No. A11-2337

STATE OF MINNESOTA
IN SUPREME COURT

John J. and Deborah W. Billion,

Relators,

vs.

Commissioner of Revenue,

Respondent.

BRIEF OF RESPONDENT COMMISSIONER OF REVENUE

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LEGAL ISSUES

I. Whether the Tax Court properly concluded that the Commissioner was entitled to summary judgment as a matter of law under Minn. Stat. § 290.095, for disallowing the Relators' deduction for carryover losses claimed in Minnesota but not claimed as a deduction on their corresponding federal return?

The Tax Court granted the Commissioner's motion for summary judgment on this claim.

Apposite Authority:

Minn. Stat. § 290.095, subd. 11
Minn. Stat. § 271.06, subd. 6
Minn. Stat. § 270C.33, subd. 6
Comm'r of Revenue v. Richardson, 302 N.W.2d 23 (Minn. 1981)

II. Whether the Tax Court properly rejected Relators' state and federal constitutional challenge to Minn. Stat. § 290.095, subd. 11 under the (state) Uniformity and the (federal) Privileges and Immunities Clauses on the basis of non-resident status, because that statute requires all taxpayers, regardless of residency, to report losses in the same amount reported on their federal returns?

The Tax Court granted the Commissioner's motion for summary judgment on this claim.

Apposite Authority:

Minn. Stat. § 290.095, subd. 11
Luther v. Comm'r of Revenue, 588 N.W.2d 502 (Minn. 1999), *cert. denied*, 528 U.S. 821 (1999)

STATEMENT OF THE CASE

During 2005 to 2007, the tax years at issue, Relators John and Deborah Billion were residents of South Dakota but had business interests that generated income and losses in other states, including Minnesota. On May 14, 2010, the Commissioner of Revenue ("Commissioner") disallowed Relators' attempt to carry over a previously-used loss deduction on their 2007 Minnesota state return and imposed an additional $3,736 in individual income tax (exclusive of interest). Relators administratively appealed and the Commissioner affirmed in a Notice of Determination on Appeal dated August 27, 2010.

Relators timely appealed to the Tax Court on October 22, 2010, challenging the Commissioner's interpretation of Minnesota's tax laws and alleging that application of the loss carryover provision unconstitutionally discriminated against non-residents.[1] The material facts surrounding the deduction are not in dispute and the matter was submitted to the Tax Court on cross-motions for summary judgment. On November 7, 2011, the Tax Court granted the Commissioner's motion and denied Relators' motion, and judgment was entered on November 22, 2011. *Billion v. Comm'r of Revenue*, Case No. 8296, 2011 WL 5515480 at *1-2 (Minn. Tax Ct. Nov. 7, 2011). This appeal by certiorari followed.

[1] Because the matter involved a constitutional claim, an *Erie* Transfer was completed on February 23, 2011. *Erie Mining Co. v. Comm'r of Revenue*, 343 N.W.2d 261 (Minn. 1984) (permitting district court to confer jurisdiction over constitutional claims on tax court).

STATEMENT OF FACTS

Relators were residents of South Dakota during the years 2005-07. R. 4 "Statement" at 1 (Appellants' Statement of Uncontested Material Facts Restated, and Appellants' Response to Commissioner's Statement of Material Facts, filed with other documents on Aug. 11, 2011) [respectively "Statement" and "Response"]; R. 7 at 3 (Memorandum of Commissioner in Opposition to Summary Judgment, filed July 21, 2011).[2] During calendar years 2005-07, John Billion owned stock in Dignified Assisted Living ("DAL"), a Minnesota subchapter S corporation, which operates solely in Minnesota. R. 4 "Statement" at 1. During that same timeframe, Deborah Billion owned stock in Kelly Inns, Inc. ("Kelly Inns"). R. 4 "Response" at 2. This entity operates in multiple states, including Minnesota. *Id.*

In 2005, DAL had a Minnesota loss of $71,915,[3] while Kelly Inns had income attributable to Minnesota in the amount of $2,217. Res. App. 1-3 (2005 Schedule KS for

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[2] References to the record are designated as "R. ___" and reflect the paragraph numbers in which these documents appear in the Tax Court's March 6, 2012 Return to Writ of Certiorari to this Court. A description of the document also is included for reference. References to Respondent's Appendix are designated "Res. App. ___."

[3] There are occasional small differences in dollar amounts in the state and federal forms, which appear to be due to rounding. For example, when the S-corporation generated its passive activity statements for Relators in 2005, the 2005 DAL loss was reported as $71,915 on the federal form (Schedule K-1) and $71,916 on the state form (Schedule KS).

DAL and 2004 Schedule KS for Kelly Inns); R. 4 "Response" at 2.[4] Relators also had passive activity income from other, non-Minnesota sources. Res. App. 33, 30 (2005 Form 8582 and Schedule E, respectively); R. 4 "Statement" at 1. On their joint federal income tax return in 2005, Relators applied federal rules on loss limitations to claim a $49,867 portion of the DAL loss. Res. App. 33, 30, 29 (2005 Form 8582, Schedule E and Form 1040, respectively); R. 4 "Response" at 5.[5] This amount was used to offset the Relators' 2005 passive income from all sources, including the Kelly Inns income of $2,217 attributable to Minnesota. Res. App. 32 (2005 Form 8582); R. 4 "Response" at 5. On both their 2005 state and federal tax returns, Relators reported their federal adjusted gross income ("AGI") and calculated their federal taxable income to include the claimed $49,867 loss deduction attributable to the DAL loss. Res. App. 29 (2005 Form 1040); Res. App. 14 (2005 Form M1); R. 4 "Response" at 5. Because Minnesota's tax calculations begin with reported federal taxable income, the federal loss offset automatically carried through to the calculation of Relators' state base tax. Res. App. 14 (2005 Form M1, item D and line 1); R. 9 (Exhibits filed June 27, 2011) at Exh. 7. For non-residents of Minnesota, the state base tax is then reduced to reflect the proportion of

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[4] Kelly Inns reports income on a fiscal year, rather than a calendar year basis, so the applicable forms in the record date from the previous fiscal year. *See* Res. App. 3, 7, 11-12; R. 9 at Exhs. 4-6.

[5] As discussed further below, passive loss deductions in any given year are limited by passive activity income and other federal restrictions. *See, e.g.*, R. 9 at Exh. 10 (2005 IRS Form 8582 (Passive Activity Loss Limitations) [Res. App. 31-33]; 2005 IRS 1120S Schedule K-1 (Shareholder's Share of Income, Deductions, Credits, etc.); and 2005 IRS Schedule E (Supplemental Income and Loss) [Res. App. 30]).

the taxpayers' federal taxable income allocable to Minnesota in that year. Res. App. 15 (2005 Sched. M1, line 18); R. 9 at Exh. 7. The allocation calculation includes the taxpayers' passive activity from Minnesota sources in that year, taking into account any applicable federal limitations. Res. App. 16 (2005 Sched. M1NR, line 6, col. B); R. 9 at Exh. 7. *See* Res. App. 4 (2005 Schedule KS Instructions, discussing "Minnesota portion" limitations based on what was reported in taxpayer's federal return).

In 2005, Relators calculated the proportion of their federal taxable income allocable to Minnesota in that year. In this calculation, Relators did not report any of their Minnesota passive activity income or loss to the state, as required, contrary to Relators' assertion. Relators' Brief ("Rel. Br.") at 6. Such figures, including a portion of the large 2005 DAL loss, would have appeared on Relators' 2005 Schedule M1NR, at line 6, column B, but Relators chose to leave that line blank. Res. App. 16 (2005 Sched. M1NR, line 6, col. B); R. 9 at Exh. 7.[6]

In 2006, DAL had Minnesota income of $12,696, and Kelly Inns had income attributable to Minnesota in the amount of $3,154. Res. App. 5-7 (2006 DAL Schedule KS, 2005 Kelly Inns Schedule KS); R. 4 "Response" at 3. Relators also had passive activity income from other, non-Minnesota sources. Res. App. 36-39 (2006 Schedule E and Form 8582); R. 4 "Statement" at 1. On their joint federal income tax return in 2006, Relators claimed a loss carryover deduction of $14,214, which was the allowable portion

[6] As it happened, this did not affect Relators' 2005 Minnesota tax, as their Minnesota source income fell below minimum filing requirements in that year.

of the remaining 2005 DAL loss. Res. App. 39 (2006 Form 8582); R. 4 "Response" at 6.[7] As in 2005, this amount was used to offset passive income from all sources, including the DAL income and the Kelly Inns income. Res. App. 37, 36, 35 (2006 Form 8582, Schedule E and Form 1040, respectively); R. 4 "Response" at 6. This offset effectively reduced their federal AGI and federal taxable income once again (and that reduced amount was reported on both state and federal returns in 2006 for purposes of calculating state tax). Res. App. 35 (2006 Form 1040); Res. App. 19 (2006 Form M1); R. 4 "Response" at 6. As in 2005, however, when calculating the proportion of income allocable to Minnesota in 2006, Relators did not report any of their 2006 Minnesota passive activity income or loss to the state, as required. Res. App. 21 (2006 Sched. M1NR, line 6, col. B); R. 9 at Exh. 8. They again simply left the appropriate line blank.[8]

In 2007, DAL had Minnesota income of $198,141. Res. App. 9 (2007 DAL Schedule KS); R. 4 "Response" at 4. Kelly Inns had income attributable to Minnesota of $3,897. Res. App. 11 (2006 Kelly Inns Schedule KS); R. 4 "Response" at 4. Relators also had passive activity income from other, non-Minnesota sources. Res. App. 42 (2007 Schedule E); R. 4 "Statement" at 1. On their joint federal income tax return for 2007,

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[7] At this point, the taxpayers had a balance of $7,834.00 from the 2005 DAL loss ($71,915-$49,867-$14,214=$7,834).

[8] Relators state that they reported this income to the state of Minnesota, Rel. Br. at 7, but this is plainly incorrect from the face of their state tax returns. *See* Res. App. 21 (2006 Sched. M1NR, line 6, col. B); R. 9 at Exh. 8. Instead, as in 2005, they left the appropriate line blank. In 2006, unlike in 2005, Relators' failure to properly report these numbers did affect their total Minnesota tax obligation, resulting in an underpayment of over $700. Any such amount is not part of this appeal.

Relators claimed a loss carryover of $7,834, which was the remaining balance of the 2005 DAL loss. Res. App. 42 (2007 Schedule E); R. 4 "Response" at 4, 7. As in 2005 and 2006, this amount was used to offset passive income from all sources, including the DAL income and the Kelly Inns income. Res. App. 42 (2007 Schedule E); Res. App. 41 (2007 Form 1040); R. 4 "Response" at 7. This offset effectively reduced their federal AGI and federal taxable income once again (and that reduced amount was reported on both state and federal returns in 2007). Res. App. 41 (2007 Form 1040); Res. App. 24 (2007 Form M1); R. 4 "Response" at 7. Unlike prior years, in 2007 Relators reported Minnesota-source passive activity on their state tax forms when allocating income to Minnesota. Res. App. 26 (2007 Sched. M1NR, line 6, col. B); R. 9 at Exh. 9. In doing so, however, they did not simply tally their Minnesota-source passive income and loss for 2007, as required by the Schedule M1NR Instructions, Res. App. 27; R. 7, Affidavit of Rita DeMeules, Att. C at 2 (2007 Nonresidents/Part-Year Residents Schedule M1NR Instructions), but they also separately deducted $55,903, which they characterized as a portion of the *2005* DAL loss. R. 4 "Response" at 4-5.[9]

In a May 14, 2010 Order, the Commissioner disallowed the $55,903 deduction on Relators' 2007 state tax return because it was not a "net operating loss" as that term is

[9] Relators apparently reached this "deduction" by aggregating their Minnesota-specific passive income and loss figures over the three years at issue (2005, 2006 and 2007), and applying a fictional loss carryover conceptually drawn from federal law. R. 4 "Reply Memoranda" at 5. As discussed further below, however, there is no provision in Minnesota law for a separate *Minnesota-specific* passive activity deduction or carryover in the absence of a federal loss.

defined by Minnesota Statutes section 290.095. The Commissioner imposed an additional $3,736 in tax (exclusive of interest). Relators administratively appealed and the Commissioner affirmed in a Notice of Determination on Appeal dated August 27, 2010. Relators timely appealed to the Tax Court on October 22, 2010, challenging the Commissioner's interpretation of Minnesota's tax laws and alleging that application of the loss carryover provision unconstitutionally discriminated against non-residents. R. 14 (Notice of Appeal). Because the matter involved a constitutional claim, an *Erie* Transfer was completed on February 23, 2011. R. 11 (*Erie* Shuffle Documents). As noted above, the material facts surrounding the deduction are not in dispute and the matter was submitted to the Tax Court on cross-motions for summary judgment. On November 7, 2011, the Tax Court granted the Commissioner's motion and denied Relators' motion, R. 3 (Order Denying Appellants' Motion for Summary Judgment) ["Tax Court Order"], and judgment was entered on November 22, 2011. R. 1 (Notice of Entry of Order). The Tax Court held that the Commissioner had properly applied Minnesota's statute on loss deductions, Minn. Stat. § 290.095, subd. 11, to the facts of this case, and that, because this statutory provision applies to all taxpayers, regardless of residence, Relators failed to meet their high burden of proving the statute unconstitutional. *Billion,* 2011 WL 5515480 at *4-5; R. 3.

Relators timely sought a writ of certiorari to this Court on December 30, 2011, re-alleging the same tax and constitutional claims raised before the Tax Court. Relators failed to address their constitutional allegations in their opening brief, however, so those arguments have been waived. *Melina v. Chaplin*, 327 N.W.2d 19, 20 (Minn. 1982) (issue not argued in briefs is waived); *see also Schoepke v. Alexander Smith & Sons Carpet Co.*, 290 Minn. 518, 519-20, 187 N.W.2d 133, 135 (Minn. 1971) ("assignment of error based on mere assertion and not supported by any argument or authorities in appellant's brief is waived and will not be considered on appeal unless prejudicial error is obvious on mere inspection").[10]

STANDARD OF REVIEW

This Court reviews decisions from the Minnesota Tax Court to determine whether: (1) the tax court had jurisdiction, (2) the tax court decision was supported by the evidence and was in conformity with the law, and (3) the tax court committed any other error of law. *McLane Minnesota, Inc. v. Comm'r of Revenue*, 773 N.W.2d 289, 293 (Minn. 2009) (*citing Mayo Collaborative Servs., Inc. v. Comm'r of Revenue,* 698 N.W.2d 408, 412 (Minn. 2005)); *see also* Minn. Stat. § 271.10, subd. 1 (2010). When, as here, the parties have agreed to the underlying facts, this Court need only consider whether the law was properly applied. *Mayo Collaborative Servs.,* 698 N.W.2d at 412. This Court reviews the tax court's conclusions of law and interpretation of statutes de novo. *Id.*

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[10] Before the Tax Court, Relators raised state and federal constitutional challenges on the basis of non-resident status, arguing that denying their carryover loss deduction violates the Minnesota Constitution's uniformity clause, Minn. Const., Art. X, ¶ 1 and the Privileges and Immunities Clause of the United States Constitution, Art. IV, § 2. The Tax Court rejected Relators' constitutional challenges as without merit. *Billion*, 2011 WL 5515480, at *4-5.

Orders of the Commissioner are presumed correct and valid. *See* Minn. Stat. § 271.06, subd. 6 (2010); Minn. Stat. § 270C.33, subd. 6 (2010). Further, Relators challenge adjustments to taxpayer-claimed deductions, which are a matter of legislative grace and are strictly construed. *See Comm'r of Revenue v. Richardson*, 302 N.W.2d 23, 26 (Minn. 1981). Relators bear the burden of demonstrating that they are entitled to judgment as a matter of law. *F-D Oil Co., Inc. v. Comm'r of Revenue*, 560 N.W.2d 701, 708 (Minn. 1997). This means Relators must demonstrate that the deduction they seek — to offset their Minnesota income with passive activity losses that were not claimed on their federal return that year — is permitted by applicable statutes and regulations.

To the extent any constitutional claims are considered on appeal (Relators failed to brief them), Relators must show that the exercise of the Commissioner's tax authority is unconstitutional beyond a reasonable doubt. *Luther v. Comm'r of Revenue*, 588 N.W.2d 502, 508 (Minn. 1999), *cert. denied*, 528 U.S. 821 (1999). This heavy burden is properly imposed because "states have wide latitude in establishing their taxation schemes," and statutes are declared unconstitutional "only when absolutely necessary." *Stelzner v. Comm'r of Revenue*, 621 N.W.2d 736, 740 (Minn. 2001).

ARGUMENT

Relators appeal from the Tax Court's grant of summary judgment to the Commissioner, upholding an income tax assessment based on Relators' incorrect reporting of Minnesota income for tax year 2007. The tax amount at issue is $3,736 (exclusive of interest). Relators object to the Commissioner's decision to disallow a deduction for prior years' operating losses ("the carryover loss") as an offset for 2007 Minnesota income. The Commissioner rejected their claim because the so-called 2007 carryover loss had already been deducted in earlier years and therefore was not deducted for federal tax purposes in 2007. By law, such losses are limited in any given year to the amount claimed on a taxpayer's federal return.

Because the Tax Court correctly concluded that Relators failed to establish their entitlement to relief as a matter of law, even viewing the agreed-upon facts in the light most favorable to them, the Tax Court's decision granting summary judgment in favor of the Commissioner should be upheld. The Tax Court correctly applied Minnesota's statutory treatment for carryover losses.

Minnesota's statutory treatment of carryover losses is presumptively constitutional, moreover, and because both residents and non-residents are subject to the same provision, Relators cannot meet their heavy burden to show unconstitutionality beyond a reasonable doubt, even if they chose to brief this argument on appeal.

I. THE TAX COURT CORRECTLY CONCLUDED THAT THE COMMISSIONER PROPERLY APPLIED MINNESOTA LAW AND DISALLOWED A CARRYOVER LOSS THAT WAS NOT CLAIMED ON THE TAXPAYERS' CORRESPONDING FEDERAL RETURN.

In general, Minnesota bases an individual's tax liability on that individual's federal taxable income. *See, e.g.*, Minn. Stat. § 290.014; *see also* Minn. Stat. § 290.01, subd. 19 (defining "net income" as "federal taxable income as defined" in 26 U.S.C. § 63). A non-resident taxpayer who is a shareholder in an S-corporation is taxed on the income that is allocable to Minnesota by assignment or apportionment. *See* Minn. Stat. § 290.014, subd.

2(5). This case involves a deduction for a claimed loss related to the taxpayers' Minnesota S-corporation, DAL.

A. Under Minnesota Law, Net Operating Losses Are Limited To The Amount Claimed On A Taxpayer's Federal Return.

Minnesota law allows a state income tax deduction for net operating losses. Minn. Stat. § 290.095, subd. 1. The law also specifically allows losses to be carried forward or back. *Id.* at subd. 3. By the express terms of this statute, however, loss carryover or carryback for individuals in any given year is limited to the amount reported on a taxpayer's federal return:

> (a) . . . [F]or individuals, estates and trusts the amount of a net operating loss that may be carried back or carried over *shall be the same dollar amount allowable in the determination of federal taxable income* . . .
>
> (b) The net operating loss carryback or carryover applied as a deduction in the taxable year to which the net operating loss is carried back or carried over shall be equal to the net operating loss carryback or carryover *applied in the taxable year in arriving at federal taxable income[.]*

Minn. Stat. § 290.095, subd. 11 (emphasis added); *see also* Minn. R. 8002.0200, subp. 8 (defining amount of net operating loss carryforward as "the same dollar amount allowed in the determination of federal adjusted gross income").

Applying this law to the facts of the present case, Relators were permitted to carry DAL's 2005 \$71,915 Minnesota loss over to future years, so long as any carryover was consistent with the federally allowed dollar amount. Relators rejected this limitation. In 2007, the remaining permissible carryover loss from DAL's 2005 operations was \$7,834. Relators properly reported and claimed this loss on their federal returns. Relators did not stop there, however. Instead, as described further below, Relators invented a separate "Minnesota" loss carryover deduction and attempted to claim $55,903 of DAL's 2005 losses as "Minnesota" net operating losses in 2007. There is no legal support for this practice. *See* Minn. Dep't of Revenue Fact Sheet, Net Operating Losses ("Minnesota has adopted the same federal rules for NOLs [net operating losses] for individual income tax purposes. *There is no separate NOL for state purposes[.]*) (emphasis in original), *at* http://taxes.state.mn.us/individ/pages/other_supporting_content_net_operating_loss.aspx ["DOR Fact Sheet"].

In 2007, once Relators applied the remaining balance of their 2005 DAL loss ($7,834) at the federal level, Relators had received the full tax benefit of that loss. At that point, all that remained for Relators to do was to allocate 2007 income and losses to Minnesota. With respect to passive activity, this simply entailed aggregating their *2007* Minnesota-source income and losses (reported on Schedule KS, with any applicable federal limitations), and entering that figure on line 6, column B of the non-resident tax form. Res. App. 27; R. 7, Affidavit of Rita DeMeules, Exh. C at 2 (2007 Nonresidents/Part-Year Residents Schedule M1NR Instructions).[11] This number then figures into the 2007 allocation ratio. According to Relators' Schedule KS's for 2007,

[11] These instructions provide: "**Column B Instructions**": "Assign income or expenses to Minnesota according to the following instructions. However, if you are a . . . shareholder, enter the amounts from the Schedule . . . KS and follow the instructions with that schedule. . . . **Line 6, Column B**[:] . . . Include income or loss reported on Schedule E from . . . S corporations . . . and amounts from Minnesota sources recognized while a nonresident."

their aggregate 2007 Minnesota-source income/loss was $202,039.[12] Res. App. 9-12. This is the number that should have been entered on their 2007 Schedule M1NR, at line 6, column B.

Instead, Relators substituted their own calculation into line 6, column B. Relators summed their 2007 Schedule KS amounts and then, though not authorized to do so anywhere in the tax instructions or forms, Relators unilaterally calculated and applied a three-year Minnesota-specific carryover deduction of $55,903. Res. App. 26 (2007 Sched. M1NR, line 6, col. B); R. 9 at Exh. 9. This reduced their total 2007 Minnesota taxable income and their appropriate Minnesota tax. Notably, this $55,903 deduction did not appear anywhere on Relators' federal tax return.

By the express terms of Minn. Stat. § 290.095, subd. 11, as noted above, the amount of a net operating loss that may be carried back or carried over "shall be the same dollar amount allowable in the determination of federal taxable income." Any deduction "shall be equal to the net operating loss carryback or carryover applied in the taxable year in arriving at federal taxable income[.]" *Id.* Moreover, "there is no separate [net operating loss] for state purposes." DOR Fact Sheet. Relators ignored all of this language in substituting their own calculation of Minnesota-source income. No Minnesota statute allows divergence between federal and Minnesota reported income/losses found in Relators' 2007 returns, and there is no exception to this statutory

[12] This figure represents the rounded sum of $3,897 for DAL and $198,141 for Kelly Inns, which were their only sources of Minnesota income/loss that year. R. 4 "Response" at 4.

rule. *See Utica Bankshares Corp. v. Oklahoma Tax Comm'n*, 892 P.2d 979, 983 (Okla. 1994) (noting taxpayer "does not cite a state statute which authorizes an Oklahoma carryback deduction in excess of the federal NOL deduction utilized by a taxpayer and no deduction may be allowed in the absence of statutory authority"). Relators do not suggest — nor could they credibly suggest — that their novel calculation is warranted by the tax forms, schedules or instructions for non-resident filers in Minnesota.

In effect, Relators attempted to deduct the 2005 DAL loss a second time in 2007, after Relators had already claimed all of the 2005 DAL loss on their federal returns over three years. Relators offer no statutory language that, by its express terms, permits a Minnesota taxpayer to reclaim previously reported and claimed losses. *See, e.g., National Can Corp. v. Comm'r of Revenue*, 437 N.W.2d 416, 418 (Minn. 1989) ("Taxation is presumed and the burden is on the taxpayer to show it is entitled to a deduction.").

The plain statutory language demonstrates the validity and correctness of the Tax Court's Order and the legal failure of Relators' argument. The taxpayers' claimed $55,903 carryover loss on their 2007 state return, which is inconsistent with the $7,834 loss claimed on their 2007 federal return, cannot be reconciled with the controlling statutory language. The Tax Court's Order should therefore be affirmed.

B. Relators' Attempt To Introduce A New Method Of Calculating Passive Activity Losses Finds No Support In The Tax Code.

While Minnesota defines state taxable income with reference to the federal Internal Revenue Code ("IRC"), Minnesota has enacted specific Minnesota statutory requirements governing losses and does not permit taxpayers to calculate and claim Minnesota-specific passive activity losses in the same manner as in the IRC.

1. Passive activity losses fall within the federal definition of net operating loss for purposes of state tax deductions.

While Minnesota does not have a statute specifically dealing with passive activity, Minnesota's definition of (and requirements for) net operating losses specifically include all deductions under Chapter 1 of the Internal Revenue Code, and that chapter includes passive activity. Thus, passive activity losses fall within the federal definition of net operating loss for purposes of state tax deductions. Specifically:

(1) In Minnesota, a "net operating loss" is as "defined in section 172(c) of the Internal Revenue Code," with modifications not applicable here. Minn. Stat. § 290.095, subd. 2.

(2) Section 172(c) of the Internal Revenue Code defines "net operating loss" as "the excess of the *deductions allowed by this chapter* [Chapter 1 of the Internal Revenue Code] over the gross income." 26 U.S.C. § 172(c) (emphasis added).

(3) The deductions allowed by Chapter 1 of the Internal Revenue Code include both passive activity losses (IRC § 469) and net operating losses (IRC § 172), among many other provisions.

Since a passive activity loss deduction or offset falls within the definition of a net operating loss found in IRC § 172(c), the Tax Court properly concluded that it may be considered a net operating loss for purposes of Minn. Stat. § 290.095 and therefore is subject to the restrictions in that statute. *See* R. 3 at 10 (Tax Court Order); *Billion,* 2011 WL 5515480, at *4. Relators' attempt to create a new rule for passive activity losses should be rejected. The Court's proper focus is on the application of Minn. Stat. § 290.095.

2. Relators' strained reading of Minnesota statutes finds no support in the tax code.

Relators essentially argue that because Minnesota's tax code references a federal tax definition in determining how income is allocated to Minnesota, this permits — indeed, requires — non-resident Minnesota taxpayers to deconstruct this federal formula, then reconstruct and duplicate it at the state level. *See, e.g.,* Rel. Br. at 11-13, 17-18. There is no support for Relators' approach.

The clause at issue is contained in the description of Minnesota's allocation ratio - specifically, the numerator of that ratio - which is used to determine the percentage of taxable income allocable to Minnesota in the given year. Minn. Stat. § 290.06, subd. 2c(e)(1).[13] This numerator is based on a non-resident taxpayer's "Minnesota source federal adjusted gross income as defined in section 62 of the Internal Revenue Code," with certain additions and deductions specified in Minnesota law. *Id.* The intent of this clause, supported by its plain language and context, is to separate (or allocate) Minnesota source income from the taxpayer's total federal adjusted gross income in the taxable year in question. The emphasis is on "Minnesota source." For shareholders of S corporations, the allocation process is eased by Schedule KS, which provides Minnesota source income in one tidy spot for each corporation.

[13] The denominator of that ratio is the taxpayer's federal adjusted gross income.

Instead of this common sense reading of Minn. Stat. § 290.06, Relators emphasize the last half of the phrase: "income as defined in section 62 of the [IRC]." Or, rather, they misrepresent the language of the statute by substituting income "as *determined by*" section 62 of the IRC. Rel. Br. at 11, 17 (emphasis added). Under this interpretation, rather than viewing the IRC reference as confirmation of the meaning of "federal adjusted gross income," Relators view it as an order to deconstruct IRC § 62 into its constituent elements and reconstruct "Minnesota source" income using those elements. With respect to passive activity losses, the argument continues, because federal adjusted gross income contains a distinct passive loss carryover element, so must state income. Relators are undeterred by the fact that there are no official Minnesota forms or schedules on which state passive activity carryover losses are calculated and recorded (unlike at the federal level). Instead, apparently, a taxpayer keeps private track of Minnesota-specific carryover and applies it in whatever years he decides are appropriate (and, presumably, this private tally requirement would apply in every other state in which a taxpayer's S corporation does business).

Relators strain and misread this simple provision of Minnesota law. Minnesota does not require taxpayers to deconstruct and reconstruct the elements of federal taxable income in determining appropriate state tax. Indeed, the sheer accounting complexity of Relators' interpretation is inconsistent with the Minnesota state taxation system, which simplifies the state tax calculation by drawing on federally reported figures. Relators' argument also takes no account of the state loss carryover statute, which directly governs the deduction in this case. Minn. Stat. § 290.095, subd. 11. Relators' arguments in this regard should be rejected.

C. Relators' Additional Statutory Arguments Do Not Outweigh The Reasonable Mandate Of Minn. Stat. § 290.095, subd. 11.

Relators also assert that the Commissioner's interpretation of section 290.095 does not "clearly report" Relators' Minnesota income, but this too should be rejected by this Court. Rel. Br. at 24-26. The fact that the DAL loss was applied against all income, Minnesota and non-Minnesota, does not mean that Relators' 2007 Minnesota income was not clearly or fairly reported, as required by Minn. Stat. § 290.07, subd. 7. The general language in section 290.07, moreover, does not override the specific loss carryover requirements of section 290.095. *See* Minn. Stat. § 645.26, subd. 1 (specific provision controls over general). Given that Relators reduced their reportable or federal taxable income in 2005 and 2006 by claiming the bulk of DAL's 2005 loss in those years, Relators have not explained why re-using those losses in 2007 "clearly reflects" their 2007 Minnesota income.

D. Minnesota Rules Do Not Dictate A Different Result.

Relators finally attempt to rely on a carryover exception in Minnesota Rule 8002.0200,[14] but this only applies to trusts and estates, not to individuals.

In this case, the "exception" language relied upon by Relators appears in both the net operating loss statute and the rules; the rule is silent on its application to individuals, but the statute is clear that this exception does not apply to individuals, only to trusts and estates. Section 290.095 states that

> (b) The net operating loss . . . carryover . . . shall be equal to the net operating loss . . . carryover applied in the taxable year in arriving at federal taxable income provided that *trusts and estates* must apply the following modifications:
>
> . . .
>
> (2) . . . if a net operating loss carryback or carryover was allowed to offset federal income in a year earlier than was possible on the Minnesota return, *an estate or trust* shall still be allowed to offset Minnesota income but only if the loss was assignable to Minnesota in the year the loss occurred.

Minn. Stat. § 290.095, subd. 11(b)(2) (emphasis added).

Relators fail to bring this dispositive italicized language to the Court's attention. Relators' interpretation of Rule 8002.0200 conflicts with the express language of section 290.095 by reading an extra exception into the statute for individuals. As the Tax Court properly recognized, however, when there is a potential inconsistency between a statute and its rules, statutory language controls, and therefore the quoted language from the rule

[14] Minn. R. 8002.0200, subp. 8 provides "[a] net operating loss carryback or carryover that was allowed to offset federal income in a year earlier than was possible on the Minnesota return shall still be allowed to offset Minnesota income." Minn. R. 8002.0200, subp. 8.

cannot be read inconsistently with the statute to apply to individuals such as Relators. *See Billion*, 2011 WL 55145480, at *3.[15]

E. Minnesota's Statute On Net Operating Loss Is A Rational Policy Choice Consistent With Practices In Other States.

Minnesota's treatment of net operating losses is a rational policy choice consistent with the law in other states. Courts in other states have repeatedly upheld tax policies that key off of amounts reported on a taxpayer's federal return. *See, e.g., Getty Oil Co. v. Oklahoma Tax Comm'n*, 563 P.2d 627, 630-31 (Okla. 1977) (analyzing carryover loss deductions with reference to what amounts were reported on the taxpayer's federal return); *Green v. State Tax Assessor*, 562 A.2d 1217, 1219-20 (Me. 1989) (same). This is to assist in providing a relatively simple means of tax calculation. *E.g., Green*, 562 A.2d at 1223-24.

II. RELATORS FAIL TO DEMONSTRATE THAT THE LEGISLATURE'S DECISION TO FOLLOW FEDERAL TAX REPORTING FOR INCOME AND LOSSES IS UNCONSTITUTIONAL.

Relators failed to renew their constitutional arguments in their opening brief and thus have waived them for purposes of this appeal. To the extent Relators attempt to

[15] Relators also urge application of a different provision of Rule 8002.0200 that clearly does not apply in this instance. *See* Rel. Br. at 24. Subpart 8(C) of the Rule 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 carryover or carryback in that year but must instead apply such loss in the next consecutive taxable year. Relators appear to be arguing that this "required" carryover justifies their specific Minnesota carryover calculation in 2007. Whatever Relators intended by quoting this provision, however, it does not apply to this case because Relators had taxable income attributable to Minnesota in each of the years in question.

address these issues for the first time in a reply brief, and the Court considers them, the Commissioner asserts that any such constitutional claims fail.

Relators have not shown that the Legislature's decision to follow federal tax reporting for income and losses is unconstitutional beyond a reasonable doubt. *Luther*, 588 N.W.2d at 508 (taxpayer asserting constitutional challenge to Commissioner's authority must demonstrate the alleged unconstitutionality beyond a reasonable doubt). The Legislature's policy choice cannot be second-guessed, particularly when Relators, by 2007, had obtained the economic benefit of all but $7,834 of DAL's 2005 loss. By claiming $64,081 of DAL's loss in 2005 and 2006 ($14,214 in 2005 and $49,867 in 2006), Relators had already offset, or reduced, their reported Minnesota source income (and other income) for those years. DAL's significantly increased income in 2007 does not warrant re-using losses that were previously claimed to reduce earlier years' income, nor does it support a finding that it is "absolutely necessary" to declare Minnesota's tax treatment unconstitutional. *See Stelzner,* 621 N.W.2d at 740 (upholding constitutionality where taxpayer did not meet evidentiary burden).

Not only has this Court upheld the constitutionality of a previous version of Minnesota's net operating loss statute, *see National Can Corp.*, 437 N.W.2d at 421 (rejecting equal protection and commerce clause challenges to Minn. Stat. § 290.095 (1980)), Relators' assertion that the state's treatment of net operating losses discriminates against non-residents is simply wrong. As the statutory provisions discussed above make clear, net operating losses (and thus deductions for such losses) are not defined by the location of the activities. Minnesota statutes permit both residents *and* non-residents to deduct such losses, and section 290.095, subdivision 11 requires both residents and non-residents to deduct *only* the amounts claimed on their federal returns. In general, in fact, the deductions that Minnesota permits from federal taxable income are not defined by their Minnesota or non-Minnesota character. *See* Minn. Stat. § 290.01, subd. 19b. Relators' statements about the impact of section 290.095 on non-residents are speculative. This cannot possibly form the basis of a constitutional violation.

A. Minnesota's Treatment Of Carryover Loss Deductions Is Consistent With The Uniformity Clause Of The Minnesota Constitution.

Minnesota's uniformity clause requires that taxes be "uniform upon the same class of subjects." Minn. Const., Art. X, ¶ 1. The scope of this clause "is equivalent to the scope afforded equal protection rights." *See J.L. Shiely Co. v. County of Stearns*, 395 N.W.2d 357, 359 (Minn. 1986). Challenges brought under this clause are subject to a rational basis standard. *See Kolton v. County of Anoka*, 645 N.W.2d 403, 411 (Minn. 2002). Given the legislature's "broad discretion" in the tax area, this Court has upheld tax classifications against uniformity challenges unless the classifications are clearly arbitrary and have no conceivable rational basis. *Council of Indep. Tobacco Mfrs. of America v. State*, 713 N.W.2d 300, 308 (Minn. 2006). Rational basis review is inherently deferential and "courts are especially deferential in the context of classifications made by complex tax laws." *John Hancock Mut. Life Ins. Co. v. Comm'r of Revenue*, 497 N.W.2d 250, 253 (Minn. 1993) (internal quotation marks and citations omitted).

Though not cast as a constitutional argument in their opening brief, Relators have asserted that all shareholders of Minnesota S corporations should be taxed on the "economic gain" from the conduct of business in Minnesota, whether or not the shareholders are residents of Minnesota. *E.g.*, Rel. Br. at 24-26. This is, in effect, what occurs in Minnesota. Shareholders of S corporations are taxed on "all net income"; non-resident shareholders are taxed on the income allocable to Minnesota under Sections 290.17, 290.191, or 290.20, which takes any of the year's losses into account. *See* Minn. Stat. § 290.14, subds. 1, 2(5). Thus, the same concept applies to both residents and non-residents. Any difference in a taxpayer's overall tax burden is dictated only by each non-resident state's inherently limited power to tax only income that is allocable to that state. This is not an arbitrary distinction. *Cf. Maland v. Comm'r of Revenue*, 331 N.W.2d 486, 488 (Minn. 1983) (noting, in explaining federal standard for equal protection challenge, that "those challenging the legislative judgment must convince the court that the legislative facts on which the classification is apparently based . . . could not reasonably be conceived to be true by the governmental decision-maker") (citation and quotation omitted). The Tax Court thus properly concluded that any uniformity challenge should be dismissed, particularly given the presumptive constitutionality of Section 290.095.

B. Minnesota's Treatment Of Carryover Loss Deductions Does Not Violate The Privileges And Immunities Clause Of The Federal Constitution.

The Privileges and Immunities Clause "requires that a state accord residents and non-residents equal treatment in activities bearing on the operation of the nation as a single entity. *In Re Petition of Dolan*, 445 N.W.2d 553, 559 (Minn. 1989). "Like many other constitutional provisions, the privileges and immunities clause is not an absolute." *Maland,* 331 N.W.2d at 488. Thus, assuming there is any difference in treatment between residents and non-residents of Minnesota, some "disparity in treatment" and a lack of "perfection" are permissible. *Id.* at 488-89 (upholding denial of exemption to non-resident that was available to resident). *See, e.g., Getty Oil*, 563 P.2d at 631 ("Taxing statutes are frequently discriminatory, but for an income tax classification to be constitutional, all that is required is that the classification and apportionments be reasonable and related to the object of the tax action."); *Green*, 562 A.2d at 1221-23 (noting decisions "indicate that not all differentiation between residents and nonresidents for purposes of state taxation constitutes discriminatory treatment," and notwithstanding some "disparity of treatment" in reporting losses, substantial equality in treatment remains).

Minnesota's net operating loss deduction is derived from the federal net operating loss shown on the taxpayers' return. Thus, if there is no net operating loss claimed for federal tax purposes — because, for example, losses claimed on federal returns in earlier years were used to offset income from another state — there will be no Minnesota loss in that same year. This distinction does not deny a non-resident the privileges afforded to a resident; residents and non-residents are subject to the same rule. Instead, it is statutory tax treatment that maintains consistency with the taxpayer's federal tax reporting in light of the state's jurisdiction to tax income. *See, e.g., Shaffer v. Carter*, 252 U.S. 37, 57

(1920) (upholding Oklahoma's denial of a non-resident's deduction for losses incurred outside the state, and noting the "difference . . . is only such as arises naturally from the extent of the jurisdiction of the state in the two classes of cases, and cannot be regarded" as discrimination). The Tax Court thus properly rejected Relators' privileges and immunities challenge because they cannot demonstrate unconstitutionality beyond a reasonable doubt.[16]

In sum, Relators have not met - and cannot meet - their heavy constitutional burden in this instance.

CONCLUSION

For the above-stated reasons, the Commissioner respectfully requests that the Tax Court's decision be affirmed. Relators have attempted to create a new rule to circumvent clear statutory language, and this effort must be rejected. Relators also fail to meet the extremely high burden of proving the statute unconstitutional. Relators have not

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[16] In the Tax Court, Relators relied on the United States Supreme Court's decision in *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287 (1998) for their privileges and immunities challenge, but the Tax Court properly concluded that such reliance was misplaced and Relators do not cite *Lunding* in their opening brief. In *Lunding*, the Court reviewed New York's tax laws, which for all purposes save one - alimony - treated residents and non-residents alike. Federal law permitted a deduction for alimony, but, for non-residents, New York did not. Because New York could not offer an explanation for singling out alimony from all other deductions otherwise permitted to non-residents, the Court concluded that the single exception for alimony bore no rational relationship to a reasonable state interest, particularly where New York previously allowed non-residents such a deduction. There is no similar "singling out" of deductions for non-residents in the present case, so *Lunding* simply does not apply here. Even if it did, however, the United States Supreme Court refused to "imply that States invariably must provide to nonresidents the same manner of tax credits available to residents." *Lunding*, 522 U.S. at 311.

demonstrated that residents and non-residents are treated differently at all for purposes of deducting net operating losses, let alone that the net operating loss provision is unconstitutional beyond a reasonable doubt.

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Respectfully submitted,

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