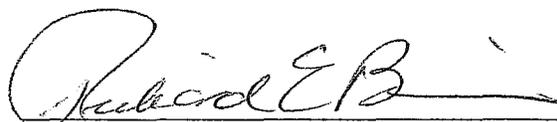
codified at IRC §469, the Appellants could only realize the effect of interim losses which occurred here, by restricting investment solely in Minnesota entities so as to match those with Minnesota operating income.

CONCLUSION

The Appellants' 2007 Minnesota return was correct as filed. The Tax Court erred when it failed to apply the mandatory method of computing a non-resident's Minnesota tax liability, MN Stat. 290.06 Subd 2c(e). Alternatively, Minn. Admin R. 8002.0200 subpart 8C clearly applies to the Billions; they were entitled to carry their 2005 Minnesota NOL forward to apply it against their 2007 Minnesota income. Under either authority, Commissioner and the Tax Court erred in denying them the loss carryforward from 2005.

The Commissioner's Order, therefore, must be reversed, and the Commissioner ordered that the tax assessment be abated.

Dated: April 5, 2012.



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

The undersigned certifies that the Brief submitted herein contains 7089 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 2010, the word processing system used to prepare this Brief.