STATE OF ARKANSAS
DEPARTMENT OF FINANCE AND ADMINISTRATION
OFFICE OF HEARINGS & APPEALS

ADMINISTRATIVE DECISION

IN THE MATTER OF [redacted] **ACCT. NO.:** [redacted]	**REFUND CLAIM DISALLOWANCE** **(**Corporate Income Tax**)**
DOCKET NO.: 17-396	**DATE OF CLAIM: 02/15/16** **($**[redacted]**)**

RAY HOWARD, ADMINISTRATIVE LAW JUDGE

APPEARANCES

This case is before the Office of Hearings and Appeals upon a written protest dated September 9, 2016, signed by [redacted], Attorney at Law ([redacted]), on behalf of [redacted], the Taxpayer. The Taxpayer protested the denial of a refund claim[1] by the Department of Finance and Administration ("Department"). The Letter ID Number is [redacted].

An administrative hearing was held on June 14, 2017, at 9:00 a.m., in Little Rock, Arkansas. The Department was represented by Lisa Ables and Lauren Ballard, Attorneys at Law, Office of Revenue Legal Counsel ("Department's Representatives"). Present for the Department were Tommy Burns - Tax Auditor, Faye Husser - Audit Supervisor, and Scott Fryer – Assistant Administrator/Corporate Income Tax Section. The Taxpayer was represented by [redacted], Attorneys at Law ([redacted])

[1] Resulting from the Department's reclassification of nonbusiness income to business income.

("Taxpayer's Representatives"). Present for the Taxpayer was [redacted] – Assistant Vice President, [redacted].

FINDINGS OF FACT/CONTENTIONS OF THE PARTIES

The Taxpayer distributes [redacted] products and [redacted] parts in the United States. The Taxpayer's Answers to Information Request set forth the relevant facts and issues and stated, as follows:

> . . . this case is about whether Arkansas can tax as apportionable business income the proceeds from the disposition of credits [redacted] The relevant facts consider the relationship between the business as a whole and the transactions or activities for which the business / nonbusiness classification is in dispute—here, six sales of [redacted] credits. [P. 1].

The Tax Auditor testified that: (1) for the period ending March 31, 2015, the Department sent a letter to the Taxpayer requesting information regarding a deduction adjustment made for nonbusiness income in the amount of $[redacted]; (2) no response was received from the Taxpayer, and an adjustment was made disallowing the deduction; (3) the Department sent a formal denial of a refund request for overpayment of tax; (4) the Taxpayer sold [redacted] credits ("credits") in fiscal year 2015 to other [redacted] [redacted]; (5) the Taxpayer could carry the credits forward, use the credits, or sell them; (6) according to the Taxpayer's protest, the proceeds from sales of the credits were paid to the Taxpayer's parent company; (7) the proceeds from sales of the credits accounted for [redacted] of the Taxpayer's taxable income on the federal level in 2015; (8) the proceeds from sales of the credits allowed the Taxpayer to pay cash dividends which is an integral part of the business; (9) Exhibit K to the Taxpayer's Pre-hearing Brief is a copy of the Taxpayer's Arkansas Income Tax Return for the period ending March 31, 2015, which disclosed the Taxpayer's position regarding the classification of the proceeds from the sales of the credits; and (10) the Taxpayer never actually requested a refund but requested that an overpayment be applied to the following year.[2]

The Department's Assistant Administrator testified that: (1) every [redacted] in the United States either earns the credits or [redacted]; (2) [redacted] that do not [redacted]; (3) transactions involving the credits is an activity the Taxpayer would be expected to engage in; (4) the credits would not be earned if the Taxpayer [redacted]; (5) the credits can be carried forward for [redacted] then expire so, if the credits are not used, it would be a dereliction of duty to allow the credits to expire without getting full value for the credits; (6) the credits are integral to the success of the Taxpayer's business; (7) he does not have any special knowledge of [redacted] or the Taxpayer; (8) the Taxpayer did not have to sell the credits, the credits could have been allowed to expire and nothing would have been received by the Taxpayer; (9) federal taxable income is different from generally accepted accounting principles income; (10) he would not be surprised if the Taxpayer had greater generally accepted accounting principles income than federal taxable income;

[2] The Department equated this to a refund claim.

and (11) with respect to dividends, if proceeds from sales of credits result in dividends, then the proceeds would be business income under the functional test.

The Taxpayer's Assistant Vice President testified that: (1) he works in the Taxpayer's [redacted] Office; (2) his current role would encompass the 2015 tax year; (3) his primary role is working on new [redacted]; (4) there are currently 3 members of his group, there were 2 members in the 2015 tax year; (5) the Taxpayer was approached by a prospective buyer of the credits; (6) in 2009, the [redacted] and ultimately a memorandum of understanding was signed by the negotiating parties; (7) the minimum requirement [redacted]; (8) the Taxpayer did not advocate credit trading when working on [redacted]; (9) Exhibit B to the Taxpayer's Pre-hearing Brief is a copy of the Taxpayer's 2012 [redacted] for the Taxpayer's products, and based on a uniform formula, [redacted] is determined as well as [redacted]; (10) Exhibit D to the Taxpayer's Answers to Information Request reflects a page of the [redacted] website where information can be obtained regarding the Taxpayer's products and the credits available; (11) the Taxpayer sold credits received in 2011; (12) every contract relating to the credits has confidentiality provisions; (13) the Table 1 on page 4 of the Taxpayer's Pre-hearing Brief is an accurate summary of the credits transactions from the 2015 fiscal year; (14) Exhibit C to the Taxpayer's Pre-hearing Brief contains copies of emails relating to a credit transaction and he responded to an inquiry about the availability of credits;[3] (15) the Taxpayer was concerned about the reputational impact of selling credits; (16) Page 0092 in Exhibit C to the Taxpayer's Pre-hearing Brief, dated March 6, 2013, refers to a meeting that he had with the Taxpayer's CEO where he received approval for the sales of credits and it was unusual because there were no processes in place for selling the credits; (17) the Taxpayer had allowed other types of intangibles similar to the credits to expire so the Taxpayer was breaking new ground by selling credits; (18) Page 0092 in Exhibit C to the Taxpayer's Pre-hearing Brief refers to the exchange of a draft contract with a prospective buyer; (19) Page 0099 in Exhibit C to the Taxpayer's Pre-hearing Brief refers to an exchange with the prospective buyer which required renegotiating the agreement for sales of credits; (20) Exhibit D to the Taxpayer's Pre-hearing Brief contains copies of contracts for the sales of credits, the contracts were for 10 years with a right of first refusal because the Taxpayer did not anticipate doing any more transactions involving credits (he thought it was a one-time deal); (21) Page 0114 in Exhibit C to the Taxpayer's Pre-hearing Brief reflects that we requested a credit requirement, Pages 0112 and 0113 contains the buyer's responses, and Page 0111 was the Taxpayer's acceptance on January 31, 2014; (22) Page 0107 in Exhibit C to the Taxpayer's Pre-hearing Brief reflects that the credits finally posted to the buyer's account; (23) Page 0077 in Exhibit E to the Taxpayer's Pre-hearing Brief was a letter to [redacted] directing transfer of credits from the Taxpayer's account to the buyers account and Pages 80 and 81 detail the credits requested and conveyed; (24) on

[3] There was a meeting in [redacted] and the quantity and prices of credits were discussed. Ultimately, the terms of a contract were negotiated.

April 4, 2014, the Taxpayer's 2011 credits were sold; (25) the second time the Taxpayer sold credits, it was easier; (26) the proceeds from sales of credits are received by wire transfer to the finance division and the proceeds all went to dividends to the parent company; (27) he suggested that the credit proceeds be reinvested but that suggestion was rejected because the Taxpayer cannot plan on this money and it is not a regular part of the Taxpayer's business; (28) year-to-year, he does not know if there will be any prospective buyers; (29) he is not evaluated on the sales of credits and there is no commission; (30) the Taxpayer has always desired to be [redacted] and [redacted]; (31) the Taxpayer met [redacted] without the need to use [redacted]; (32) Exhibit A to the Taxpayer's Answers to Information Request is an article from [redacted] discussing [redacted]; (33) Pages 3 and 4 of Exhibit B to the Taxpayer's Answers to Information Request is the Taxpayer's Annual Report for [redacted] detailing excellent [redacted]; (34) Exhibit C to the Taxpayer's Answers to Information Request depicts [redacted]; (35) Exhibit A to the Department's Answers to Information Request is the [redacted] for 2015, page 7 reflects goals for [redacted] and page 10 reflects [redacted]; (36) he works on future [redacted]; (37) the Taxpayer had credits to sell because the Taxpayer's [redacted] exceeded [redacted]; (38) obtaining the credits has not affected the Taxpayer's design or development [redacted]; (39) R & D was informed that money from sales of credits cannot be guaranteed; (40) there is uncertainty regarding the availability of credits in the future; (41) he traded commodities early in his career and that experience helped with the sales of the credits; (42) it is difficult to determine the price for the credits but the starting point is the cost of the buyer's [redacted] (43) the majority of the Taxpayer's profits are derived from the Taxpayer's business of selling [redacted]; (44) Exhibit A to the Taxpayer's Pre-hearing Brief is an announcement of the Taxpayer's [redacted] for 2015; (45) Exhibit K to the Taxpayer's Pre-hearing Brief is the tax return reflecting total sales of $[redacted]; (46) the sales of credits is a small factor in the Taxpayer's business and unreliable; (47) the Taxpayer does not budget with respect to the credits unless a binding contract is in place; (48) the sales of credits is a windfall; (49) the Taxpayer was an involved stakeholder [redacted] apply to the Taxpayer; (50) many factors are considered with respect to [redacted] such as fairness and whether [redacted] will change the Taxpayer's business; (51) the Taxpayer did not initially know that it would benefits from the credits but ultimately it did; (52) the Taxpayer is listed as a party to the contracts for sales of credits; (53) the [redacted] directed the first buyer to the Taxpayer and the Taxpayer was interested in selling the credits; (54) there is no visibility to know if there will be prospective buyers in the future; (55) a [redacted] that does not meet the [redacted] will need credits; (56) [redacted] will impact the future of [redacted]; (57) it is possible that the Taxpayer may fall short of [redacted] and need to use the credits; (58) the first year the credits could be sold was [redacted] and none of the credits have expired; (59) the Taxpayer sold credits in [redacted]; (60) the negotiation process for the first sale of credits actually required 20 – 30 hours over an 8-

month period; and (61) the Taxpayer has never used the credits to meet [redacted].

ISSUE

Whether the Department's denial of the Taxpayer's refund claim should be sustained? Yes.

CONCLUSIONS OF LAW

Standard of Proof

Ark. Code Ann. § 26-18-313(c) (Supp. 2015) addresses the burden of proof to be applied to matters of fact and evidence in this case and states, as follows:

> The burden of proof applied to matters of fact and evidence, whether placed on the taxpayer or the state, in controversies regarding the application of a state tax law shall be by **preponderance of the evidence**. [Emphasis added].

A preponderance of the evidence means the greater weight of the evidence. See Chandler v. Baker, 16 Ark. App. 253, 700 S.W.2d 378 (1985). In Edmisten v. Bull Shoals Landing, 2014 Ark. 89, at 12-13, 432 S.W.3d 25, 33, the Arkansas Supreme Court explained that:

> [a] preponderance of the evidence is not necessarily established by the greater number of witnesses testifying to a fact but by evidence that has the most convincing force; superior evidentiary weight that, though not sufficient to free the mind wholly from all reasonable doubt, is still sufficient to incline a fair and impartial mind to one side of the issue rather than the other.

The Department bears the burden of proving that the tax law applies to an item or service sought to be taxed, and a taxpayer bears the burden of proving entitlement to a tax exemption, deduction, or credit. Ark. Code Ann. § 26-18-313(d) (Supp. 2015). Statutes imposing a tax or providing a tax exemption, deduction, or credit must be reasonably and strictly construed in limitation of their application, giving the words their plain and ordinary meaning. Ark. Code Ann. § 26-18-313(a), (b), and (e) (Supp. 2015). If a well-founded doubt exists with respect to the application of a statute imposing a tax or providing a tax exemption, deduction, or credit, the doubt must be resolved against the application of the tax, exemption, deduction, or credit. Ark. Code Ann. § 26-18-313(f)(2) (Supp. 2015).

Ark. Code Ann. § 26-18-507 (Repl. 2012) provides for a refund of any state taxes erroneously paid in excess of the taxes lawfully due. The Taxpayer bears the burden of proving by a preponderance of the evidence that the claimed refund was erroneously paid and in excess of the taxes lawfully due.

Refund Claim

The State of Arkansas has adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA"). See Ark. Code Ann. § 26-51-701 et seq. (Repl. 2012). In Pledger v. Getty Oil Exploration Co., 309 Ark. 257, 831 S.W.2d 121 (1992), the Court stated that:

> [UDITPA] governs the manner in which Arkansas may impose income and franchise taxes on the earnings of multistate and multinational corporations doing business in the State. UDITPA is designed to fairly apportion among the states in which a corporation does business the fair amount of regular business income earned by the corporation's activities in each state. Under UDITPA, net taxable business income of a corporate taxpayer involved in a multistate business is apportioned by a well-recognized three-factor formula consisting of tangible property, payroll, and sales.

Id. at 261 - 262, 831 S.W.2d at 124.

"Business income" is defined as “income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations”. Ark. Code Ann. § 26-51-701(a) (Repl. 2012). "Nonbusiness income" is defined as “all income other than business income”. Ark. Code Ann. § 26-51-701(e) (Repl. 2012).

In Pledger v. Getty Oil Exploration Co., supra, the Arkansas Supreme Court stated that, “business income arises from either of two sources: (1) transactions and activity in the regular course of the taxpayer’s business, referred to as the transactional test, or (2) income from the acquisition, management, and disposition of property that constitutes integral parts of the taxpayer’s regular business, referred to as the functional test.” Id. at 262, 831 S.W.2d at 124 - 125.

I.

The Pre-hearing Brief filed by the Taxpayer contended that a threshold issue to be decided in this case is:

> . . . whether [this tribunal] should consider a separate functional test after changes to Arkansas law requiring narrow construction of taxing statutes. [Taxpayer’s] Answers to Information Request explained that a narrow reading of the statutory definition of ‘business income’ treats the phrase as modifying the transactional test rather than providing an alternative definitional test for business income. [P. 15-16].

With respect to the functional test referred to in Pledger v. Getty Oil Exploration Co., supra, the Taxpayer’s Answers to Information Request stated that, “the continuing validity of a separate functional test is questionable after the

2015 amendments to Arkansas Code Annotated section 26-18-313 requiring narrow and literal statutory construction."[4]

The Arkansas Supreme Court construed the provisions of Ark. Code Ann. § 26-51-701(a) in Pledger v. Getty Oil Exploration Co., supra, and the enactment of Section 3 of Act 896 of 2015 (codified at Ark. Code Ann. § 26-18-313 (Supp. 2015)) did not operate to repeal or reverse the Court's interpretation of the provisions of Ark. Code Ann. § 26-51-701(a).

II.

The facts in this case preponderate in favor of a finding that the functional test is satisfied.[5] With respect to the functional test, the Taxpayer's Pre-hearing Brief stated as follows:

> Assuming that the functional test does continue to apply, it must apply narrowly. The statute provides that business income "includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Ark. Code Ann. § 26-51-701(a). The regulation adds that "[g]ain or loss from the sale, exchange or other disposition of real property or of tangible or intangible personal property constitutes business income if the property, while owned by the taxpayer, was used in the taxpayer's trade or business."
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> To the language in the rule, the credits never were used in [redacted] business. The company always exceeded the [redacted] [redacted], and so it had no need of them. The credits were intangible rights in the records of the [redacted]. When the credits were sold, they had no effect on [redacted] business because they had never been used in the business.
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> From a statutory perspective, each of these three parts of the functional test must be met for the credit sales proceeds to be business income: integral acquisition, integral management, and

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[4] See Footnote 8 on Page 12 of the Taxpayer's Answers to Information Request.

[5] Since satisfaction of either the transactional test or the functional test is determinative under Pledger v. Getty Oil Exploration Co., supra, it is not necessary to address the transactional test in this administrative decision.

integral disposition. Many states have changed their statutory language to make this test disjunctive and allow taxation if either acquisition, management, or disposition was integral to the taxpayer's business. Arkansas has not done so and thus still requires that all parts of the test be met. In the absence of any one of the three elements, the functional test is not satisfied. *May Department Stores Co. v. Ind. Department of State Revenue*, 749 N.E. 2d 651, 664-65 (Ind. Tax Ct. 2001) (classifying proceeds from sale of real estate as nonbusiness income because the disposition of the property was not an integral part of the taxpayer's regular trade or business of retailing). These are three distinct elements. None are present here.

The acquisition of credits was not an integral part of [redacted] regular business of [redacted]. It is true that [redacted] would not have received the [redacted] credits if it had not sold [redacted]. But [redacted] did not manage its business in order to generate credits. They were a byproduct of its [redacted]. The transferable credits programs could end tomorrow and [redacted] would not change how it manages its business, including the development and production of [redacted].

The management of credits was not an integral part of [redacted] regular business. The credits were entries in the records of the [redacted]. They did not require [redacted] management. It is true that the company did track its credits, but it is far from the case that this recordkeeping of intangible assets was an integral part of the business of [redacted]. Recordkeeping is inherent in ownership of assets. The Treasuries, foreign currencies, and other assets at issue in Getty Oil, for example, would have involved taxpayer recordkeeping.

The disposition of credits was not an integral part of [redacted] regular business. It was a limited activity conducted by a handful of people in the company's [redacted] office who spent a small portion of their time responding to inquiries, negotiating agreements on fair terms, and fulfilling contracts. [redacted] did not auction or otherwise actively market the credits. The buyers were [redacted]. The result here should follow that of *May Department Stores*, where the disposition of real estate assets "could not have constituted an integral part of [the taxpayer's] regular trade or business operations," which were department store retailing activities. 749 N.E. 2d at 665.

For purposes of the functional test, integral should mean "essential to completeness" or a similar sense of the word. *See Willamette Indus.*, 15 P. 3d at 20 (citing Webster's Third New International Dictionary); *May Department Stores*, 749 N.E. 2d at 664-65 (citing Black's Law Dictionary, 6th ed.); Merriam-Webster.com (accessed June 4, 2017) (attached as Exhibit 0). Such a strict, plain-language interpretation of "integral" is required under Arkansas Code Annotated section 26-18-313.

As previously noted (see [redacted] Answers at 20), the Department's claim for a less restrictive definition of "integral" is based on selectively quoting its regulation to purportedly require apportionment of "income of any type or class and from any source." (*See* DFA Answers at 13.) The Department's position rejects the plain meaning of "integral" and essentially asserts that anything somehow related to a business is integral and therefore meets the functional test. In fact, the language in that rule is limited to income that "arises from transactions and activity occurring in the regular course of business," which is not the situation in the present dispute. Further, the Arkansas Supreme Court rejected a "full apportionment" rationale in *Illinois Tool Works*. *See* 306 Ark. at 138, 141 (discussing the full apportionment interpretation of "business income" and going on to overturn *Qualls v. Montgomery Ward & Co.*, 266 Ark. 207 (1979)).

The Department's reliance on *Hoechst Celanese Corporation v. Franchise Tax Board*, 25 Cal. 4th 508 (2001) (*see* DFA Answers at 12-13), also is mistaken, because that decision read the definition of business income broadly. Instead of basing its opinion on the plain language of the statute read narrowly, as now required in Arkansas, the California court recognized ambiguity in the statutory language and took a broader reading of the term "integral" in light of policy considerations and pre-UDITPA California case law. *See* 25 Cal. 4th at 529-32. This expansive interpretation led the *Hoechst* court to treat the pension reversion income as business income. The result contrasts with the earlier North Carolina *Union Carbide* decision, which reached the opposite conclusion under similar facts because the North Carolina court took a strict, plain-meaning approach of weighing whether the property was necessary or essential to the regular trade or business. *Union Carbide Corp. v. Offerman*, 526 S.E. 2d 167, 171 (N.C. 2000); *see also Hoechst*, 25 Cal. 4th at 537-38 (explaining the differences in analysis and result).

In sum, the term "integral" cannot be read broadly as any income from the disposition of property in any way connected with the business. Here, the credits were never used in [redacted]

> [redacted] regular business of [redacted], and the acquisition, management, and disposition of credits were not integral parts of that business. The credit sales proceeds are nonbusiness income under the functional test. [Footnotes omitted, P. 16-19].

The Department's Answers to Information Request addressed the functional test and stated, in part:

> . . . In contrast to the transactional test, which focuses on the nature of the income-producing transactions and activity, the functional test focuses on the income-producing "property," which may be tangible or intangible. As the Kansas Supreme Court explained in *In Re Tax Appeal of the Kroger Co.*, 270 Kan. 148 (2000):
>
> > The functional test, rather than focusing on the particular transaction giving rise to the income as required by the transactional test, focuses on the utilization of the property in the business. [citation omitted]. **Under the functional test, gain from the sale of property is business income if the property was used in the taxpayer's business operations.** [Emphasis added].
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> The Tennessee Supreme Court in *Union Carbide Corporation v. Huddleston*, 854 S.W.2d 87 (Tenn. 1993) has also explained the functional test and stated, in part:
>
> > Other jurisdictions ... have applied what is referred to as the "functional test," which focuses on the language stating that `business earnings' include 'earnings from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.' ... In contrast to the transactional test, **income from the sale of an asset will be considered business income under the functional test if the asset produced business income while it was owned by the taxpayer, regardless of the extraordinary nature or infrequency of the transaction disposing of the property and giving rise to the gain...** [Emphasis added].
>
> The phrase "acquisition, management, and disposition of the property" refers to a taxpayer's interest in and power over the income-producing property and thus encompasses a myriad of ways that a company may control and use the rights and privileges

commonly associated with property ownership. *See Kroger*, 220 III.Dec. 566, 673 N.E.2d. Relevant considerations concerning the "acquisition, management, and disposition of the income-producing property," involves the question of whether the taxpayer:

(1) obtained some interest in and control over the property;
(2) controlled or directed the use of the property; and
(3) transferred, or had the power to transfer the property in some manner.

In addition to the control and use of the income-producing "property," such "property" must be an "integral part" of the Taxpayer's "regular trade or business operations" and must materially contribute to the taxpayer's production of business income such that it becomes interwoven into and inseparable from the business. The relationship between income-producing "property" and a taxpayer's "business operations" is the critical inquiry. *See Texaco-Cities*, 230 III. Dec. 991, 695 N.E.2d.

The California Supreme Court applied the same logic in *Hoechst Celanese Corporation v. Franchise State Board*, 25 Cal. 4th 508 (2001). That case provides further support for the Department's position. Celanese Hoechst Corporation ("Hoechst"), a Delaware corporation with its principal place of business in New Jersey and its commercial domicile in New York, manufactures and sells a diversified line of chemicals, fibers, and specialty products. Hoechst conducted business operations in California and filed California franchise tax returns. California also employs the unitary business principle and formula apportionment to assess franchise taxes against multistate corporations doing business both inside and outside the state. Following the termination of its company pension plan and qualified pension trust, Hoechst received proceeds from the reversion of surplus pension plan assets. Hoechst paid income tax based on an apportioned share of the pension reversion proceeds but later sought a refund of corporate franchise tax, claiming that its reversion of surplus pension plan assets constituted nonbusiness income. The Court agreed with Hoechst that the surplus pension plan assets were insufficient to satisfy the "transactional test," basing that decision on its finding that the "reversion was a once-in-a-lifetime corporate occurrence, and the only transaction or activity that generated any taxable income for the corporation was the reversion itself."

However, the *Hoechst* Court held that the reversion of surplus pension plan assets constituted apportionable "business income" under the "functional test" because "Hoechst created the pension plan and trust in order to retain and attract employees; it exercised control over the plan; it funded the plan with business income; it used the contributions to reduce its tax liability; and, it used the surplus to reduce its contributions."

In the same way, the Taxpayer obtained the Credits in order to offset the expense of [redacted]. *See* [redacted] ttached as **Exhibit A**. As the *Hoechst* court recognized, even though surplus pension plan assets were not a regular occurrence, the company's creation of the asset, control over its disposition, and its subsequent use of the pension assets satisfied the functional test.

The Taxpayer appears to interpret the term "integral" as "necessary or essential" to [redacted] entire operation and economic enterprise as a whole. Such a restrictive interpretation conflicts with Arkansas law under the UDITPA. The UDITPA contemplates the apportionment of gains realized from "income of any type or class and from any source." *See* Arkansas Corporate Income Tax Rule 2.26-51-701, ¶3.

In this case, to answer the critical inquiry regarding the relationship between income-producing "property" and a taxpayer's "business operations," the Taxpayer incorrectly argues that the "functional test" is not satisfied, stating that its sales of Credits are not an "integral part of its trade or business." In support of this argument, the Taxpayer states that "the Credits were benefits bestowed upon it by [redacted], and that it did not manage its business to generate such Credits." Rather, it just so "happened that the [redacted] gave the Credits to [redacted] because of the characteristic of its [redacted], which reflects [redacted] market position and [redacted]" The Taxpayer further states that "once the Credits were granted, it passively sold them upon requests from [redacted]."

The Taxpayer states that unlike [redacted], it did not auction credits or otherwise actively sell them, nor market its Credits or manage the sale of the Credits as a business. Nevertheless, the Taxpayer admits that its Office [redacted] employees did contact [redacted] which had previously purchased Credits to determine whether they would like to do so again. Otherwise, the team responded to inquiries and considered offers, accepting those whose terms were reasonable. The Taxpayer has provided no documentary evidence to support those statements.

Selling Credits is not a new phenomenon for the Taxpayer. The office that manages the sales of the Credits is the same office that manages the [redacted] programs that create and obtain the Credits. It is an indicator of how interwoven the selling of Credits is that so little time is needed to administer that process — it is a seamless part of the office's daily activity. The Taxpayer has sold excess Credits each year since the first year it was eligible for them.

The Taxpayer places the focus on the amount of time spent by employees to administer the program and contrasts its marketing efforts to those of other [redacted]. Neither of these factors is relevant to a determination of whether the functional test is met. Regardless of the amount of effort required to realize the value of the Credits either as tax deductions or as proceeds from their sale, the fact remains that the Taxpayer had a regular mechanism for managing these assets; which appear to be a function of the same office that works to generate the Credits.

Further, the Taxpayer downplays its role in seeking to obtain these Credits which benefit its economic enterprise. According to its 2015 [redacted] was an early [redacted] According to the Taxpayer, a [redacted] is an efficient market-based tool in achieving the goal of [redacted]. Therefore, it is clear that Taxpayer considers the accumulation of the Credits at issue an active part of its business model.

Applying the statutory language and case law rulings to the facts herein clearly demonstrates that the Taxpayer's sale of the Credits meets the criteria required under the functional test set forth by the Kroger court. *See Kroger* 220 III.Dec. 566, 673 N.E.2d. First, the Taxpayer not only *acquired* these Credits from [redacted], it sought to obtain the Credits from the [redacted] by actively creating an interest in such property, as evidenced by its 2015 [redacted]. The Taxpayer not only controlled the disposition of the Credits. It actually *managed* the Credits through its Office [redacted], thereby demonstrating that it controlled and/or directed the use of such property. The Taxpayer clearly *had the power to transfer* the Credits, and did transfer those Credits to [redacted].

Additionally, the Credits were an "integral part of the Taxpayer's regular trade or business operations" because the proceeds derived from the distribution of the Credits materially contributed to the taxpayer's production of business income as demonstrated by the fact that the proceeds accounted for [redacted] of

> Taxpayer's federal taxable income for period 2015. The Credits were interwoven into and inseparable from the Taxpayer's trade or business because but for its [redacted], [redacted] the Credits would not have been bestowed upon the Taxpayer by the [redacted] because it would not have qualified for the Credits. If the Taxpayer had not earned the Credits, it would have been unable to sell the Credits to other [redacted]. [P. 10-17].

The Department's arguments regarding the functional test are persuasive. The Taxpayer received the credits from [redacted] because of the business it is in, the Taxpayer's [redacted] Office has managed the credits since 2011, and the Taxpayer sold credits in 2013, 2014, and 2015, with sales of the credits amounting to [redacted] of the Taxpayer's federal taxable income for 2015. The credits are integral parts of the Taxpayer's business and the proceeds generated from the sales of the credits are apportionable business income. Consequently, the Department correctly denied the Taxpayer's refund claim.

DECISION AND ORDER

The refund claim denial is sustained. The file is to be returned to the appropriate section of the Department for further proceedings in accordance with this Administrative Decision and applicable law. Pursuant to Ark. Code Ann. § 26-18-405 (Supp. 2015), unless the Taxpayer requests in writing within twenty (20) days of the mailing of this decision that the Commissioner of Revenues revise the decision of the Administrative Law Judge, this decision shall be effective and become the action of the agency. The revision request may be mailed to the Assistant Commissioner of Revenues, P.O. Box 1272, Rm. 2440, Little Rock, Arkansas 72203. A revision request may also be faxed to the

Assistant Commissioner of Revenues at (501) 683-1161 or emailed to revision@dfa.arkansas.gov. The Commissioner of Revenues, within twenty (20) days of the mailing of this Administrative Decision, may revise the decision regardless of whether the Taxpayer has requested a revision. The Taxpayer may seek relief from the final decision of the Administrative Law Judge or the Commissioner of Revenues on a final notice of a denial of a claim for refund by following the procedure set forth in Ark. Code Ann. § 26-18-406 (Supp. 2015).

OFFICE OF HEARINGS & APPEALS

Ray Howard
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RAY HOWARD
ADMINISTRATIVE LAW JUDGE

DATED: August 7, 2017