

No. A11-2337

**STATE OF MINNESOTA
IN SUPREME COURT**

John & Deborah Billion,

Relators,

vs.

Commissioner of Revenue,

Respondent.

**RELATORS JOHN AND DEBORAH BILLION'S
REPLY BRIEF**

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TABLE OF CONTENTS

	<u>Page</u>
TABLE OF AUTHORITIES	iii
ARGUMENT	1
1. The Commissioner errs in her statement that the state income tax base is reduced to reflect the proportion of the taxpayers' federal taxable income attributable to Minnesota	1
2. The Commissioner errs in her argument that a Passive Activity Loss is a Net Operating loss.	2
3. The Commissioner erroneously alleges error because the Relators “substituted their own calculation into line 6, Column B though not authorized to do so by the tax instructions, forms or fact sheets	2
4. The Commissioner argues that Relators “invented a separate ‘Minnesota’ loss carryover deduction” where there was not authority for such	3
5. The Commissioner argues that Minn. Stat. 290.06 Subd. 2c(e) is simply an allocation ratio.....	4
6. The Commissioner argues that Minnesota does not have a statute specifically dealing with passive activity, but the NOL rules apply to PALs.	4
7. The Commissioner erroneously argues that because Relators are claiming a deduction, they must prove statutory entitlement where the statute is strictly construed against them	6
8. The Commissioner erroneously argues that Relators’ argument is not supported by tax forms, schedules or instructions for non-resident filers in Minnesota.....	6
9. The Commissioner erroneously argues that the intent of 290.06 Subd. 2c(e)(1) is to separate Minnesota source	

income from the taxpayers’ total federal adjusted income.....	7
10. The Commissioner erroneously argues that Relators improperly place incorrect emphasis on last half of phrase in Mn. 290.06 Subd. 2c. (e) “ ‘income as defined in section 62 of the [IRC]’ ”.....	7
11. The Commissioner erroneously argues administrative expediency	8
12. The Commissioner argues that Mn. Rule 8002.0200 does not apply to an individual. Her argument is erroneous.....	8
CONCLUSION.....	9
REQUEST FOR RECUSAL	9
CERTIFICATE OF COMPLIANCE.....	10

TABLE OF AUTHORITIES

	<u>Page</u>
Federal Cases	
<i>Utica Bankshares Corporation v. Oklahoma Tax Comm'r</i> , 892 P2d.979, 983 (Ok. 1994).....	4,5
State Cases	
<i>Birkel v Comm'r</i> , 1990 Minn. Tax Lexis 218	7
<i>Comm'r v Richardson</i> , 302 N.W. 2d 23, 26 (Minn. 1981)	2
<i>Concord Property Co. v County of Otter Tail</i> , 1987 Minn. Tax Lexis 48	6
<i>Johnson v. Comm'r</i> , 2010 Minn. Tax Lexis 5 (Mn. Tax Court 2010).....	5
<i>Mankato Citizens Telephone Co. v. Comm'r</i> , 145 N.W. 2 nd 313, 317 (Mn. 1966).....	3
<i>Northfield Country Club v Comm'r</i> , 241 N.W.2d 806, 807 (Mn. 1976).....	6,7
<i>Olympia Brewing Co. v Commissioner of Revenue</i> , 326 N.W.2d 642, 648 (Minn. 1982)	8
<i>Puckett v Comm'r</i> , 1989 Minn. Tax lexis 92, 32-33	2
Federal Statutes	
IRC §62.....	5
IRC §172.....	2
IRS §469	2
Federal Regulations	
Treas. Reg. 1.469-5.....	6
State Statutes	
Minn. Stat. 270C.06.....	9

Minn. Stat. 290.01	8
Minn. Stat. 290.06	passim
Minn. Stat. 290.095	2
Minn. Stat. 645.16	7
Minn. Stat. 645.44	4
Other Authorities	
Minnesota Administrative Rule 8002.0200.....	8,9

The Commissioner's brief contains errors of law and argument for which there is no authority. In most instances, the supporting authority is contrary to the Commissioner's argument. The erroneous statements are set out below underlined. Relators' response follows.

1. The Commissioner errs in her statement that the state income tax base is reduced to reflect the proportion of the taxpayers' federal taxable income attributable to Minnesota.¹

This is erroneous. The Commissioner continues this error stating that in 2005 Relators calculated their proportion of federal taxable income allocatable to Minnesota. The Relators' tax liability, as non-residents of Minnesota, is allocated based on their Minnesota adjusted gross income- not taxable income.² *Emphasis ours.*

Relators do not argue that tax forms are authoritative, however, only as a visual aid, Relators direct the Court to Relators' 2007 tax return appended to the opening brief at A-20-A-22. As reported on page one, Relators' federal adjusted gross income was \$ 563,945.³ The federal adjusted gross income after Minnesota adjustments was \$ 571,267⁴ - the difference being the federally tax exempt interest, \$ 7,322.⁵ The Minnesota tax determined from Relators federal taxable income increased for Minnesota adjustments (tax exempt interest and state income tax) is multiplied by the fraction, whose Minnesota adjusted gross income is the

¹ Respondent's brief pps. 4-5

² Minn. Stat. Subd. 290.06 2c.(e).

³ A-20

⁴ A-22 line 23.

⁵ Id. at line 9.

denominator and whose numerator is the federal adjusted gross income adjusted for tax exempt income.⁶

2. The Commissioner errs in her argument that a Passive Activity Loss is a Net Operating loss.⁷

The Commissioner argues that a Net Operating Loss (NOL) is a deduction allowed under Chapter 1 of the Internal Revenue Code (IRC); that a PAL is a deduction allowed under Chapter 1 of the Internal Revenue Code and, thus, a PAL is a NOL and therefore, its application is governed by Minn. Stat. §290.095 Subd.2. This is the same erroneous reasoning applied by the Minnesota Tax Court. As initially briefed by Relators at pps. 18-21, the fallacious reasoning is the product of omitting the phrases “the excess of” and “over the gross income” to achieve the desired result. Furthermore, a NOL is defined in IRC §172. A PAL is defined in IRC § 469. The definitions are mutually exclusive.

3. The Commissioner erroneously alleges error because the Relators “substituted their own calculation into line 6, Column B though not authorized to do so by the tax instructions, forms or fact sheets.”⁸

The Commissioner does not cite authority for this argument. The authority is contrary. Instructions to tax forms have no legal effect.⁹ Only the language of the actual Minnesota tax statute is legally binding.¹⁰ As regards the fact sheets, the

⁶ A-22 line 22 divided by line 23 multiplied by line 25.

⁷ Res. Br. p. 16.

⁸ Res. Br. pps. 13-14.

⁹ *Comm'r v. Richardson*, 302 N.W.2d 23, 26 (Minn. 1981)

¹⁰ *Puckett v. Comm'r*, 1989 Minn. Tax Lexis 92, 32-33

Commissioner's interpretation of a statute is not binding.¹¹ Relators' 2007 tax return complied with the mandate in Minn. Stat. 290.06 Subd. 2c.(e).

4. The Commissioner argues that Relators "invented a separate 'Minnesota' loss carryover deduction" where there was not authority for such.¹²

Relators have legal authority for their position. The legal authority defining Relators' Minnesota tax liability is Minn. Stat. 290.06 (2005) which provides in relevant part:

Rates of tax; credits.

Subd. 2c. Schedules of rates for individuals, estates, and trusts. (a) The income taxes imposed by this chapter upon married individuals filing joint returns and surviving spouses as defined in section 2(a) of the Internal Revenue Code must be computed by applying to their taxable net income the following schedule of rates:

- (1) On the first \$25,680, 5.35 percent;
- (2) On all over \$25,680, but not over \$102,030, 7.05 percent;
- (3) On all over \$102,030, 7.85 percent.

x x x

(e) 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 nonrefundable 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

¹¹ *Mankato Citizens Telephone Co. v. Comm'r*, 145 N.W. 2nd 313, 317 (Mn. 1966)

¹² Res. Br. p. 13

(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 ours.

5. The Commissioner argues that Minn. Stat. 290.06 Subd. 2c(e) is simply an allocation ratio.¹³

This is erroneous. Minn. Stat. 290.06 Subd. 2c.(e) is a tax statute.¹⁴ Minn. Stat.

290.06 Subd. 2c(e) provides:

“An individual who is not a Minnesota resident for the entire year must compute the individual’s Minnesota income tax liability as provided in this subdivision.”

Emphasis ours. Must is mandatory.¹⁵ Minn. Stat. 290.06 Subd. 2c(e) is clear and unambiguous.

6. The Commissioner argues that Minnesota does not have a statute specifically dealing with passive activity, but the NOL rules apply to PALs.¹⁶

Relators agree that Minnesota does not have a statute dealing with passive activities, however, that does not preclude that application of the PAL rules as they are incorporated by reference to IRC § 62. The Commissioner cites *Utica Bankshares Corporation v. Oklahoma Tax Comm’r*¹⁷ for the proposition that no deduction may be allowed in the absence of statutory authority; however, *Utica*

¹³ Respondent’s brief p. 17.

¹⁴ Minn. Stat. 645.44 Subd. 19.

¹⁵ Minn. Stat. 645.44 Subd. 15a.

¹⁶ Res. Br. p. 16.

¹⁷ 892 P. 2nd 979, 983 (Ok. 1994) .

articulates Relators’ argument that Relators have attempted to convey to the Commissioner and to the tax court: The PAL rules are incorporated by reference. Utica Bankshares had a federal NOL in 1982 which it carried back to federal tax years 1972 through 1980. The amount of the federal NOL applied was \$2,704,337. Because of tax exempt interest earned, Utica’s Oklahoma income was greater than its federal income; it attempted to carry an additional \$8,120,684 of its NOL back against Oklahoma income. The Oklahoma Tax Commission only allowed \$281,246 of the federal carryback against Oklahoma income. Oklahoma tax statutes did not explicitly allow a deduction based on a federal net operating loss. Nonetheless, the Supreme Court of Oklahoma allowed the full amount of the federal net operating loss deduction, \$2,704,337 and no more, because “deductions based on federal net operating loss are integrated into the state tax structure through the definitions of ‘Oklahoma adjusted gross income’ and ‘Oklahoma taxable income’”¹⁸

This is Relators’ argument – the PAL rules are integrated into the tax determination for a non-resident through the Minn. Stat. 290.06 Subd. 2c(e) reference to IRC § 62.

The Commissioner has previously incorporated the PAL rules by reference; she applied PAL rules to a Minnesota taxpayer absent explicit statutory authorization.¹⁹ The taxpayer deducted losses associated with their 11%

¹⁸ *Id.* at 979.

¹⁹ *Johnson v. Comm’r*, 2010 Minn. Tax Lexis 5 (Mn. Tax court 2010)

ownership of a liquor store in Fargo North Dakota. Husband and wife both had full time jobs. The taxpayers argued that their losses were not passive losses and thus fully deductible. On audit, the commissioner inquired as to their material participation in the liquor store and finding none, denied the claimed loss. The tax court, reasoning that net income for purposes of Minnesota income tax is based on federal taxable income under the Internal Revenue Code, incorporated the passive activity provisions of the IRC as well as the material participation regulations, Treas. Regs. 1.469-5 and 1.469-5T. It held that the losses were passive losses and sustained the Commissioner's order.

7. The Commissioner erroneously argues that because Relators are claiming a deduction, they must prove statutory entitlement where the statute is strictly construed against them.

As previously argued supra, Mn. Stat. 290.06 Subd. 2c(e) is a tax statute. Tax statutes are construed strictly against the government as they deprive the citizen of his property.²⁰ Doubt in the meaning of a taxing statute is resolved in the taxpayer's favor.²¹

8. The Commissioner erroneously argues that Relators' argument is not supported by tax forms, schedules or instructions for non-resident filers in Minnesota.²²

Tax form instructions have no force and effect.²³ The reasoning is that were the Commissioner's instructions authoritative, the Commissioner would have legislative powers; there would be no need for the legislature.²⁴

²⁰ *Concord Property Co. v. County of Otter Tail*, 1987 Minn. Tax Lexis 48.

²¹ *Northfield Country Club v. Comm'r*, 241 N.W. 2d. 806, 807 (Mn. 1976).

²² Res. Br. p. 15.

9. The Commissioner erroneously argues that the intent of 290.06 Subd. 2c(e)(1) is to separate Minnesota source income from the taxpayers' total federal adjusted income.²⁵

Intent is of no consequence if a statute is clear on its face. A court is not allowed to extend the scope of a tax-levying schedule beyond the clear meaning of the statutory language.²⁶ 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.²⁷

10. The Commissioner erroneously argues that Relators improperly place incorrect emphasis on last half of phrase in Mn. 290.06 Subd. 2c. (e) “ ‘income as defined in section 62 of the [IRC]’ ”²⁸

All words in a statute to be given their meaning.²⁹ Applying elementary school grammar lessons, the construction of the statute is as follows: numerator is the subject; is is the verb; “the individual’s Minnesota source federal adjusted gross income” is the predicate nominative and “as defined in section 62 of the Internal Revenue Code” is the subordinate clause which modifies the predicate nominative. The subordinate clause cannot stand on its own. Every law is to be construed to

²³ *Birkel v. Comm’r.*, 1990 Minn. Tax LEXIS 218.

²⁴ *Id.*

²⁵ *Id.* at p. 17.

²⁶ *Northfield* at 807.

²⁷ Minn. Stat. 645.16.

²⁸ *Id.* at p. 18.

²⁹ Minn. Stat. 645.16

give effect to all its provisions.³⁰ Relators' interpretation complies with Minn. Stat. 645.16.

11. The Commissioner erroneously argues administrative expediency.³¹

The Commissioner argues that there would be a burden on the taxpayers to construct and deconstruct their state calculation.³² She argues that the allocation process "is eased by Schedule KS, which provides Minnesota source income in one tidy spot for each corporation."³³

Minn. Stat. 290.06 Subd. 2c(e) defines a non-resident's Minnesota tax obligation. It may be easier to merely transfer numbers from the taxpayers federal return to the Minnesota return or directly from Schedules KS. Nevertheless, ease of administration does not justify an interpretation inconsistent with the statute.³⁴

12. The Commissioner argues that Mn. Rule 8002.0200 does not apply to an individual. Her argument is erroneous.

Mn. Rule 8002.0200 Subp. 8 C. applies to "A taxpayer who is not a resident of Minnesota during any part of the taxable year ...". Taxpayer is a defined term. "Taxpayer" means any person or corporation subject to tax under Chapter 290.³⁵

Person also is defined. The term "person" includes individuals.³⁶ The

Commissioner's argument that the rule does not apply to an individual is

³⁰ *Id.*

³¹ Res. Br. p. 18.

³² *Id.*

³³ *Id.* at p. 17.

³⁴ *See Olympia Brewing Co. v. Commissioner of Revenue*, 326 N.W.2d 642, 648 (Minn. 1982)

³⁵ Minn. Stat. 290.01 Subd. 6.

³⁶ Minn. Stat. 290.01 Subd. 2.

untenable. The Commissioner's rule has the force of law.³⁷ The cited rule is authority for the Relators' alternate argument.

CONCLUSION

The Relators' 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 Relators; 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.

REQUEST FOR RECUSAL

Relators note that the Commissioner cites to the affidavits of Rita DeMeules. Relators direct the court's attention to the fact that Ms. DeMeules represented the Commissioner in the tax court proceedings. Ms. DeMeules now serves as the Supreme Court Commissioner.³⁸ In that role she serves as chief counsel to the Minnesota Supreme court.³⁹ In that capacity she provides legal advice and recommends disposition of cases that come before the Court.⁴⁰

³⁷ Minn. Stat. 270C.06

³⁸ Supreme Court news release November 29, 2011.

³⁹ *Id.*

⁴⁰ *Id.*

Relators respectfully request that Ms. DeMeules be recused from participating in this case.

Respectfully submitted this 25TH day of May, 2012.



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

The undersigned certifies that the Reply Brief submitted herein contains 2765 words and complies with the type/volume limitations of the Minnesota Rules of Appellate Procedure 132. This Reply 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 Reply Brief.

