

STATE OF ARIZONA

Department of Revenue
Office of the Director
(602) 716-6090



Janet Napolitano
Governor

Gale Garrriott
Director

CERTIFIED MAIL [REDACTED]

**The Director's Review of the Decision
of the Hearing Officer Regarding:**

[REDACTED]

FEIN [REDACTED]

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ORDER

Case No. 200600161-C

On June 7, 2007 the Hearing Officer issued a decision regarding the protest of [REDACTED] ("Taxpayer"). Taxpayer timely appealed the decision of the Hearing Officer. Taxpayer's Appeal states that Taxpayer and the Department of Revenue's Corporate Tax Appeals Section have agreed to submit the Appeal to the Director of the Department of Revenue ("Director") based on the record and memoranda presented to the Hearing Officer. No additional information has been submitted to the Director. The Director has reviewed Taxpayer's appeal to determine whether a review of the Hearing Officer's decision by the Director is warranted.

The Corporate Income Tax Section of the Audit Division ("Division") issued a deficiency assessment to Taxpayer for tax years 1995 through 1999. Taxpayer protested the assessment. The issue before the Hearing Officer was the propriety of the assessment issued by the Division. The Hearing Officer upheld the assessment.

The following two issues were presented to the Hearing Officer, and now to the Director:

1. Did the Department use the correct methodology to calculate the usage of the acquired Arizona NOL carryforward; and

2. Is 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, constitutional.

FINDINGS OF FACT

The Director adopts the Hearing Officer's Findings of Fact. The evidence and the parties' joint listing of facts presented to the Hearing Officer presented the following relevant facts:

1. Taxpayer is engaged in the [REDACTED] business in Arizona.
2. [REDACTED]'s commercial domicile was in Arizona during 1995 through 1999.
3. For tax years 1995 through 1997, [REDACTED] was included in the combined Arizona corporate income tax return filed under the name [REDACTED] and Subsidiaries.
4. [REDACTED] had [REDACTED] short years in [REDACTED], [REDACTED] ending because it was a subsidiary of [REDACTED], which merged with [REDACTED].
5. For the years ending [REDACTED] was included in a combined Arizona corporate income tax return filed under the name [REDACTED].
6. During the years at issue Taxpayer received interest income from both Arizona and non-Arizona state and local bonds.
7. The Division audited Taxpayer's Arizona corporate income tax returns for the 1995 through 1999 tax years.
8. Taxpayer acquired Arizona net operating loss carry forward during 1994 and 1995 through the acquisition of [REDACTED].
9. Over [REDACTED]% of the acquired loss was from losses incurred by [REDACTED] prior to the merger.

10. The Division determined that Taxpayer had miscalculated its Arizona net operating loss (NOL) carryforward.
11. The Division issued a proposed assessment for the years at issue.
12. Taxpayer timely protested the assessment.
13. The Division subsequently modified the assessment twice, and the parties have entered into a partial closing agreement. Those are not at issue in this case.

CONCLUSIONS OF LAW

The Director adopts the Hearing Officer's Conclusions of Law, specifically,

1. 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.
2. 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.
3. A.R.S. § 43-1123 provides for the separate calculation of Arizona NOL for corporate taxpayers.
4. A.A.C. R15-2D-302.B. (former A.A.C. R15-2-1123.B.), provides that a taxpayer may not include 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.
5. In the case of a corporation's merger with a sister corporation, the surviving corporation may only carryover a pre-merger loss to the extent that the loss being used to offset the subsequent gains are from the same business unit.

State Tax Commission v. Oliver's Laundry & Dry Cleaning Co., 19 Ariz. App. 442, 508 P.2d 107 (1973).

6. I.R.C. §§ 381 and 382 regarding a successor's use of an acquired company's NOL carryover in a statutory merger are not applicable in calculating a company's NOL carryover for Arizona corporate income tax purposes.
7. A.R.S. § 43-1121.1 requires a corporation to add back 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 by related expenses.
8. A legislative act is presumed to be constitutional. *In Re One 1965 Ford Mustang*, 105 Ariz. 293, 463 P.2d 827 (1970).
9. Only a court, not the Arizona Department of Revenue, can declare a statute unconstitutional. *Estate of Bohn*, 174 Ariz. 239, 248-50, 848 P.2d 324, 333-35 (App. 1992). Arizona's add-back requirement has not been declared unconstitutional by a court.

NET OPERATING LOSS CARRYFORWARD

With regard to the NOL 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 then provides for a subtraction of the amount of NOL allowed by A.R.S. § 43-1123. Because the federal NOL is added back to Arizona income, then the Arizona NOL, as computed pursuant to A.R.S. § 43-1123, is subtracted from Arizona income, the Hearing Officer concluded that Arizona has its own NOL computation for corporate taxpayers as provided by A.R.S. § 43-1123.

Calculating Arizona NOL is addressed by both Arizona administrative rules and rulings. 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.

The rule is based on the Arizona Court of Appeals opinion in *State Tax Commission v. Oliver's Laundry & Dry Cleaning Co.*, 19 Ariz. App. 442, 508 P.2d 107 (1973). In that case the court addressed whether a corporation surviving from a merger of itself and a sister corporation may carry over and deduct pre-merger NOL's of the merging corporation from the post-merger income of the surviving corporation. The Court stated that in the case of 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." 19 Ariz. App. at 447. The Court concluded that "New Cascade having sustained pre-merger losses may not carry them over to post-merger gains attributable to a different business unit." *Ibid.*

The Division applied CTR 91-2 to calculate Taxpayer's 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 NOL's (see *Oliver's Laundry*), it is reasonable to conclude that the Division 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

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NOL's but instead Arizona has adopted its own law regarding NOL's. 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 NOL's.

Taxpayer also cited *Newmarket Manufacturing Co. v. United States*, 233 F.2d 493 (1 Cir., 1956), *E. & J. Gallo Winery v. Commissioner*, 227 F.2d 699 (9 Cir., 1955), *Stanton Brewery, Inc., v. Commissioner*, 176 F.2d 573 (2 Cir., 1949) and *Koppers Co. v. United States*, 134 F.Supp. 290, 133 Ct.Cl. 22 (1955) arguing that those cases allowed carryovers and carrybacks across the line of corporate fusion where the reorganization took the form of a statutory merger. Those cases are not applicable here. The basis for the rule and the ruling supporting the Division is found in *State Tax Commission v. Oliver's Laundry & Dry Cleaning Co., supra*. The basis for *Oliver's Laundry* is *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 77 S.Ct. 990 (1957), and the "continuity of business enterprise" concept.

The taxpayer in *Libson Shops* relied on the same four cases cited by Taxpayer here in arguing that a corporation resulting from a statutory merger should be treated as the same taxable entity as its constituents. In addressing those cases, the Supreme Court stated, 353 U.S. at 386, 77 S.Ct. at 992-93:

However, we find it unnecessary to discuss this issue since an alternative argument made by the Government is dispositive of this case. The Government contends that the carry-over privilege is not available unless there is a continuity of business enterprise. It argues that the prior year's loss can be offset against the current year's income only to the extent that this income is derived from the operation of substantially the same business which produced the loss. Only to that extent is the same 'taxpayer' involved.

For the same reason, the cases cited by Taxpayer do not need to be discussed here. As the Hearing Officer found on page 5 of his decision, the Arizona Legislature made a clear statement that Arizona does not adopt federal law regarding NOL's, but instead Arizona has adopted its own law regarding NOL's. Arizona law has been interpreted by

the Arizona Court of Appeals as requiring a continuity of the same business that produced the law. Taxpayer has not demonstrated such continuity. Therefore, Taxpayer has not shown it is entitled to the NOL it claims.

MUNICIPAL BOND INTEREST

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, citing the Kentucky Court of Appeals' decision in *Davis v. Department of Revenue*, 197 S.W.3d 557 (Ky.App. 2006).

First, only a court, not the Arizona Department of Revenue, can declare a statute unconstitutional. *Estate of Bohn*, 174 Ariz. 239, 248-50, 848 P.2d 324, 333-35 (App. 1992).

Second, a statute is presumed to be constitutional. *In Re One 1965 Ford Mustang*, 105 Ariz. 293, 463 P.2d 827 (1970); *J.C. Penney Company, Inc. v. Arizona Department of Revenue*, 125 Ariz. 469, 610 P.2d 471 (App. 1980). The Arizona Supreme Court stated in *State v. Davey*, 27 Ariz. 254, 258, 232 P. 884, 885 (1925):

We have repeatedly said, following the almost universal practice of the courts, that we would not declare an act of the Legislature unconstitutional unless satisfied thereof beyond reasonable doubt. The burden therefore is upon the appellee in this case to convince us that the subject of the act is not reasonably embraced in the title thereof, by as great a weight of evidence and reasoning as would be required to be presented by the state to convict a defendant of murder. Every intendment and every presumption is in favor of the law, and if on any reasonable theory we can hold it constitutional, statutory construction requires us to do so.

Insufficient evidence has been produced to overcome these presumptions.

Third, the United States Supreme Court recently granted review of the Kentucky *Davis* case at ___ U.S. ___, 127 S.Ct. 2451, 167 L.Ed.2d 1129 (2007). The status of the Kentucky Court of Appeals decision is presently uncertain.

Taxpayer requested the Director to review the Hearing Officer's decision based on the record and memoranda presented to the Hearing Officer. The record before the Hearing Officer has presented no facts or arguments that would warrant the Director reversing the decision of the Hearing Officer. A.A.C. R15-10-131.H. provides that the Director may issue a decision that summarily affirms the decision of the Hearing Officer. The Director finds that the decision of the Hearing Officer should be affirmed.

ORDER

The Hearing Officer's decision is affirmed.

This decision is the final order of the Department of Revenue. Taxpayer may contest the final order of the Department in one of two manners. Within 60 days of the receipt of the final order, Taxpayer may file an appeal to the State Board of Tax Appeals, 100 North 15th Avenue, Suite 140 Phoenix, AZ 85007 or, if the amount in dispute is greater than five thousand dollars, Taxpayer may bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003). For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this 29th day of October, 2007.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified original of the foregoing
mailed by certified mail to:

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Copies of the foregoing mailed to:

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cc: Corporate Income Appeals
Audit Division
Corporate Income Audit Section