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. 15-11**
TO ASSESSMENT ISSUED UNDER LETTER
ID NO. L1907135952

AMENDED 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.

The original Decision and Order in this matter, No. 14-45, was issued on December 29, 2014. On January 28, 2015, the Department filed a Motion for Reconsideration. On February 6, 2015, Taxpayer objected to the Department's Motion for Reconsideration. Through an order issued concurrently with this decision, the Department's Reconsideration was granted and the original Decision and Order No. 14-45 was withdrawn in favor of this Amended Decision and

Order. 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 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 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 elected to switch to the combined 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].

17. In its 2012 combined 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].

18. Although ultimately an incorrect interpretation of law, Taxpayer established through its careful review and analysis of the various statutes, regulations, and instructions that it made a mistake of law made in good faith and on reasonable grounds when it claimed the net operating loss deductions first claimed by separate entity filings in previous years.

19. Taxpayer's 2012 CIT-1 Return shows how Taxpayer was to calculate base and net income in New Mexico. On Line 1, Taxpayer was required to enter the federal taxable income before federal net operating losses. This amount becomes the New Mexico base income on line 4 unless there were any additions for municipal bond interest (line 2) or subtractions for other federal special deductions (line 3), neither of which occurred in this case. From the base income amount on line 4, a taxpayer then can subtract the New Mexico net operating loss carryover amount listed on line 5 to calculate the New Mexico net taxable income on line 9. [Taxpayer Ex. O].

20. 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 CIT return. [09-04-14 CD 0:30:23-35].

21. 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].

22. 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].

23. 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.

24. 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.

25. 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.

26. 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.

27. The original Decision and Order No. 14-45 in this matter was issued on December 29, 2014.

28. On January 28, 2015, the Department filed a Motion for Reconsideration of the original Decision and Order. On February 6, 2015, Taxpayer filed an Objection in Opposition to the Department's Motion for Reconsideration. Both pleadings are part of the record in this matter.

29. On March 23, the Hearings Bureau issued an order concurrently with this decision granting Taxpayer's motion for reconsideration and withdrawing the original Decision and Order, No. 14-45, in favor of this Amended Decision and Order.

DISCUSSION

There are no disputes of fact in this matter. There are three legal issues at protest. The 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. Alternatively, if not allowed to claim the net operating losses, Taxpayer asked to be allowed to change its CIT reporting method back to separate entities. The final issue is whether civil negligence penalty should be abated.

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, the Net Operating Carryover Deduction, and CIT Reporting Methods

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. 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 and argues that rather than adopting federal treatment of net operating losses under Section 172 (a) of the Internal Revenue Code, the "base income" definition in fact requires a taxpayer to add back the amount of any claimed federal net operating loss deductions allowable under Section 172 in order to determine New Mexico base income.

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).

In pertinent part, NMSA 1978, Section 7-2A-2 (H) (1999) defines "'net income' as base income adjusted to exclude[1]:

> (4) 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.

In other words, Section 7-2A-2 (H) (4) allows a net operating loss carryover deduction only as specified (the carryover may not extend past five years and there are no carrybacks after 1991). This is confirmed by Section 7-2A-2 (J), where 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,

[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.

pursuant to Paragraph (3) or (4) of [Section 7-2A-2 (H)] of this section, may be excluded from base income."

In New Mexico, under NMSA 1978, Section 7-2A-2 (C) (1999), "base income"

> means 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 for income tax purposes plus, for taxable years beginning on or after January 1, 1991, the amount of the net operating loss deduction allowed by Section 172(a) of the Internal Revenue Code, as that section may be amended or renumbered, and claimed by the taxpayer for that year; "base income" also includes interest received on a state or local bond.

As the Department argues in its reconsideration and the hearing officer now agrees, the term "plus" in Section 7-2-2 (C) requires that a taxpayer add back the amount of net operating losses claimed on the federal return to derive a New Mexico base income. That is, rather than adopting Section 172(a) of the Internal Revenue Code's treatment of net operating loss deductions, the New Mexico Legislature requires a taxpayer to add that amount back in order to arrive at the New Mexico base income.

The reason why this interpretation is persuasive is because it harmonizes Section 7-2A-2 (C) with Section 7-2A-2 (H). *See Regents of the Univ. of New Mexico v. New Mexico Fed'n of Teachers,* 1998-NMSC-20, ¶28, 125 N.M. 401(Statutes are also to be interpreted in a manner to give the entire statute effect and not render portions of the statute superfluous). Reading the base income definition in harmony with Section 7-2A-2 (H), once a taxpayer adds the claimed federal net operating losses back to establish the New Mexico base income, Section 7-2A-2 (H)(4) allows a taxpayer then to exclude (or subtract out) the net operating loss carryovers expressly allowed under that section to derive the taxable net income.

This calculation is seen in the structure of the 2012 CIT Return, admitted into the record as Ex. O. Line 1 on the return requires Taxpayer to enter the federal taxable income before federal net

operating losses had been subtracted out on the federal return. Unless there is an addition for municipal bond interest (line 2) or subtractions for other federal special deductions (line 3), neither of which occurred in this case, the federal taxable income before the federal net operating losses becomes the New Mexico base income on line 4 of the CIT return. From the base income amount on line 4, a taxpayer then can subtract the New Mexico NOL carryover listed on line 5 to calculate the New Mexico net taxable income on line 9.

Rather than adopt Section 172(a)'s treatment of net operating loss deductions, the Legislature in Section 7-2A-2 (H) determined the extent of an allowable net operating loss carryover deduction in New Mexico. Anything not included in Section 7-2A-2 (H)'s allowance for a net operating loss carryover deduction, even if allowed federally under Section 172(a) as a net operating loss deduction, was not expressly contemplated by the Legislature as a deduction in New Mexico. *See Wing Pawn Shop,* ¶16, 111 N.M. 735 (deductions from tax must construed narrowly in favor of taxing authority and the right to such deduction must be clearly established by the taxpayer). There is nothing in Section 7-2A-2 (H) (4) that suggests that the Legislature intended to adopt Section 172 (a) of the Internal Revenue Code's treatment of a net operating loss stemming from another taxpayer's separate entity return. In fact, because the Legislature requires taxpayers to add back the federal net operating loss deduction permitted by Section 172 (a) before then establishing a specific exclusion in New Mexico for net operating loss carryovers under Section 7-2A-2 (H) (4), the Legislature did not intend to adopt Section 172 (a)'s treatment of net operating losses. *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").

Turning from the statutes to the regulations at issue, 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, 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."

In this case, 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.

Given that Section 7-2A-2 (H) (4) does not expressly allow any net operating loss other than the net operating carryover articulated in that section, Regulation 3.4.1.11 (A) NMAC's prohibition of the deduction at issue does not conflict with that statute or create an arbitrary limitation on a deduction expressed by the legislature. Therefore, the undersigned Hearing Officer's conclusion that

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

Regulation 3.4.1.11 (A) NMAC is *ultra vires* in the original Decision and Order was incorrect[3], as that regulation is a proper interpretation of the statutes allowing only for net operating loss carryovers as described in Section 7-2A-2 (H).

Taxpayer cited 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. 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.

However, considering Section 7-2A-2 (H) and Section 7-2A-2 (C) in harmony, there is a distinction between Florida law and New Mexico law that makes *Golden W. Fin. Corp.* not

[3] As Justice Felix Frankfurter once noted, "[w]isdom too often never comes, and so one ought not to reject it merely because it comes late." *Henslee v. Union Planters Nat'l Bank & Trust Co.*, 335 U.S. 595, 600 (U.S. 1949).

applicable: New Mexico does not adopt Section 172 of the Internal Revenue Code. In fact, Section 7-2A-2 (C) requires a taxpayer to add back any deduction allowed federally under Section 172 to derive the New Mexico base income. The source of an allowable net operating loss deduction in New Mexico is not Section 172 (a) of the Internal Revenue Code but Section 7-2A-2 (H).

As the original decision and order indicated, Regulation 3.4.1.9 (C)(1) NMAC appeared to support Taxpayer's claim for the net operating loss deduction at issue. Under Regulation 3.4.1.9 (C)(1) NMAC,

> [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.

However, in this case, Taxpayer did not acquire other corporations but simply changed its reporting method for separate entities that it had always owned and operated. The previous returns were made by a separate entities already controlled by Taxpayer, but not by Taxpayer. Taxpayer still needs to go through the additions and subtractions as outlined on the return and under Section 7-2A-2 (C) and Section 7-2A-2 (H). That being said, there is little doubt that the Department's regulations could be clearer in this area explaining the interaction between base income under Section 7-2A-2 (C), net income and net operating loss carryovers under Section 7-2A-2(H), and also in clarifying what appears to be a potential contradiction between regulations.

In summary of the main issue, Section 7-2A-2 (H) and not Section 172(a) of the Internal Revenue Code defines the extent of a net operating loss carryover deduction in New Mexico. Since the deduction at issue in this case is not included under Section 7-2A-2 (H), the Department's prohibition of that deduction at issue under Regulation 3.4.1.11 (A) NMAC was proper.

Alternatively, Taxpayer argued that it be allowed to return to a separate entity reporting method so that it could still claim the net operating loss carryovers first reported by the separate corporate entities before 2012. The Department opposed this request because Taxpayer never requested permission to return to the separate entity reporting method and because such election of reporting method cannot apply retroactively.

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. 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). 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 first step 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, which did not occur. Moreover, even if permission had been sought and granted, that change of election could not apply retroactively. *See* Regulation 3.4.10.8 (E) NMAC.

Interest and Penalty.

When a taxpayer fails to make timely payment of taxes due to the state, "interest *shall* be paid to the state on that amount from the first day following the day on which the tax becomes due...until it is paid." NMSA 1978, § 7-1-67 (2007) (italics for emphasis). Under the statute, regardless of the reason for non-payment of the tax, the Department has no discretion in the imposition of interest, as the statutory use of the word "shall" makes the imposition of interest mandatory. *See Marbob Energy Corp. v. N.M. Oil Conservation Comm'n*, 2009-NMSC-013, ¶22, 146 N.M. 24 (use of the word "shall" in a statute indicates provision is mandatory absent clear indication to the contrary). The language of Section 7-1-67 also makes it clear that interest begins to run from the original due date of the tax until the tax principal is paid in full. The Department has no discretion under Section 7-1-67 and must assess interest against Taxpayer from the time the 2012 CIT tax was due but not paid until Taxpayer satisfies the CIT tax principal.

When a taxpayer fails to pay taxes due to the State because of negligence or disregard of rules and regulations, but without intent to evade or defeat a tax, by its use of the word "shall", Section 7-1-69 requires that civil penalty be added to the assessment. As discussed above, the statute's use of the word "shall" makes the imposition of penalty mandatory in all instances where a taxpayer's actions or inactions meets the legal definition of "negligence." However, in instances where a taxpayer might otherwise fall under the definition of civil negligence generally subject to penalty, Section 7-1-69 (B) provides a limited exception: "[n]o penalty shall be assessed against a taxpayer if the failure to pay an amount of tax when due results from a mistake of law made in good faith and on reasonable grounds."

In this case, Taxpayer rebutted the presumption of correctness as it relates to the assessed penalty. Although ultimately incorrect, Taxpayer provided a careful legal explanation weaving through the various statutes and regulations to demonstrate why it believed it was entitled to the claimed net operating loss deductions. Further, Regulation 3.4.1.9 (C) (1) NMAC has some consistency with Taxpayer's legal analysis. Once Taxpayer rebutted the presumption by showing that its "failure to pay an amount of tax when due results from a mistake of law made in good faith and on reasonable grounds" under Section 7-1-69 (B), the burden shifted to the Department to support that Taxpayer was subject to civil negligence penalty. *See MPC Ltd.*, ¶13. The Department did not meet that burden. Therefore, under the unique facts of this case, civil penalty is abated.

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 without the Secretary's permission once it filed in 2012 as a combination of unitary corporations.

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. This section requires Taxpayer to add back the amount of net operating losses claimed on the federal return pursuant to Section 172(a) of the Internal Revenue Code in order to derive a New Mexico base income.

E. Under Section 7-2A-2 (H), "net income" includes "base income adjusted to exclude" the items specified in that section. The net operating loss deduction at issue here is not income that is to be excluded from base income. Section 7-2A-2 (H) therefore does not expressly allow Taxpayer's claimed deduction. *See Wing Pawn Shop*, ¶16, 111 N.M. 735 (deductions from tax must construed narrowly in favor of taxing authority and the right to such deduction must be clearly established by the taxpayer)

F. Moreover, Regulation 3.4.1.11 (A) NMAC prohibits Taxpayer from claiming the deduction at issue in this case. *See Chevron U.S.A., Inc.* ¶16 (regulations are presumed proper interpretation of statute).

G. Under NMSA 1978, Section 7-1-67 (2007), Taxpayer is liable for accrued interest under the assessment. Interest continues to accrue until the tax principal is satisfied.

H. Under NMSA 1978, Section 7-1-69 (B) (2007) Taxpayer rebutted the presumption of correctness of the assessed penalty by establishing that its failure to pay CIT tax when due resulted "from a mistake of law made in good faith and on reasonable grounds." The

Department did not reestablish the validity of the assessed penalty, as required under *MPC Ltd.*, ¶13.

For the foregoing reasons, Taxpayer' protest **IS PARTIALLY DENIED AND PARTIALLY GRANTED**. Pursuant to Section 7-1-69 (B), penalty is abated. As of the date of hearing, Taxpayer owed $74,313.00 in corporate income tax, and $3,273.89 in interest. Interest continues to accrue until the tax principal is satisfied.

DATED: March 24, 2015.

Brian VanDenzen, Esq.,
Chief Hearing Officer
Taxation & Revenue Department
Post Office Box 630
Santa Fe, NM 87504-0630