

included in a combined Arizona corporate income tax return filed under the name [REDACTED].

The Section audited Taxpayer's Arizona corporate income tax returns for the 1995 through 1999 tax years and, among other adjustments, determined that Taxpayer had miscalculated its Arizona net operating loss (NOL) carryforward. The Section accordingly issued a proposed assessment for the years at issue that included tax and interest. Taxpayer timely protested the assessment. The Section subsequently modified the assessment twice. The parties have entered into a partial closing agreement.

The parties agree that there are two issues before the Hearing Office. The first issue concerns the correct methodology to calculate the usage of the acquired Arizona NOL carryforward. Taxpayer asserts that the correct Arizona NOL carryforward utilization for the audit period is [REDACTED] of the acquired Arizona NOL carryforward of [REDACTED]. The Section has allowed the usage of [REDACTED] of the acquired Arizona NOL carryforward. The acquired Arizona NOL carryforward at issue arose from the acquisition of [REDACTED] on [REDACTED], [REDACTED] on [REDACTED], and [REDACTED] on [REDACTED]. These acquired [REDACTED] had NOLs before they were merged and Taxpayer deducted them on its returns in years after the mergers. The second issue is whether the exclusion of in-state municipal bond interest from taxable income, while requiring the addition of income received as interest from out-of-state municipal bonds, is unconstitutional.

CONCLUSIONS OF LAW

With regard to the first issue, A.R.S. § 43-1121.7 provides that in computing Arizona taxable income for a corporation, the amount of NOL taken pursuant to I.R.C. § 172 shall be added to Arizona gross income. A.R.S. § 43-1122.7 provides that in computing Arizona taxable income for a corporation, the amount of NOL allowed by A.R.S. § 43-1123 shall be subtracted from Arizona gross income. Arizona has its own NOL computation for corporate taxpayers provided at A.R.S. § 43-1123. Whatever NOL is taken at the federal level is added back to income, then the Arizona NOL, as computed pursuant to A.R.S. § 43-1123, is subtracted from income.

With regard to corporate NOLs, the Arizona Administrative Code, at A.A.C. R15-2D-302.B. (former A.A.C. R15-2-1123.B.), provides in pertinent part:

In calculating the Arizona net operating loss, the taxpayer shall not include:

* * *

3. A net operating loss from a prior period if such loss was incurred by another corporation or group of corporations, prior to a merger, consolidation, or reorganization with the taxpayer, to the extent that Arizona adjusted income, earned after the merger, consolidation, or reorganization, is not attributable to the same entity which incurred the net operating loss.

In *State Tax Commission v. Oliver's Laundry & Dry Cleaning Co.*, 19 Ariz. App. 442, 508 P.2d 107 (1973), the Arizona Court of Appeals addressed whether a corporation surviving from a merger of itself and a sister corporation may carry over and

deduct pre-merger NOLs of the merging corporation from the post-merger income of the surviving corporation. The Court stated at page 447 that in the case of such a merger, "the loss may be carried over only to the extent that the losses being used to offset the subsequent gains are from the same business unit." The Court concluded at page 447 that "New Cascade having sustained pre-merger losses may not carry them over to post-merger gains attributable to a different business unit." Although A.A.C. R15-2D-302.B.3 uses the phrase "same entity" rather than the phrase "same business unit" used by the Court in *Oliver's Laundry*, A.A.C. R15-2D-302.B.3 is consistent with *Oliver's Laundry*.

The evidence indicates that in its assessment, the Section applied Arizona Corporate Tax Ruling No. CTR 91-2 to calculate the Arizona NOL carryforward. CTR 91-2 relies on the principles set forth in *Oliver's Laundry* and former A.A.C. R15-2-1025 in addressing the allowable Arizona NOL for corporations which change their method of filing to Arizona from separate to combined or combined to separate. Since similar principles apply to pre-merger and post-merger NOLs (see *Oliver's Laundry*), it is reasonable to conclude that the Section properly applied CTR 91-2 and A.A.C. R15-2D-302 (former A.A.C. R15-2-1123) to the facts in the present case.

Taxpayer argues that Arizona follows federal law (I.R.C. §§ 381 and 382) regarding the successor's use of an acquired company's NOL carryover in a statutory merger. However, in enacting A.R.S. §§ 43-1121.7, 43-1122.7 and 43-1123, the Arizona

Legislature made a clear statement that Arizona does not adopt federal law regarding NOLs but instead Arizona has adopted its own law regarding NOLs. Therefore, federal NOL law does not apply to this case. The phrase "subject only to modifications contained in this title" in A.R.S. § 43-102.A.2 supports this conclusion. The Department and Taxpayer are bound by Arizona law regarding NOLs.

The second issue in this case is whether the exclusion of in-state municipal bond interest from taxable income, while requiring the addition of income received as interest from out-of-state municipal bonds, is unconstitutional. A.R.S. § 43-1121.1 provides in part that in computing Arizona taxable income for a corporation, the amount computed pursuant to A.R.S. § 43-1021.3 shall be added to Arizona gross income. A.R.S. § 43-1021.3 requires an addition for:

The amount of interest income received on obligations of any state, territory or possession of the United States, or any political subdivision thereof, located outside the state of Arizona, reduced, for tax years beginning from and after December 31, 1996, by the amount of any interest on indebtedness and other related expenses that were incurred or continued to purchase or carry those obligations and that are not otherwise deducted or subtracted in arriving at Arizona gross income.

Taxpayer argues that the statutory provisions under Arizona law (A.R.S. §§ 43-1121.1 and 43-1021.3) that include interest from non-Arizona state and local bonds in taxable income, while exempting interest from Arizona state and local bonds, violate

the Commerce Clause. Taxpayer asserts that Arizona's statutory provisions are facially discriminatory and invalid because they favor in-state bonds over out-of-state bonds without sufficient justification. Taxpayer further argues that to correct the violation, interest from non-Arizona federally tax-exempt local and state debt obligations must also be excluded from Arizona taxable income.

It is a settled principle of law in Arizona that a legislative act is presumed to be constitutional. *In Re One 1965 Ford Mustang*, 105 Ariz. 293, 463 P.2d 827 (1970). It is also well established that a tax is presumed to be constitutional. *J.C. Penney Company, Inc. v. Arizona Department of Revenue*, 125 Ariz. 469, 610 P.2d 471 (App. 1980). Insufficient evidence has been produced to overcome these presumptions.

Taxpayer argues that the Department should follow the Kentucky Court of Appeals' decision in *Davis v. Department of Revenue*, No. 2004-CA-001940-MR (Ky. Ct. App. January 6, 2006) because Arizona's bond taxation system is similar to that in *Davis*. However, the United States Supreme Court recently granted review of the *Davis* case so the status of the decision in that case is presently uncertain.

The presumption is that an assessment of additional income tax is correct. *Arizona State Tax Commission v. Kieckhefer*, 67 Ariz. 102, 191 P.2d 729 (1948). Taxpayer has produced insufficient evidence to overcome the presumption. Taxpayer has produced insufficient evidence to show that the Section

incorrectly recalculated the NOL carryforward. Taxpayer has produced insufficient evidence to show that its estimates must be used.

Based on the foregoing, Taxpayer's protest is denied.

DATED this 7th day of June, 2007.

ARIZONA DEPARTMENT OF REVENUE
APPEALS SECTION

[REDACTED]
Hearing Officer

Original of the foregoing sent by certified mail to:

[REDACTED]

Copies of the foregoing mailed to:

[REDACTED]

[REDACTED]

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue
Corporate Audit Section