NO. CV 11 6011324

STEPHEN AND DENISE ADAMS	:	SUPERIOR COURT
	:	TAX SESSION
v.	:	JUDICIAL DISTRICT OF
	:	NEW BRITAIN
KEVIN SULLIVAN, COMMISSIONER OF REVENUE SERVICES	:	JULY 24, 2014

NO. CV 11 6011326

STEPHEN AND DENISE ADAMS	:	SUPERIOR COURT
	:	TAX SESSION
v.	:	JUDICIAL DISTRICT OF
	:	NEW BRITAIN
KEVIN SULLIVAN, COMMISSIONER OF REVENUE SERVICES	:	JULY 24, 2014

NO. CV 11 6011327

STEPHEN AND DENISE ADAMS	:	SUPERIOR COURT
	:	TAX SESSION
v.	:	JUDICIAL DISTRICT OF
	:	NEW BRITAIN
KEVIN SULLIVAN, COMMISSIONER OF REVENUE SERVICES	:	JULY 24, 2014

NO. CV 11 6011328

STEPHEN AND DENISE ADAMS	:	SUPERIOR COURT
	:	TAX SESSION
v.	:	JUDICIAL DISTRICT OF
	:	NEW BRITAIN
KEVIN SULLIVAN, COMMISSIONER OF REVENUE SERVICES	:	JULY 24, 2014

MEMORANDUM OF DECISION

In this tax appeal, the plaintiffs Stephen and Denise Adams challenge the decision of the commissioner of revenue services (commissioner) partially disallowing the plaintiffs' claims for refunds of the Connecticut income tax they paid in each of the taxable years of 2003 through and including 2006 (the taxable years).[1]

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The commissioner initially claimed that the court lacks subject matter jurisdiction to consider the plaintiffs' claims because of the state's sovereign immunity and failure to exhaust their administrative remedies. The commissioner makes a vague reference to the plaintiffs filing new claims. The only new claim filed by the plaintiffs was the case of Adams v. Commissioner of Revenue Services, Docket No. CV 11 6011329, which the plaintiffs have withdrawn. As noted in the commissioner's 1/24/14 brief:

"The amended Connecticut Returns and supplements thereto were reviewed by the Department's Audit Division. The Audit Division disagreed with Plaintiffs' position and partially disallowed the Plaintiffs' claims for refund. The Plaintiffs timely protested the Audit Division's partial disallowances of their claims for refund to the Department's Appellate Division and did so by letter dated April 29, 2010 ('Plaintiffs' Protest Letter').

In each of the taxable years of 2003 through 2006, the plaintiffs reported a substantial amount of income. However, in 2008, the plaintiffs reported a loss in income resulting in a net operating loss (NOL) of $66,044,546. Because of the substantial income reported on their federal and state tax returns in their taxable years, the plaintiffs filed amended tax returns for the taxable years in order to offset the loss reported in 2008 and to seek a refund of taxes resulting from the offset.[2]

The first carryback year under consideration was the taxable year of 2003. In order to put into effect the carryback of the NOL incurred in 2008, the plaintiffs were required to file an amended federal income tax return for taxable year 2003. See Exhibit N (Form 1045). As a result of this filing, the plaintiffs were required to file an amended Connecticut tax return for 2003. See footnote 2. The plaintiffs originally reported federal

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"The Department's Appellate Division agreed with the Audit Division's determination that the application of the 2008 NOL should be limited to the amount permitted federally and upheld the Audit Division's partial disallowances of the Plaintiffs' refund requests. The Plaintiffs appealed therefrom to this Court."

(Defendant's 1/24/14 brief, pp. 3-4.)

Given the sequence of events, as recited by the commissioner, there is no jurisdictional issue due to a failure to exhaust administrative remedies.

[2] The plaintiffs elected to carry the 2008 NOL back five years for federal income tax purposes. The first year affected by the carryback of the NOL was taxable year 2003. In order to effectuate the carryback of the NOL, the plaintiffs were required to amend their federal income tax return for each carryback year as well as file an amended Connecticut tax return for each taxable year affected. See General Statutes § 12-727 (b) (2).

adjusted gross income (AGI) of $12,429,994 on their original 2003 Connecticut tax return. As a result of the $66,044,546 NOL for 2008, the plaintiffs sought to reduce their 2003 federal tax liability to zero and claim a refund of the entire amount of tax they paid on their original 2003 Connecticut return, which amounted to $619,738. The commissioner gave the plaintiffs a partial refund based on the plaintiffs' 2003 federal taxable income of $2,874,720.[3] The same process was carried out for the taxable years of 2004 through and including 2006.

Simply put, the plaintiffs, having earned a substantial amount of money reported on both of their federal and state income tax returns in prior years and having paid taxes on those earnings, seek to offset a substantial loss in earnings (NOLs) incurred in a subsequent tax year in order to recoup those taxes previously paid.

This case involves the interplay between General Statutes § 12-701 (a) (19)-(20) and Internal Revenue Code (IRC) §§ 62-63 and 172.

General Statutes § 12-701 (a) (19) defines AGI to mean "[AGI] of a natural person with respect to any taxable year, as determined for federal income tax purposes and as properly reported on such person's federal income tax return."

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"[T]he Commissioner determined that the Plaintiffs were limited to reducing their federal [AGI] as reported on their Original Connecticut Return by the amount of their federal taxable income in 2003, or $2,874,720." (Defendant's 1/24/14 brief, p. 21.)

General Statutes § 12-701 (a) (20) defines "Connecticut adjusted gross income" (CAGI) to mean AGI with modifications.

IRC § 62 defines federal AGI as AGI in the case of an individual minus trade and business deductions. (26 U.S.C. § 62.)

IRC § 63 defines federal taxable income as "gross income minus the deductions allowed by this chapter (other than the standard deduction)." (26 U.S.C. § 63.)

IRC § 172 defines the NOL deduction, which permits an individual taxpayer to carryback or carryover NOLs incurred in a taxable year. "There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the [NOL] carryovers to such year, plus (2) the [NOL] carrybacks to such year." (26 U.S.C. § 172 (a).)

The plaintiffs argue that in deducting NOLs from taxable income, the commissioner is required, pursuant to § 12-701 (a) (19), to use CAGI, not federal taxable income.

It is the commissioner's contention that the NOLs in each carryback year may be utilized only to the extent that the NOLs are used to reduce the plaintiffs' federal taxable income (in the loss year) to zero, not the plaintiffs' CAGI.

The treatment of NOLs is derived from federal tax law[4] that "allows a taxpayer to offset each year's business income with the taxpayer's 'ordinary and necessary' business expenses incurred during the same period. This deduction for business expenses is a fundamental aspect of federal tax policy because it recognizes that only 'net' income (rather than 'gross' income) is subject to tax. . . .

"Section 172 of the [IRC] . . . was enacted to mitigate the consequences when a taxpayer's income and expenses are not perfectly aligned. The provisions [in § 172] were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were 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." Eilian v. Dir. of Revenue, 402 S.W.3d 566, 568 (Mo. 2013), citing Libson Shops, Inc. v. Koehler, 353 U.S. 382, 386, 77 S.Ct. 990, 1 L. Ed. 2d 924 (1957).

NOLs are a creature of federal tax law when reporting federal individual taxable income. There is no counterpart in Connecticut tax law that allows business deductions

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26 U.S.C. § 172 provides as follows: "Net operating loss deduction. (a) Deduction allowed. There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the [NOL] carryovers to such year, plus (2) the [NOL] carrybacks to such year. For the purposes of this subtitle . . . the term '[NOL] deduction' means the deduction allowed by this subsection. . . . (c) Net operating loss defined. For purposes of this section, the term '[NOL]' means the excess of the deductions allowed by this chapter . . . over the gross income. Such excess shall be computed with the modifications specified in subsection (d)."

when computing the Connecticut state individual income tax. This is so because Connecticut bases its income tax reporting on federal AGI as required by General Statutes § 12-701 (a) (19)-(20), which includes ordinary and necessary business expenses.

The issue in this case is whether, in applying the NOLs incurred in a loss year back to profitable years, the goal is to reduce the NOLs based on the plaintiffs' federal taxable income or the plaintiffs' CAGI.

In addition to this case being one of first impression in Connecticut, there is a split of authority among the various states tackling this issue. As noted in J. Hellerstein & W. Hellerstein, State Taxation (3d Ed. 1998) § 7.16 [1], the states are divided into three categories: (1) states in conformity with the federal tax base; (2) states with NOL deductions that operate in the same manner as the federal tax code; and (3) states that are a hybrid of the first two approaches.

Connecticut appears to be in the third category as a hybrid between strict conformity with the federal tax code and separate state NOL deductions. The reason for putting Connecticut in this category is that the court in Bell Atlantic NYNEX Mobile, Inc. v. Commissioner of Revenue Services, 273 Conn. 240, 262, 869 A.2d 611 (2005), held that although our courts have recognized that federal tax concepts are incorporated into state tax laws, there is "no general incorporation of federal tax principles into our state tax law . . . . [I]ncorporation requires an express reference to the federal tax code and is limited to the principles associated with that reference."

Other states have put themselves in the first category by incorporating the IRC into state laws. On March 21, 2014, Minnesota Governor Dayton signed an omnibus tax bill which conforms the state's corporate and personal income tax to the IRC. See State and Local Taxes Weekly, 03/31/2014, Volume 75, No. 13. Also, Maine has eliminated the problem caused by applying federal or state tax laws by enacting a Maine statute under emergency conditions entitled "An Act to Conform the Maine Tax Laws to the United States Internal Revenue Code." The purpose of the emergency act was to avoid the delay in processing of 2013 income tax returns. See 2013 Maine Senate Paper No. 671, Maine 126th Legislature - 2nd Regular Session.

In a number of states, the issue of applying NOLs to federal taxable income or AGI has been considered by way of judicial interpretation as follows:

Pollack v. Michigan Dept. of Treasury, Michigan Tax Tribunal, Docket No. 97970 (Aug. 20, 1987), where the tribunal concluded that AGI as defined in the IRC (not federal taxable income), is taxable income used by Michigan. The Michigan legislature subsequently amended Michigan's income tax statute (in the same year as the Pollack decision) to add back the deduction allowed under IRC § 172 in determining federal AGI.

In Rosedale v. Zaino, Ohio Board of Tax Appeals, No. 2003-M-2101 (Feb. 11, 2005), the board of tax appeals, noting that the issue was one of first impression, concluded that the NOLs used for federal purposes should also be used for state purposes.

The board of tax appeals further noted that Ohio income taxes start with the federal AGI, as does Connecticut: "While both federal and state law allow for additional deductions from [AGI], those deductions are not correspondent. For federal income purposes, the deductions appear in IRC [§] 63 (b), 151, and those commonly known as 'itemized deductions.' . . . For state income tax purposes, the deduction permitted from [AGI] is found in R.C. 5747.025, permitting an exemption for the taxpayer, spouse, and each dependent child.

"While the state of Ohio begins with federal [AGI], the state does not permit a taxpayer to further reduce income by federally permitted itemized deductions. The effect of itemized deductions on NOL is the source of the dispute between appellants and the Tax Commissioner. When appellants applied NOL to their income for federal income tax purposes, they were only required to utilize the NOL to the extent of their *taxable* income, i.e., income after federal itemized deductions."
(Emphasis in original.)

In Matter of Berg v. Tully, 461 N.Y.S.2d 562 (3d Dept. 1983), the Appellate Division of the Supreme Court of New York concluded that limiting the deduction of NOLs to the amount of federal taxable income was appropriate.

In Utica Bankshares Corp. v. Oklahoma Tax Comm'n, 892 P.2d 979 (Okla. 1994), a taxpayer could not use federal NOLs to reduce state income tax through separate deduction of those losses.

In Eilian v. Dir. of Revenue, 402 S.W.3d 566, supra, the court held that it was appropriate to limit the application of NOLs for Missouri income tax purposes to federal taxable income. The plaintiffs distinguish the Eilian case, noting that the taxpayers in Eilian were not residents of Missouri at the time, in contrast to the plaintiffs in this case being Connecticut residents.

The distinction between the federal taxable income and CAGI is shown on plaintiffs' federal and state income tax returns as follows:

Plaintiffs' federal taxable income:		Plaintiffs' Connecticut (federal) AGI:	
Year 2003	$ 2,874,720	Year 2003	$12,429,994
Year 2004	$13,692,032	Year 2004	$35,159,328
Year 2005	$29,960,043	Year 2005	$52,299,374
Year 2006	$10,848,903	Year 2006	$26,472,289

See Exhibit N.

The reason for the difference between the federal taxable income and the federal AGI is that the federal taxable income is derived by the taxpayers making certain itemized deductions pursuant to 26 U.S.C. § 63, which defines taxable income.

IRC § 63 (a) recites as follows: "In general. Except as provided in subsection (b), for purposes of this subtitle . . . the term 'taxable income' means gross income minus the deductions allowed by this chapter . . . (other than the standard deduction)." Regarding itemized deductions, IRC § 63 (d) recites that "[f]or purposes of this subtitle . . . the term 'itemized deduction' means the deductions allowable under this chapter other than -- (1) the deductions allowable in arriving at [AGI], and (2) the deduction for personal exemptions provided by [§] 151. . . ."

There is no comparable statutory provision in Connecticut individual income tax law for a taxpayer to deduct the "itemized deductions" allowed on the federal level in IRC § 63 (d). However, since a federal AGI does include business expense deductions pursuant to IRC § 63 (d), the plaintiff tangentially gains the benefit of this deduction when filing his Connecticut income tax return.

On the federal level, the plaintiffs reported federal taxable income of $2,874,720 on their 2003 federal income tax Form 1040 (calculated on federal AGI of $12,429,994, minus itemized deductions of $9,555,274).

On the state level, the plaintiffs reported 2003 CAGI based on federal AGI of $12,429,994 and sought to offset this full amount against the 2008 NOL of $66,044,546.

In 2004, the federal taxable income (federal AGI minus itemized deductions) was $13,692,032, whereas the plaintiffs reported on Connecticut Form 1040, a federal AGI of $35,159,328, which the plaintiffs claim they were entitled to offset in full.

The commissioner points out how the plaintiffs in taxable years 2003 through and including 2006 offset a combined $116,584,867 against the NOL of $66,044,546:

Year	**Amount of AGI offset by 2008 NOL for CT purposes**	**Amount of 2008 NOL allowed for Federal Purposes**
2003	$12,429,994	$ 2,874,720
2004	$35,159,328	$13,692,032
2005	$49,477,794	$29,960,043
2006	$19,517,751	$10,848,903
	$116,584,867	$57,375,698

See defendant's Exhibit 1; see also defendant's 1/24/14 brief, p. 24.

The commissioner contends that the plaintiffs, using CAGI rather than the federal taxable income, have exceeded the NOL of $66,044,546 by $54,386,060. As the commissioner notes, the plaintiffs' use of the CAGI results in permitting the taxpayers to have a double deduction leading to bizarre results.[5] See defendant's 1/24/14 brief, p. 25.

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5 "The plaintiffs filed amended Connecticut returns in 2004, 2005 and 2006 and, in each year, applied an NOL in the same manner as they did in taxable year 2003. In other words, the plaintiffs reduced their federal [AGI] as reported for Connecticut purposes in each of these years by an amount that exceeded the amount of the NOL deduction they were allowed for federal purposes in each of these years. As explained herein, the total amount of the NOL the

The distinction between federal tax law and Connecticut tax law involving the use of NOLs is that federal law was enacted to specifically relate NOLs to federal taxable income. On the contrary, Connecticut has no such legislative enactment that authorizes an individual taxpayer to apply federal NOL directly to CAGI. In Connecticut, the reference to individual income taxes relating to federal tax law is § 12-701 (a) (19), requiring a Connecticut individual taxpayer, when preparing his or her tax return, to start with his or her CAGI, which is by statute, the taxpayer's federal AGI.

The plaintiffs acknowledge that, in preparing a Connecticut individual income tax return, the starting point for the tax return is the determination of the federal AGI. Federal AGI comes from the plaintiffs' federal income tax return Form 1040. This reliance by Connecticut on federal tax laws and principles has been recognized by our Supreme Court in Leonard v. Commissioner of Revenue Services, 264 Conn. 286, 295, 823 A.2d 1184 (2003), noting that "in construing our tax laws, we often look to federal law, in recognition that, in many instances, our tax laws incorporate federal tax principles . . . . [A]ccord Berkley v. Gavin, 253 Conn. 761, 773-74, 756 A.2d 248 (2000)." (Citation

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plaintiffs incurred in 2008 was $66,044,546. Yet, under the methodology used by the plaintiffs on their 2003, 2004, 2005 and 2006 Connecticut income tax returns, the plaintiffs used such NOL to offset $116,584,867 of [AGI] . . . . [C]onstruing . . . § 12-701 (a) (19) in such a way leads to bizarre and unworkable results." (Defendant's 1/24/14, p. 15, n.11.)

See, e.g., Ilfeld Co. v. Hernandez, 292 U.S. 62, 68, 54 S.Ct. 596, 78 L. Ed 1127 (1934), holding that the U.S. Tax Code should not be interpreted to allow for the equivalent of double deductions.

omitted; internal quotation marks omitted.) See also Bell Atlantic NYNEX Mobile, Inc. v. Commissioner of Revenue Services, supra.

As an example of incorporation, our legislature has provided for the treatment of NOLs that are incurred in corporate businesses (but not as to individual taxpayers) by the enactment of General Statutes § 12-217 (a) (4).[6] There is no similar provision in § 12-700 et seq. for an individual taxpayer addressing the deduction of business losses from individual AGI. However, the plaintiffs point out, that General Statutes § 12-711 (b) (3), considering the income of nonresident natural persons deriving their income from sources within Connecticut, recites: "Deductions with respect to capital losses and [NOLs] shall be based solely on income, gain, loss and deduction derived from or connected with sources within this state, under regulations adopted by the commissioner, but otherwise shall be determined in the same manner as the corresponding federal deductions."[7]

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General Statutes § 12-217 (a) (4) recites, in relevant part, as follows: "Notwithstanding anything in this section to the contrary, (A) any excess of the deductions provided in this section for any income year commencing on or after January 1, 1973, over the gross income for such year or the amount of such excess . . . shall be an operating loss of such income year and shall be deductible as an operating loss carry-over for operating losses incurred prior to income years commencing January 1, 2000, in each of the five income years following such loss year, and for operating losses incurred in income years commencing on or after January 1, 2000, in each of the twenty income years following such loss year . . . ."

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The plaintiffs refer to Regulations § 12-711 (b)-6. "Deductions with respect to. . . [NOLs] (a) Connecticut [AGI] derived from or connected with sources within this state includes deductions entering into the [CAGI] of a nonresident individual with respect to . . . [NOLs], but only to the extent that the items of . . . loss and deduction that entered into Connecticut

The commissioner submits that "Connecticut law provides for a state specific NOL deduction for nonresidents. See Conn. Agencies Regs. § 12-711 (b)-(6). However, as the plaintiffs were residents during all periods covered in this appeal, these provisions have no relevance to this appeal." (Defendant's 1/24/14 brief, p. 16, n.12.) Section 12-711 (b) (6) of the Regulations allows a carryback or carryforward of NOLs that are related only to Connecticut source losses.

The plaintiffs' contention is that there is no need to adopt federal concepts of itemized deductions and federal taxable income. The plaintiffs propose an alternate solution which would permit the plaintiffs to use NOLs to reduce CAGI without considering federal taxable income.[8]

In order to agree with the plaintiffs' concept of treating NOLs deducted from federal AGI rather than federal taxable income, the legislature would have to address this

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[AGI] are based solely on items of . . . loss and deduction derived from or connected with Connecticut sources." The regulation itself is authorized by the General Statutes. See § 12-711 (b) (3).

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As an example, in 2003, the plaintiffs would offset the $12,429,994 of CAGI against the 2008 loss of $66,044,546, leaving NOL of $53,614,552 to be applied to the tax year of 2004 offsetting CAGI of $35,159,328, leaving a NOL balance of $18,455,224 to be applied to the tax year of 2005.

issue by enacting legislation permitting a Connecticut individual income taxpayer the right to offset federal NOLs against CAGI, not federal taxable income.[9]

In comparing Connecticut to other states that have dealt with this issue, the court notes that in Berg v. Tully, supra, 461 N.Y.S.2d 564, "there is no statutory provision in New York State's Tax Law which specifically provides for a [NOL] deduction to be carried forward or carried back. New York taxpayers are permitted to carry back or carry forward operating losses only insofar as such items are, for Federal income tax purposes, deducted from gross income to arrive at [AGI]." The Berg court recognized that New

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In a colloquy between plaintiffs' attorney and the court, plaintiffs' attorney noted:

"We are proposing to the court that the limit should be as simple as: this is what you used for Connecticut purposes. It's very easy to track. When it's exhausted, it's exhausted for Connecticut purposes . . . . And it just happens that this is the first time that this question has come up in Connecticut.

"The COURT: Wouldn't you need legislation to carry out that concept?

"ATTY. LENORE: I don't believe so.

"THE COURT: Then why do you have a legislation dealing with nonresidents and no legislation dealing with your proposal?

"ATTY LENORE: I believe it's an oversight, Your Honor. If, if the Department had thought about it, I believe they would have addressed it. I can't speak for that, that process. It was back in 1994, the regs were finalized, so we've, we've come 20 years before we've had the question, and we still don't know the answer. . . ."

See Tr., April 3, 2014, p. 17.

York Tax Law provides that New York AGI shall be the same as the federal AGI with certain modifications not relevant here.[10] The plaintiffs have not identified any specific Connecticut law that permits an individual Connecticut taxpayer to carry back or carry forward a NOL deduction pursuant to IRC § 172 against his or her CAGI.

Recognizing that Connecticut individual state income taxes are a creature of statute, see § 12-700 et seq., the lack of statutory authority to deduct NOLs arrived at under federal tax laws, precludes the plaintiffs from deducting NOLs from CAGI rather than federal taxable income. NOLs were created under federal tax laws to deal with excess business losses used to offset positive income years arrived at under federal tax laws. Federal tax laws provide for the limitation on the use of NOLs to *taxable income* rather than *AGI.* This is more in line with the application of federal tax concepts to Connecticut tax laws.[11] Considering all of the factors in this case, the only conclusion for the court to arrive at is that the plaintiffs are limited to applying their federal NOLs to federal taxable income rather than to CAGI, which is, in fact, federal AGI.

10

Similar to New York, the court in Eilian, supra, recognized that there was nothing in IRC § 172 that authorized a taxpayer to use its NOL to offset Missouri taxable income and that there was no Missouri law, as is the case in Connecticut, that authorizes a taxpayer to circumvent IRC § 172.

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See Berkley v. Gavin, supra, 253 Conn 772-73, noting that "§ 12-701 (a) (19) . . . referring to the phrase 'as determined for federal income tax purposes,' means as determined in accordance with federal income tax methodology . . . ."

Accordingly, judgment may enter in favor of the commissioner in all pending cases, without costs to any party.

Arnold W. Aronson
Judge Trial Referee