



**In the
Missouri Court of Appeals
Western District**

**JONATHAN D. AND
AMANDA A. EILIAN,**

Respondents,

v.

DIRECTOR OF REVENUE,

Appellant.

WD74900

OPINION FILED:

January 15, 2013

APPEAL FROM THE ADMINISTRATIVE HEARING COMMISSION

Before James Edward Welsh, C.J., Mark D. Pfeiffer, J., and Abe Shafer, Sp. J.

The Director of Revenue (Director) appeals from the Administrative Hearing Commission's (AHC) decision that Jonathan D. and Amanda A. Eilian were not liable for a deficiency on their 2006 Missouri income taxes. The Director asserts that the Eilians inappropriately utilized the net operating loss deduction on their 2006 Missouri tax return, resulting in their receiving an impermissible double benefit. The issue presented here requires the construction rather than the application of the revenue laws of this state. Pursuant to Article V, Section 3 of the Missouri Constitution, the Missouri Supreme Court has exclusive jurisdiction over cases involving the construction of revenue laws of this state. We, therefore, transfer this cause to that court.

For the tax year 2005, Jonathan Eilian filed a Federal individual income tax return, reporting a net operating loss of \$34,535,832. Pursuant to 26 U.S.C. § 172, Jonathan Eilian made an election to forgo the carry back of the net operating loss and elected to carry it forward in future tax years.

The Eilians were married during 2006 and filed a joint 2006 Federal income tax return, carrying forward the net operating loss from 2005. Although the Eilians were non-residents of Missouri, they earned income in Missouri and were required to file income tax returns as non-residents of Missouri. Pursuant to section 143.491, RSMo 2000, the Eilians filed a joint 2006 Missouri income tax return and then subsequently filed an amended joint Missouri income tax return.¹ On their amended return, Jonathan Eilian reported a Federal adjusted gross income of negative \$6,096,650, a net operating loss addition modification of \$34,535,832 and a net operating loss subtraction modification of \$34,535,832.² Amanda Eilian reported a Federal adjusted gross income of \$102,814, and she had no additions and no subtractions to her Federal Adjusted gross income. Thus, the 2006 Missouri amended return resulted in a combined Federal adjusted gross income of negative \$5,993,836 and a combined Missouri adjusted gross income of negative \$5,102.325.

Jonathan Eilian then filed his 2007 Federal individual income tax return claiming "married filing separate" status. In that return, he claimed a carry forward of \$6,117,375 from the 2005 net operating loss as a deduction. Jonathan Eilian also filed his 2007 Missouri income tax return claiming "married filing separate" status. In his 2007 Missouri return, he reported a

¹The reasons for the amendment are unrelated to the issues on appeal.

²The AHC found that the Eilians' entry of the net operating loss as an addition on the 2006 return was a mistake and that the Eilians were supposed to report the net operating loss as an addition on the 2005 return only.

Federal adjusted gross income of \$40,600,729, an addition modification of \$10,914,727 which included a carried forward net operating loss adjustment of \$6,117,375, and a subtraction modification of \$6,262,316 which included carried forward net operating loss adjustment of \$6,117,375.

On January 21, 2009, the Department of Revenue (Department) sent the Eilians a "Notice of Proposed Changes" for the 2006 tax year disallowing the Eilians' \$34,535,832 net operating loss subtraction modification and explaining that the Eilians underpaid on their 2006 Missouri taxes. Following a series of correspondence between the Eilians' certified public accountant and the Department, wherein the Eilians protested the proposed changes, the Department issued a "Notice of Adjustment" for the 2006 tax year to the Eilians on March 11, 2009. The Notice of Adjustment indicated that the net operating loss carry forward had been adjusted to \$6,117,375 and that the amount due on the return had been adjusted to \$47,192. The Notice of Adjustment indicated, however, that the balance on the Eilians 2006 Individual Income Tax Account was \$56,515.86, which included interest and additions. On August 12, 2009, the Department issued a final "Notice of Deficiency" for the Eilians' 2006 tax year which stated that the balance due from the Eilians was \$57,511.41.

The Eilians filed a protest, and, on November 2, 2009, the Director of Revenue issued a Final Decision finding that the Notice of Deficiency issued by the Department was correct and finding that the Eilians owed \$47,192 in unpaid taxes, plus interest. The Director found that "[b]ecause \$6,117,375 of the carryover to 2006 was also carried over to 2007, an equal amount must be added back to 2006 federal adjusted gross income to reflect the net operating loss deduction exclusively in 2006, and to prevent a cumulative deduction of \$40,653,207 for a total net operating loss of only \$34,535,832."

On November 25, 2009, the Eilians filed a complaint with the AHC challenging the Director's Final Decision upholding a previously issued Notice of Deficiency that found a deficiency for the Eilians' 2006 income tax. The Director filed her answer, and the parties filed a joint stipulation of facts with the AHC.

On January 23, 2012, the AHC issued its decision that the Eilians were "not liable for a deficiency on their 2006 individual income tax arising from any failure to pay amounts due from an alleged miscalculation of their net operating loss deduction for 2006." The Director then filed a Petition for Review with this court.

In her sole point on appeal, the Director contends the AHC erred in concluding that the Eilians were not liable for a deficiency on their 2006 Missouri income taxes. The Director asserts that the Eilians inappropriately utilized the net operating loss deduction on their 2006 Missouri tax return, resulting in their receiving an impermissible double benefit.

The Missouri Supreme Court has exclusive appellate jurisdiction over cases involving the construction of revenue laws of this state. MO. CONST. art. V, § 3. This provision "speaks to the seriousness with which the people of this state view the efforts of government to reach into their pockets and pocketbooks [T]he people of this state intend their highest appellate court to determine the meaning and validity of laws by which the tax collector exacts tribute for the support of government." *Kuyper v. Stone Cty. Comm'n*, 838 S.W.2d 436, 438 (Mo. banc 1992). If, however, the issues raised in the appeal can be disposed by the application of a prior Supreme Court construction, the Supreme Court does not have exclusive jurisdiction, and this court may decide the legal issues concerning revenue laws. *Purler-Cannon-Schulte, Inc. v. City of St. Charles*, 146 S.W.3d 31, 37 (Mo. App. 2004).

According to the Supreme Court, "A 'revenue law' directly creates or alters an income stream to the government that imposes a tax or fee on property owned or used or an activity undertaken in that government's area of authority" *Alumax Foils, Inc. v. City of St. Louis*, 939 S.W.2d 907, 910 (Mo. banc 1997). The Supreme Court further explained, "a revenue law either establishes or abolishes a tax or fee, changes the rate of an existing tax, broadens or narrows the base or activity against which a tax or fee is assessed, or excludes from or creates exceptions to an existing tax or fee[.]" *Id.*

In this case, the parties agree that pursuant to section 143.181, RSMo Cum. Supp. 2011, the starting point for the calculation of a nonresident individual's income is the individual's Missouri adjusted gross income, calculated as if he or she was a resident of Missouri. Pursuant to section 143.121 RSMo Supp. 2007, the Missouri adjusted gross income of a resident individual shall be the taxpayer's Federal adjusted gross income, subject to modifications in section 143.121. Section 143.121 provides in part:

1. The Missouri adjusted gross income of a resident individual shall be the taxpayer's federal adjusted gross income subject to the modifications in this section.

2. There shall be added to the taxpayer's federal adjusted gross income:

. . . .

- (d) The amount of any deduction that is included in the computation of federal taxable income for net operating loss allowed by Section 172 of the Internal Revenue Code of 1986, as amended, other than the deduction allowed by Section 172(b)(1)(G) and Section 172(i) of the Internal Revenue Code of 1986, as amended, for a net operating loss the taxpayer claims in the tax year in which the net operating loss occurred or carries forward for a period of more than twenty years and carries backward for more than two years. Any amount of net operating loss taken against federal taxable income but disallowed for Missouri income tax purposes pursuant to this subdivision after June 18, 2002, may be carried forward and taken against any income on the Missouri income tax return for a period of not more than twenty years from the year of the initial loss[.]

Section 172 of the Internal Revenue Code sets forth the procedure for carrying over a net operating loss to future tax years of the revenue. Section 172 provides in relevant part:

(a) Deduction allowed.--There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

(b) Net operating loss carrybacks and carryovers.--

(1) Years to which loss may be carried.--

(A) General rule.--Except as otherwise provided in this paragraph, a net operating loss for any taxable year--

(i) shall be a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss, and

(ii) shall be a net operating loss carryover to each of the 20 taxable years following the taxable year of the loss.

....

(2) Amount of carrybacks and carryovers.--The entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall be computed--

(A) with the modifications specified in subsection (d) other than paragraphs (1), (4), and (5) thereof, and

(B) by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter, and the taxable income so computed shall not be considered to be less than zero.

(3) Election to waive carryback.--Any taxpayer entitled to a carryback period under paragraph (1) may elect to relinquish the entire carryback period with respect to a net operating loss for any taxable year. Such election shall be made in such manner as may be prescribed by the Secretary, and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the net operating loss for which the election is to be in effect. Such election, once made for any taxable year, shall be irrevocable for such taxable year.

26 U.S.C. § 172. The United States Supreme Court stated the purpose of § 172 as follows: "[It was] enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. [It was] designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year." *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 386 (1957).

The Director poses the issue in this case as: "[M]ay a taxpayer be allowed to benefit twice from the same loss?" In particular, the Director argues:

[T]he question is how to treat a negative amount of income reported on the first line of a return when that negative income amount allows the taxpayer a benefit at the Missouri level that was not truly allowed at the federal level. . . .

The fundamental problem is the starting point. The Eilians included the entire amount (\$35,429,672) of the [net operating loss] carried forward from 2005 to 2006 in calculating their 2006 federal adjusted gross income ("FAGI"). They were limited, however, in the amount used to offset their 2006 federal income. The Eilians do not deny that at the federal level they utilized \$28,418,457 of the 2005 [net operating loss] in 2006 and \$6,117,375 of the 2005 [net operating loss] in 2007. The specific [net operating loss] amount used in 2006 was dictated by the Eilians' modified taxable income, not by FAGI. Yet, Missouri *begins* the calculation of tax with FAGI, an amount calculated by including the entire amount

of the 2005 [net operating loss] carried forward to 2006. Because of this discrepancy between the amount of 2005 [net operating loss] included in the calculation of the 2006 FAGI, and the amount of 2005 [net operating loss] actually utilized in 2006 at the federal level, Missouri must make an adjustment to properly reflect this difference.

The Director, therefore, argues that we must construe section 143.121 concerning net operating losses in a way that taxpayers do not receive a double recovery on a tax deduction and make an adjustment to line 1 of the Eilians' 2006 Missouri return to prevent them from receiving an impermissible double benefit for Missouri purposes.

This case appears to be a matter of first impression, and we do not have prior Supreme Court precedent to apply. The Director argues that the Supreme Court's decision in *Brown Group, Inc. v. Administrative Hearing Commission*, 649 S.W.2d 874 (Mo. banc 1983), controls, but, in that case, the Supreme Court addressed the issue whether Federal taxable income under section 143.431, RSMo 1978, which concerned the Missouri taxable income of a corporation, may be less than zero. The case did not construe section 143.121 and the effect of net operating losses for individual taxpayers. The Director essentially wants us to borrow the rationale from *Brown* regarding the taxable income of corporations and construe the statutes regarding individual taxpayers in the same way.³ The Director acknowledges:

In *Brown* . . . , the focus was on federal taxable income, because that is the starting point for computing Missouri tax for a corporation. For an individual, however, the computation of Missouri tax begins with [Federal adjusted gross

³There is a difference between controlling precedent and analogous cases that may present persuasive reasoning for construing a different revenue law in another case. At the most, the issue in *Brown* is analogous to the issue presented in this case. If the Missouri Supreme Court has already decided an issue involving a revenue law of this state, we may apply the Supreme Court precedent to resolve a case involving that revenue law. But, using an analogous Supreme Court case to resolve an issue concerning a different revenue law requires us to construe the statute and not merely apply Supreme Court precedent.

income]. So, for individuals the application of the *Brown* . . . holding should focus on [Federal adjusted gross income], and the question should be whether the inclusion of a negative amount on line 1 (i.e. [Federal adjusted gross income] for an individual) should result in multiple benefits arising from a single loss."

Such a construction, however, is an issue within the exclusive jurisdiction of the Missouri Supreme Court and is not a mere application issue, given that the Missouri Supreme Court has never construed the statutes regarding individual taxpayers in the manner urged by the Director.

Moreover, although the Supreme Court determined in *Brown* that a corporation's Federal taxable income for purposes of line 1 on the Missouri income tax return may not be a negative number, *id.* at 877, the legislature amended section 143.431 in 2004 and subsection 5 of that statute now provides that "[f]or all tax years ending on or after July 1, 2002, federal taxable income may be a positive or negative amount." Thus, to the extent that the *Brown* court held that allowance of a negative number for a corporation's Federal taxable income on line 1 on the Missouri tax return would result in multiple benefits to a corporate taxpayer in that the loss would be available to offset any positive Missouri modification and would allow for "multiple benefits arising from a single loss," *id.*, such appears to be no longer the law.

The issue, therefore, before this court, calls for the construction of section 143.121 to determine whether the Eilians inappropriately utilized the net operating loss deduction on their 2006 Missouri tax return, resulting in their receiving an impermissible double benefit. The issue necessarily involves the construction of a state revenue law, and such issues fall within the exclusive jurisdiction of the Missouri Supreme Court. Because the Supreme Court has exclusive jurisdiction over the matter, we transfer the case to the Missouri Supreme Court pursuant to Article V, Section 3 of the Missouri Constitution. *See St. Louis Sw. Ry. Co. v. State Tax Comm'n*

of State of Mo., 706 S.W.2d 916, 917 (Mo. App. 1986); *Master Typographers, Inc. v. King*, 654 S.W.2d 371, 372 (Mo. App. 1983).

/s/ JAMES EDWARD WELSH
James Edward Welsh, Chief Judge

All concur.