BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO

IN THE MATTER OF THE PROTEST OF
COVENANT TRANSPORTATION GROUP INC. **No. 14-45**
TO ASSESSMENT ISSUED UNDER LETTER
ID NO. L1907135952

DECISION AND ORDER

A protest hearing occurred on the above captioned matter on September 4, 2014 before Brian VanDenzen, Esq., Hearing Officer, in Santa Fe. Loren Chumley and Blair Norman, CPA, of KPMG appeared in person, representing Covenant Transportation Group, Inc. ("Taxpayer"). Paul Bunn, Chief Accounting Officer, and Kerry Finley, Senior Corporate Tax Manager, of Taxpayer appeared telephonically. Staff Attorney Peter Breen appeared representing the State of New Mexico, Taxation and Revenue Department ("Department"). Protest Auditor Tom Dillon appeared as a witness for the Department. Taxpayer Exhibits #A-O and Department Exhibit #1 were admitted into the record, as described more thoroughly in the Administrative Protest Hearing Exhibit Log. Without objection, the undersigned hearing officer takes notice and admits the "2012 New Mexico Instructions for Form CIT-1 Corporate Income and Franchise Tax Return" into the record. Based on the evidence and arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. On February 12, 2014, the Department assessed Taxpayer for $74,313.00 in corporate income tax, $7,431.30 in penalty, and $2,003.45 in interest for a total assessment of $83,747.75 for the reporting period ending on December 31, 2012. [Letter id. no. L1907135952].

2. On April 25, 2014, Taxpayer protested the Department's assessment.

3. On May 20, 2014, the Department acknowledged receipt of Taxpayer's protest.

4. On June 12, 2014, the Department requested a hearing in this matter with the Hearings Bureau.

5. On June 16, 2014, the Hearings Bureau sent Notice of Administrative Hearing, scheduling this matter for a hearing on July 21, 2014.

6. On July 14, 2014, Taxpayer moved to continue the July 21, 2014 protest hearing. The Department did not oppose Taxpayer's motion.

7. On July 14, 2014, the Hearings Bureau issued a Continuance Order and Amended Notice of Administrative Hearing, rescheduling the July 21, 2014 protest hearing to September 4, 2014.

8. On August 28, 2014, Taxpayer moved with the Department's agreement to have witness Paul Bunn and Kerry Finley appear telephonically at the September 4, 2014 hearing. Taxpayer's request was granted because the matter involved a dispute of law rather than a genuine dispute of fact.

9. Taxpayer, Covenant Transportation Group, Inc., is the parent corporation of a group of affiliated corporate entities specializing in transportation services across the United States and Canada.

10. Taxpayer is headquartered in Chattanooga, Tennessee.

11. At all relevant times, three entities wholly owned by Taxpayer did business in New Mexico: Covenant Transport, Inc.; CTG Leasing Company, Inc.; and Southern Refrigerated Transport, Inc. [09-04-14 CD 0:22:30-39].

12. Before 2012, all three entities—Covenant Transport, Inc., CTG Leasing Company, Inc., and Southern Refrigerated Transport, Inc.—filed New Mexico Corporate Income Tax ("NM CIT or CIT") returns as separate corporate entities. [Taxpayer Ex. A-N; 09-04-14 CD 0:21:08-59].

13. Covenant Transport, Inc. and CTG Leasing Company, Inc. generated net operating losses on their separate corporate entity returns before 2012. [Taxpayer Ex. A-N; 09-04-14 CD 0:29:40-56].

14. For the first time in 2012, Taxpayer elected to file NM CIT returns as a combined consolidated group for all entities it owned and controlled, including the three entities that had previously filed separate returns: Covenant Transport, Inc., CTG Leasing Company, Inc., and Southern Refrigerated Transport, Inc. [Taxpayer Ex. O; 09-04-14 CD 0:22:00-10 & 0:24:40-0:25:05].

15. The same entities reflected on Taxpayer's 2012 combined consolidated group New Mexico CIT return are the same entities contained on Taxpayer's federal 1120. Taxpayer and its entities were a unitary group.Taxpayer was the reporting entity for 2012 New Mexico CIT tax returns and the reporting entity for the federal 1120 in 2012. [09-04-14 CD 22:10-23:28].

16. Taxpayer was the reporting entity for the Federal 1120 in tax year 2012. [09-04-14 CD 0:23:00-18].

17. Taxpayer elected to switch to the combined consolidated group reporting method because it is simpler to file one return than multiple returns and because it believed it could use the tax benefits and attributes of the three entities that had previously filed separately when switching to the combined consolidated group. [09-04-14 CD 0:25:10-56; 0:23:18-0:24:00].

18. In its 2012 combined consolidated group CIT return, Taxpayer claimed the net operating loss carryover first reported in previous years by Covenant Transport, Inc. and CTG Leasing Company, Inc. as separate entities. [09-04-14 CD 0:30:10-23].

19. The Department disallowed Taxpayer's attempt to claim the net operating losses of Covenant Transport, Inc. and CTG Leasing Company, Inc. in Taxpayer's 2012 combined consolidated group CIT return. [09-04-14 CD 0:30:23-35].

20. Taxpayer has not petitioned the Secretary for permission to return to filing as separate corporate entities. [09-04-14 CD 0:30:45-0:31:19].

21. As of the date of hearing, the Department alleged that Taxpayer owed $74,313.00 in corporate income tax, $14,862.60 in penalty, and $3,273.89 in interest for a total outstanding liability of $92,449.49. [Department Ex. #1].

22. At the request of Taxpayer, and over the Department's objection, the parties were ordered to submit post-hearing legal briefing by October 6, 2014. On October 6, 2014, Taxpayer submitted its Post Hearing Memorandum in Support of the Protest. On October 6, 2014, the Department submitted its Post Hearing Brief. Both briefings are part of the administrative record in this matter.

23. On December 15, 2014, the undersigned hearing officer provided notice of intent to take notice of 2012 CIT instructions and any worksheets/schedules/instructions addressing net operating losses in that year. The parties did not object by the specified deadline. The "2012 New Mexico Instructions for Form CIT-1 Corporate Income and Franchise Tax Return" is made part of the record.

24. The "2012 New Mexico Instructions for Form CIT-1 Corporate Income and Franchise Tax Return," page 8, does not contain any advisement or instruction that a combined

consolidated group cannot claim a net operating loss carryover from a member entity that previously claimed the net operating loss in a separate entity return.

25. On December 15, 2014, the undersigned hearing officer ordered further briefing in this matter. On December 22, 2014, the Department filed its Second Post-Hearing Briefing (with attachments), which is incorporated into the administrative record in this matter. On December 23, 2014, Taxpayer filed its Second Post-Hearing Memorandum in this matter, which is also incorporated into the record.

DISCUSSION

There are no disputes of fact in this matter. There are two legal issues at protest. First, Taxpayer asked to be allowed to change its CIT reporting method back to separate entities in order to continue to claim the net operating loss deduction that the Department disallowed. The second and main issue in this case is whether Taxpayer filing as combination of unitary corporations may claim a deduction from New Mexico Corporate Income Tax ("CIT") for net carryover losses first reported in previous years by its wholly owned members filing on separate corporate entity basis. Taxpayer argued that the Department exceeded its authority in barring a deduction that otherwise is allowed by the statutory incorporation of a specific provision of the Internal Revenue Code.

Presumption of Correctness.

Under NMSA 1978, Section 7-1-17 (C) (2007), the assessment issued in this case is presumed correct. Consequently, Taxpayer has the burden to overcome the assessment. *See Archuleta v. O'Cheskey*, 1972-NMCA-165, ¶11, 84 N.M. 428. Unless otherwise specified, for the purposes of the Tax Administration Act, "tax" is defined to include interest and civil penalty. *See* NMSA 1978, §7-1-3 (X) (2013). Under Regulation 3.1.6.13 NMAC, the presumption of

correctness under Section 7-1-17 (C) extends to the Department's assessment of penalty and interest. Moreover, "[w]here an exemption or deduction from tax is claimed, the statute must be construed strictly in favor of the taxing authority, the right to the exemption or deduction must be clearly and unambiguously expressed in the statute, and the right must be clearly established by the taxpayer." *Wing Pawn Shop v. Taxation and Revenue Department*, 1991-NMCA-024, ¶16, 111 N.M. 735 (internal citation omitted); *See also TPL, Inc. v. N.M. Taxation & Revenue Dep't*, 2003-NMSC-7, ¶9, 133 N.M. 447. However, once a taxpayer rebuts the presumption of correctness, the burden shifts to the Department to show the correctness of the assessed tax. *See MPC Ltd. v. N.M. Taxation & Revenue Dep't*, 2003 NMCA 21, ¶13, 133 N.M. 217.

CIT, Reporting Methods, and the Net Operating Loss Deduction

a. *CIT and Reporting Methods*.

Under the Corporate Income and Franchise Tax Act, New Mexico imposes a tax on the *net income* of every domestic corporation and every foreign corporation engaged in the transaction of business in New Mexico. *See* NMSA 1978, § 7-2A-3 (1986) (emphasis added). Under NMSA 1978, Section 7-2A-2 (H) (1999), the "net income" that is subject to CIT tax is defined as "base income" adjusted to exclude four specified items under that section. In pertinent part, the Legislature defines "base income" as "that part of the taxpayer's income defined as taxable income and upon which the federal income tax is calculated in the Internal Revenue Code [26 USCS § 1 et seq.] for income tax purposes plus… the amount of the net operating loss deduction allowed by Section 172(a) of the Internal Revenue Code [26 USCS § 172(a)]… and claimed by the taxpayer for that year." *See* NMSA 1978, § 7-2A-2 (C) (1999).

New Mexico allows a taxpayer subject to the Corporate Income and Franchise Tax Act to elect one of three reporting methods. *See* Regulation 3.4.10.8 (B) NMAC. The first permissible

reporting method is the separate corporate entity method. *See* Regulation 3.4.10.8 (B) (1) NMAC and Regulation 3.4.10.7 (A) NMAC. The second permissible reporting method is the combination of unitary corporations. *See* NMSA 1978, § 7-2A-8.3 (2013) and Regulation 3.4.10.8 (B) (2) NMAC. The third reporting method is the federal consolidated group. *See* NMSA 1978, § 7-2A-8.4 (1993) and Regulation 3.4.10.8 (B) (3) NMAC. As the testimony on the record in this matter reflects, these three reporting methods are often referenced as "the ladder" of corporate income tax reporting options. This is because, while a corporation can elect to report at a higher step of the three reporting methods, it may not elect to step down to a lower reporting method without express permission of the Secretary. *See* NMSA 1978, § 7-2A-8.3 (B) (2013); *See* NMSA 1978, § 7-2A-8.4 (B) (1993); *See also* Regulation 3.4.10.8 (C) & (D) NMAC.

In this case, before tax year 2012 the three corporate entities owned by Taxpayer— Covenant Transport, Inc., CTG Leasing Company, Inc., and Southern Refrigerated Transport, Inc.— that conducted business in New Mexico reported CIT on the first step of the reporting ladder: the separate corporate entity method. Two of these three entities reported net operating loss carryovers on their separate corporate entity CIT returns. Because the separate corporate entity method is the first step of the ladder, Taxpayer was free to elect to report at either of the next two steps of the ladder in subsequent years without permission. *See* Regulation 3.4.10.8 (C) NMAC.

For tax year 2012, apparently in effort to streamline its reporting requirements in numerous states and maximize the net operating losses of some of the entities, Taxpayer elected to file under the second, combined unitary corporation method pursuant to Section 7-2A-8.3 and Regulation 3.4.10.8 (B) (2) NMAC. As such, Taxpayer was required to report "the *net income* of all the unitary corporations." § 7-2A-8.3 (A) (emphasis added). Although in its protest letter Taxpayer argued that it should be allowed to return to the separate entity method, by selecting the second step reporting

method, Taxpayer was no longer at liberty to change its election to the separate corporate entity method without obtaining permission from the Secretary to do so pursuant to Section 7-2A-8.3 (B) and Regulation 3.4.10.8 (D) NMAC. Since the Taxpayer has never requested permission from the Secretary to take a step down the reporting method ladder, that portion of Taxpayer's protest letter is denied. Even if permission had been sought and granted, that change of election could not apply retroactively. *See* Regulation 3.4.10.8 (E) NMAC.

b. *Net Operating Loss Carryover Deduction*.

The main dispute in this protest is the net operating loss carryover deduction that Taxpayer claimed in the combination of unitary corporations 2012 CIT return. In Taxpayer's combination of unitary corporations 2012 CIT return, Taxpayer claimed net operating loss carryover deductions against its net income from net operating losses first reported in previous years by its wholly owned subsidiary entities Covenant Transport, Inc. and CTG Leasing Company, Inc., which had filed as separate corporate entities before 2012. While the Taxpayer argues that such a deduction is allowable under Section 172 (a) of the Internal Revenue Code, and thus incorporated into state law through the "base income" and "net operating loss" definitions, the Department argues that such a net operating loss is excluded by Regulation 3.4.1.11 (A) NMAC.

Before resolving the dispute of over Taxpayer's claimed net operating loss carryover deduction, it is worth discussing and revisiting some of statutory definitions related to net operating losses, base income, and net income. Under NMSA 1978, Section 7-2A-2 (I) (1999), the Legislature defines a "net operating loss" as

> any net operating loss, as defined by Section 172(c) of the Internal Revenue Code [26 USCS § 172(c)], as that section may be amended or renumbered, for a taxable year as further increased by the income, if any, from obligations of the United States for that year less related expenses.

Under Section 7-2A-2 (J), the Legislature defines a "net operating loss carryover" as "the amount, or any portion of the amount, of a net operating loss for any taxable year that, pursuant to Paragraph (3) or (4) of [Section 7-2A-2 (H)] of this section, may be excluded from base income."

Careful consideration of the definition of "base income" under Section 7-2A-2 (C) and "net income" under Section 7-2A-2 (H), as fully articulated above, are important to the resolution of this issue. When considering the meaning of statutes, New Mexico begins with the plain meaning rule. *See Wood v. State Educ. Ret. Bd.*, 2011-NMCA-20, ¶12. In *Wood*, ¶12 (internal quotations and citations omitted), the Court of Appeals stated that

> the guiding principle in statutory construction requires that we look to the wording of the statute and attempt to apply the plain meaning rule, recognizing that when a statute contains language which is clear and unambiguous, we must give effect to that language and refrain from further statutory interpretation.

Statutes are also to be interpreted in a manner to give the entire statute effect and not render portions of the statute superfluous. *See Regents of the Univ. of New Mexico v. New Mexico Fed'n of Teachers*, 1998-NMSC-20, ¶28, 125 N.M. 401.

The starting point for determining "base income" is taxable income for purposes of federal law plus a net operating loss deduction as allowed specifically by Section 172(a) of the Internal Revenue Code. *See* Section 7-2A-2 (C). The "base income" definition incorporating federal taxable income plus the net operating loss deduction is unambiguous. *See generally Getty Oil Company v. Taxation and Revenue Department*, 1979-NMCA-131, ¶14, 93 N.M. 589 (Court of Appeals found similar definition of base income premised on "federal taxable income" as "unambiguous and self - explanatory."). From that "base income" starting point, the Legislature removes four specific types of income under Section 7-2A-2 (H) to reach the "net income" subject to the Corporate Income Tax in New Mexico. While the federal taxable income is a starting point in New Mexico, it is not the

end point, as the Legislature has articulated specific exclusions in New Mexico of amounts/items otherwise allowable under federal law. *See Mt. States Tel. & Tel. Co. v. N.M. State Corp. Comm'n (In re Rates & Charges of Mt. States Tel. & Tel. Co.)*, 1986-NMSC-019, ¶31, 104 N.M. 36 (while the Internal Revenue Code establishes a starting point for calculating New Mexico corporate income tax, New Mexico "does not incorporate or adopt the Internal Revenue Code and Treasury Regulations word for word").

Only one of the four legislatively-specified exclusions under Section 7-2A-2 (H) is pertinent to the question of whether Taxpayer's claimed net operating loss carryover deduction was permissible[1]. That pertinent exclusion is found under Section 7-2A-2 (H) (4) and reads

> for taxable years beginning on or after January 1, 1991, an amount equal to the sum of any net operating loss carryover deductions to that year claimed and allowed, provided that the amount of any net operating loss carryover from a taxable year beginning on or after January 1, 1991 may be excluded only as follows:
>
> (a) in the case of a timely filed return, in the taxable year immediately following the taxable year for which the return is filed; or
>
> (b) in the case of amended returns or original returns not timely filed, in the first taxable year beginning after the date on which the return or amended return establishing the net operating loss is filed; and
>
> (c) in either case, if the net operating loss carryover exceeds the amount of net income exclusive of the net operating loss carryover for the taxable year to which the exclusion first applies, in the next four succeeding taxable years in turn until the net operating loss carryover is exhausted; in no event may a net operating loss carryover be excluded in any taxable year after the fourth taxable year beginning after the taxable year to which the exclusion first applies;

Generally, this statutory exclusion limits a net operating loss carryover to five years and prohibits carrybacks. However, nothing contained in this statutory exclusion, even under a broad reading,

[1] Section 7-2A-2 (H) (3) also addresses net operating losses, but only for taxable years before January 1, 1991, a period not at issue in this matter.

would require exclusion of Taxpayer's member entities' net operating loss carryover from Taxpayer's net income in 2012.

If the Legislature intended to exclude other net operating loss deductions allowed by Section 172(a) of the Internal Revenue Code, one would reasonably expect those exclusions to be specified, along with the other listed exclusions, under Section 7-2A-2 (H). The Legislature intended net operating loss deductions as permitted by Section 172(a) of the Internal Revenue Code to be included as base income unless excluded specifically as part of the calculation of net income. This interpretation best harmonizes the two statutory definitions of "base income" and "net income." *See Regents of the Univ. of New Mexico*, ¶28 ("We will construe the entire statute as a whole so that all the provisions will be considered in relation to one another"). Since the deduction at issue is not excluded under Section 7-2A-2 (H), there is no basis to conclude that the Legislature intended removal of that deduction amount from the calculation of net income.

Nevertheless, the Department disallowed the net operating loss carryover deductions from income on Taxpayer's 2012 CIT return pursuant to Regulation 3.4.1.11 (A) NMAC and issued the assessment. In pertinent part, Regulation 3.4.1.11 (A) NMAC reads[2]:

> Net operating loss carryovers and carrybacks shall be in accordance with Subsections A through E of Section 3.4.1.9 NMAC but in no case shall a net operating loss established for the corporation reporting on a separate corporation basis be excluded from the base income of any other corporation or from the base income reported on any combined or consolidated return for any group of corporations.

The Department asserts that this regulation prohibits Taxpayer, as a combination of unitary corporations filing for the first time in 2012, from relying on the net operating loss carryovers first reported in previous tax years by Covenant Transport, Inc. and CTG Leasing Company, Inc., as separate corporate entities.

[2] The rest of the regulation establishes a method of calculating base income by preparing a pro forma, simulated federal return.

Taxpayer argues that Regulation 3.4.1.11 (A) NMAC is contrary to the Legislature's statutory definition of "base income" and "net operating loss", which provide for the deductions of net operating losses as allowed under Section 172(a) of the Internal Revenue Code. Under Section 172(a) of the Internal Revenue Code, "[t]here 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." Under 26 C.F.R 1.1502-21 (a), a consolidated net operating loss carryover consists partially of the net operating loss of the consolidated group and "[a]ny net operating losses of the members arising in separate return years." Consequently, Section 172(a) of the Internal Revenue Code would allow Taxpayer to claim a net operating loss deduction from corporate income even if it originated from a separate corporate filing of one of its members in an earlier year.

Taxpayer also cites a case from Florida, *Golden W. Fin. Corp. v. Fla. Dep't of Revenue*, 975 So. 2d 567 (Fla. Dist. Ct. App. 1st Dist. 2008), to support its argument. While it must be noted that a Florida Court of Appeals case is not controlling in New Mexico, *Golden W. Fin. Corp.* addresses a similar issue and therefore has weight in the analysis in this matter. The taxpayer in *Golden W. Fin. Corp.*, 568, sought a refund of corporate income tax paid under a consolidated group return. The refund claim was premised on the net operating loss carryover deduction stemming from previous years when members of the consolidated group filed on a separate entity basis. *See id*. Florida statute indicated that net operating losses allowable for federal income tax purposes under Section 172 of the Internal Revenue Code should be subtracted from taxable income. *See id*. The Florida Court of Appeals noted that there was no dispute that federal law "permits an affiliated group filing a consolidated federal income tax return to deduct from its gross income the net operating losses that one or more of its members sustained during a year in which those members filed separate tax

returns…" *Golden W. Fin. Corp.*, 570. Nevertheless, the Florida Department of Revenue denied the refund claim, citing a state regulation that prohibited a consolidated group from deducting a net operating loss carryover from a year in which a Florida consolidated return was not filed. *See Golden W. Fin. Corp.*, 571. The Florida Court of Appeals ultimately found that since the regulation was contrary to the statute's incorporation of Section 1502 and Section 172 of the Internal Revenue Code, the regulation was invalid exercise of delegated legislative authority and the regulation did not prohibit the deduction of the net operating losses. *See Golden W. Fin. Corp.*, 571-572.

Generally consistent with Taxpayer's argument is Regulation 3.4.1.9 (C)(1) NMAC, which appears to allow the deduction at issue. Under Regulation 3.4.1.9 (C)(1) NMAC (emphasis added),

> [t]he net operating loss carryover of a corporation or corporations acquired by the taxpayer *or otherwise included, as for example, through a change in reporting method*, in the taxpayer's return for a taxable year may be excluded from New Mexico base income only *to the extent the Internal Revenue Code and regulations issued thereunder would permit deduction of such loss carryovers for federal income tax purposes* for that taxable year by that taxpayer.

Regulation 3.4.1.9 (C)(1) NMAC appears to expressly allow a net operating loss deduction after a change of reporting method to the extent permitted by the Internal Revenue Code and its regulations. This regulation is consistent with the Legislature's references to Section 172(a) of the Internal Revenue Code contained in both the definitions of a net operating loss and base income under Section 7-2A-2. But Regulation 3.4.1.9 (C)(1) NMAC contradicts the Department's view that Regulation 3.4.1.11 (A) NMAC prohibits such a net operating loss deduction.

Agency regulations interpreting a statute are presumed proper and are to be given substantial weight *See Chevron U.S.A., Inc. v. State ex rel. Dep't of Taxation & Revenue*, 2006-NMCA-50, ¶16, 139 N.M. 498. However, it is difficult to presume the Department Regulation 3.4.1.11 (A) NMAC is proper and should be afforded proper substantial weight when another Department Regulation,

3.4.1.9 (C)(1) NMAC, appears to contradict it. Further, an administrative agency's discretion in promulgating regulations may not justify altering, modifying or extending the reach of a law created by the Legislature. *See State ex rel. Taylor v. Johnson*, 1998-NMCA-015, ¶ 22, 125 N.M. 343. In *Rainbo Baking Co. v. Commissioner of Revenue*, 1972-NMCA-139, ¶11, 84 N.M. 303, the New Mexico Court of Appeals found that the Department cannot use a regulation to restrict a statutorily created deduction when the Legislature did not prescribe such a limitation: "[t]he Commissioner exceeds this interpretative authority when he attempts by regulation to impose a limitation on the deduction which the Legislature did not prescribe."

Here, the Legislature allows for a deduction of net operating losses as permitted under Section 172(a) of the Internal Revenue code. *See* Section 7-2A-2 (C) and (I). From the base income starting point, the Legislature created specific exclusions where state law differs from federal treatment of the net operating loss deduction under Section 7-2A-2 (H). The deduction at issue in this matter was not listed by the Legislature in those specific exclusions and therefore the Legislature's general adoption of net operating loss deduction consistent with Section 172(a) of the Internal Revenue Code remains paramount. Since the net operating loss deduction at issue is allowed by Section 172(a) of the Internal Revenue Code and since it is not included in the list of statutory exclusions, Regulation 3.4.1.11 (A) NMAC exceeds its authority by attempting to prohibit a deduction otherwise allowed by the Legislature in its definition of base income and net operating loss. *See generally Rainbo Baking Co.*, ¶11.

In the second briefing ordered by the undersigned hearing officer, the Department argued that the Hearings Bureau *sua sponte* raised the issue of whether Regulation 3.4.1.11 (A) NMAC is *ultra vires* of statute. The record in this matter does not support the Department's argument that this issue was raised *sua sponte*. Taxpayer's protest letter referenced Regulation 3.4.1.11 (A) NMAC

and argued that it was not specific enough to provide authority when there was no statute or guidance regarding net operating losses for a combined group. While that argument does not go so far as to constitute an express *ultra vires* challenge, it alerted the Department that Taxpayer did not believe the Regulation 3.4.1.11 (A) NMAC was applicable. And if there were any ambiguity in the protest letter, Taxpayer expressly raised the issue of the regulation conflicting with the statutes in its opening argument at the hearing. *See* 09-04-14 CD 0:17:50-0:18:31. Taxpayer's questioning of Mr. Dillon during the hearing carefully reviewed the statutory definitions of net income, base income, and the federal treatment of net operating losses, and the apparent contradiction between those statutory provisions and the regulation. *See* 09-04-14 CD 0:35:31-0:47:09; 0:50:10-45; 0:55:28-55. Taxpayer began its closing argument by arguing that Regulation 3.4.1.11 (A) NMAC was a "usurpation of the legislative authority" given the statutory definitions. *See* 09-04-14 CD 0:58:54-0:59:38. Before the hearing officer had made any statement of the issues in this matter, the Department itself at closing argument expressly used the term *ultra vires* in discussing whether the hearing officer had authority to reject the validity of the disputed regulation. *See* 09-04-14 CD 1:06:07-38. Moreover, even if the record supported the Department's contention that the issue was raised *sua sponte*—which it most certainly does not—the undersigned hearing officer gave both parties a meaningful opportunity to be heard on the issue through legal briefing.

Without citing any authority during closing or in either of its post-hearing briefing, the Department in closing argued that the Department's administrative hearing officer lacked authority under a separation of powers basis to consider whether the regulation at issue is *ultra vires* of state law. This issue—whether the regulation can restrict or prohibit a deduction allowed by statutory definitions—was Taxpayer's primary issue in the protest, making it germane to the resolution of the protest. Moreover, the Hearings Bureau has previously considered the validity

of regulation in the context of controlling case law and the statute. *In the Matter of Corrosion Services Corporation,* No. 07-16 (non-precedential), Hearing Officer Margaret Alcock rejected a Department argument that was premised on a regulation that the Hearing Officer found to be contrary to the statute at issue and the case law. *In the matter of Perkin Elmer, Inc.*, No 11-02 (non-precedential), contract Hearing Officer Jerry Richardson expressly analyzed whether a Department Regulation was *ultra vires*.

Taxpayer's presentation at the hearing and in briefing in this matter is persuasive, rebutting the presumption of correctness and shifting the burden to the Department. *See MPC Ltd.,* ¶13. Contrary to the Department's argument in briefing that Taxpayer's argument lacked explicit statutory authority, Taxpayer carefully weaved through New Mexico's statutory definitions to reach its conclusion that the Legislature, with exception of the specific statutory exclusions, intended to allow the net operating loss deduction to the extent permitted by Section 172 of the Internal Revenue Code. In addition to the statutory language, Taxpayer's brief analyzes the case law authority and the decision and order of an Alabama administrative tax hearing officer that Taxpayer mentioned during closing arguments, neither of which the Department addressed in closing or in briefing.

In the face of that statutory authority and case law, for the most part the Department 's response simply relies on its general authority to establish accounting methods and promulgate a regulation. There is no doubt that the Department has authority to establish accounting methods and promulgate regulations, so long as the regulations are not contrary to statute. *See generally State ex rel. Taylor v. Johnson*, ¶ 22. The question in this case is not one of authority to act, but whether in acting the Department exceeded the statutes by promulgating a regulation that prohibits a deduction

allowable under the Legislature's statutory definitions of base income, net income, and net operating loss. *See generally Rainbo Baking Co.*, ¶11.

The Department cites *Edison California Stores v. McColgan*, 176 P.2d 697 (Ca. Supreme Court, 1947), *Hellerstein*, State Taxation, ¶8.12 [1], and UDITPA in support of Regulation 3.4.1.11 (A) NMAC. However, all three sources address the state's use of apportionment of income formulas. Apportionment is not the issue at protest. The Department's reliance on NMSA 1978, Section 7-4-19 (1986) is also misplaced. That provision allows the Department to make an equitable adjustment to the apportionment to more fairly represent the extent of a taxpayer's business activities within the state. There was no evidence on the record that Taxpayer's apportionment did not fairly represent Taxpayer's business activity in the state. Despite the Department's fiction-on-fiction concerns of allowing separate entities to file an elective combined return, that is exactly what the Legislature expressly allows in the Corporate and Franchise Income Tax Act regardless of the net operating loss deduction issue. Further, despite the Department's concerns, there is also no dispute that the Legislature allows a unitary group to claim a net operating loss.

The Department cites *Moyston v. N.M. PSC*, 1966-NMSC-062, 76 N.M. 146 for the proposition that in areas of complex law, general accounting principals and the need for accurate reporting requires separate accounting. The Department also cites *True v. Comm'r (In re Estate of H. A. True)*, 390 F.3d 1210 (10th Cir. 2010) for the proposition that adjustment to accounting principals is permissible in the tax context. These cases and propositions do not address the question of whether the Department through regulation can prevent a deduction otherwise allowable under statute. The Department also cited a June 3, 2008 Memorandum Opinion Regarding Motions for Summary Judgment before the First Judicial Court in *Conoco Phillips v. State of New Mexico*, D-101-CV-2007-01381. Although that Memorandum Opinion is non-precedential, it is also

distinguishable from the present protest in that the claim for net operating loss deduction stemmed from a merger of separate entities that had always filed separate entity returns and the "merged" entity continued to file as a separate entity while claiming the net operating loss deduction of the liquidated company. This is not the case of a merger, acquisition, or liquidation where the "new" separate entity claims a net operating loss of a former defunct separate corporation. In this protest, at all points Taxpayer wholly owned and operated all three entities that had filed separate returns in New Mexico before 2012, and continued to do so when changing filing methods to combined unitary corporation in 2012.

The Department concludes its second briefing by arguing that by invalidating 3.4.1.11 (A) NMAC, the Department would be "forbidden" from adopting separate accounting principles allowed in other regulatory contexts. This is a significant overreach. The Department is free to create any accounting principles, methods, or regulation it chooses so long as those accounting principles do not bar a deduction that the Legislature allows by statute.

It is important to note that New Mexico has not adopted all federal law addressing net operating loss treatment and this decision should not be read as such. Although New Mexico begins with federal taxable income plus net operating loss deductions as allowed under Section 172(a) of the Internal Revenue Code, the Legislature legitimately proscribed statutory differences between federal law and New Mexico's treatment of net operating losses in the form of the four exclusions articulated under Section 7-2A-2 (H). *See In re Rates & Charges of Mt. States Tel. & Tel. Co.*, ¶31 (While New Mexico uses federal taxable income as a starting point, it does not adopt it wholesale). Despite expressly listing net operating loss deduction differences with federal law, the Legislature did not include the disputed deduction at issue in this matter under Section 7-2A-2 (H). Therefore, since the disputed deduction would be allowed under Section 172(a) of the Internal Revenue Code

as permitted by Section 7-2A-2 (C) and the Legislature has adopted that provision under the definition of net operating loss and base income, the deduction at issue is permitted by New Mexico statute. This view is further supported by Regulation 3.4.1.9 (C)(1) NMAC, which appears to authorize the deduction at issue in this case. Because Regulation 3.4.1.11 (A) NMAC attempts to prohibit what the Legislature allows as a deduction included in its definition of base income and net operating losses, that regulation does not bar Taxpayer from claiming the net operating losses previously reported by its members in separate corporate entity filings from previous tax years. *See generally Rainbo Baking Co.*, ¶11. Therefore, Taxpayer's protest is granted.

CONCLUSIONS OF LAW

A. Taxpayer filed a timely, written protest to the assessment. Jurisdiction lies over the parties and the subject matter of this protest. The hearing was timely set within the time limits articulated by NMSA 1978, Section 7-1-24.1 (A) (2013).

B. Taxpayer was not free to return to separate entity reporting method once it filed in 2012 as a combination of unitary corporations without the Secretary's permission.

C. Under Section 7-2A-3 and Section 7-2A-8.3, Taxpayer was required to pay CIT on its "net income" from the unitary corporation.

D. Section 7-2A-2 (C) defines "base income" as taxable income plus the amount of a deduction for net operating loss as allowed by Section 172 (a) of the Internal Revenue Code.

E. Under Section 7-2A-2 (H), "net income" includes "base income adjusted to exclude" four items/amounts articulated in that section. The net operating loss deduction at issue here is not in the exclusion list under Section 7-2A-2 (H).

F. Because Section 7-2A-2 (C) allows a deduction for net operating losses consistent with Section 172 (a) of the Internal Revenue Code, and Section 172 (a) in conjunction with 26

C.F.R 1.1502-21 (a) allows the net operating loss deduction at issue in this protest, Taxpayer was statutorily entitled to the claimed net operating loss deduction at issue.

G. The Department cannot rely on Regulation 3.4.1.11 (A) NMAC to prohibit Taxpayer from claiming a deduction for which the Legislature has allowed it to claim under the definition of base income and net operating loss. *See generally Rainbo Baking Co.*, ¶11.

For the foregoing reasons, Taxpayer' protest **IS GRANTED**. The assessment is abated.

DATED: December 29, 2014.

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