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** [redacted]
DOCKET NO.: 18-467	**Date of Claim: 01/08/18 ($** [redacted] **)**

RAY HOWARD, ADMINISTRATIVE LAW JUDGE

APPEARANCES

This case is before the Office of Hearings and Appeals upon a written protest dated March 6, 2018, signed by [redacted], Vice President - Taxes, on behalf of [redacted], the Taxpayer. The Taxpayer protested the denial of a refund claim by the Department of Finance and Administration ("Department"). The Letter ID Number is [redacted].

An administrative hearing was held on September 11, 2018, at 10:00 a.m., in Little Rock, Arkansas. The Department was represented by Alicia Austin Smith, Attorney at Law, Office of Revenue Legal Counsel ("Department's Representative"). Present for the Department were Scott Fryer, Assistant Administrator - Corporate Income Tax Section, Tommy Burns - Tax Auditor, and Faye Husser - Audit Supervisor. The Taxpayer was represented by [redacted] and [redacted], Attorneys at Law, [redacted] ("Taxpayer's Representatives"). [redacted], Site Manager, appeared at the hearing for

the Taxpayer, via telephone. The record remained open for the submission of post-hearing briefs. The Department's initial post-hearing brief was filed on October 11, 2018. The Taxpayer's post-hearing brief was filed on November 13, 2018. The Department's final post-hearing brief was filed on December 17, 2018. This matter was submitted for decision on Thursday, February 28, 2019.

ISSUE

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

FINDINGS OF FACT/CONTENTIONS OF THE PARTIES

The Taxpayer operates a manufacturing facility in Arkansas. The Taxpayer's Answers to Information Request[1] was filed on July 19, 2018, and stated in pertinent part, as follows:

> [redacted] is predominantly a [redacted] (roughly [redacted] of its sales are to [redacted], either through [redacted] sales through the [redacted] or direct commercial sales under [redacted]).
>
> [redacted] operates a [redacted] in Arkansas at the [redacted]. See [redacted] Exhibit A. Page 2. The facility is part of a former [redacted]. [redacted] manufactures [redacted] there — the [redacted]. See [redacted] Ex. A, pgs. 4-55. None of these products are for use in Arkansas and [redacted]. Sales are to the [redacted] or [redacted] pursuant to [redacted].
>
> [redacted] has income from business activity which is taxable both within and without Arkansas. Arkansas treats sales of tangible personal property other than to the federal government as being sourced on a destination basis rather than on the basis of origin, as

[1] [redacted], Senior Tax Manager, submitted the Taxpayer's Answers to Information Request.

> applied to sales to the federal government, for the purposes of calculating the sales factor apportionment.
>
> [redacted] has the option to choose its method of apportionment without submitting a petition seeking approval pursuant to the Multistate Tax Compact codified at Ark. Code Ann. § 26-5-101, Article III. [P. 1-2].

The Site Manager presented testimony at the hearing consistent with the information in the Taxpayer's Answers to Information Request and also testified that: (1) the Taxpayer's plant consists of [redacted] and storage facilities; (2) the Taxpayer builds [redacted] for the [redacted]; (3) the [redacted] are shipped to destinations outside of Arkansas for use or storage; (4) the [redacted] are procured from vendors in other states (including the Taxpayer's plant in [redacted]) or countries; (5) after the [redacted] are assembled they are [redacted] then shipped out of state; (6) the Taxpayer has approximately [redacted] full-time employees; (7) [redacted] are delivered to the [redacted] and [redacted] (he is not aware of any deliveries to Texas); and (8) most of the [redacted] are used by [redacted] but one [1] of the [redacted] could be [redacted].

The Tax Auditor testified that: (1) the Taxpayer's 2016 tax return[2] used an equally-weighted 3-factor formula that Arkansas does not allow so the Department adjusted the Taxpayer's return using a double-weighted sales factor; (2) estimated payments claimed were also adjusted due to a carryforward disallowance from 2015; (3) the Department also made an adjustment because the Taxpayer did not report any penalties for underpayment of estimated tax; (4) when the adjustments were made to the Taxpayer's 2016 tax return, reported

[2] See Department Exhibit 1.

Arkansas net taxable income increased so the overpayment reported by the Taxpayer ($[redacted]) was decreased as a result of increased tax liability ($[redacted]);[3] (5) under Ark. Code Ann. § 26-18-208(6)(A) (Repl. 2012), an under estimate penalty ($[redacted] was also taken from the overpayment amount; (6) the remaining overpayment was applied to the 2015 tax assessment balance due[4] so there is no carryforward to be applied to 2017; (7) he is not aware of any request by the Taxpayer to use an alternate apportionment formula; (8) after application of the four-factor formula, there was still an overpayment of tax but after the adjusted tax liability the Taxpayer had failed to make estimated payments as required by law (there were no estimated payments made for the first two [2] quarters of 2016 and there was no carryforward from 2015); (9) he did not calculate the penalty based on the original return; and (10) it is possible to have an overpayment for an entire tax year and still have underestimate penalties per quarter.

The post-hearing briefs filed by the parties set forth the questions for decision which are set forth below with the arguments presented by the Taxpayer, the arguments presented by the Department, and a legal analysis.

CONCLUSIONS OF LAW

Standard of Proof

Ark. Code Ann. § 26-18-313(c) (Supp. 2017) 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

[3] See Department Exhibit 2.
[4] See Ark. Code Ann. § 26-18-507(e)(1)(B)(i) (Repl. 2012).

> 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. 2017).

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. 2017). 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. 2017).

A 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 under Ark. Code Ann. § 26-18-507 (Repl. 2012).

Apportionment Formula and Throwback Rule

All corporations operating within the state, both foreign and domestic, are subject to Arkansas Corporate Income Tax based on their gross income after allowance for Arkansas deductions, exemptions, and credits. Ark. Code Ann. § 26-51-205 (Repl. 2012). Further, the State of Arkansas has adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA") for purposes of apportioning interstate business income. See Ark. Code Ann. § 26-51-701 et seq. (Repl. 2012). With respect to the apportionment formula (Ark. Code Ann. § 26-51-709 (Repl. 2012)) and the throwback rule (Ark. Code Ann. § 26-51-716 (Repl. 2012)), the Taxpayer's post-hearing brief stated, as follows:

> 1. Arkansas is a signatory to the Multistate Tax Compact ("MTC") which Arkansas adopted and enacted by Act No. 410 of the 1967 Arkansas General Assembly, at A.C.A. §26-5-101 *et seq*. Under Article III of the MTC, multistate taxpayers have the option of apportioning income using either the apportionment formula prescribed by state law, or the apportionment formula established in Article IV of the MTC. That option granted to multistate taxpayers under the MTC has not been repealed or amended and Arkansas has not withdrawn from the MTC.
>
> Arkansas has also adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA"). A.C.A. §§ 26-51-701 *et seq*. The income apportionment provisions in the MTC and the UDITPA were identical when those statutes were initially adopted. In 1995, pursuant Act, 682 of 1995, the Legislature revised the UDITPA formula to provide for a double-weighted sales factor.
>
> In that same Act, the Legislature attempted to amend the provisions of the MTC by changing the apportionment formula under the MTC to include a double-weighted sales factor. This attempt by the Legislature to amend a specific provision of the MTC is ineffective. In 1967, the Legislature adopted and enacted the MTC as a whole compact; it did not codify each of the separate provisions in the MTC and they are not separate sections of the Arkansas Code over which the Legislature has authority. Thus, a multistate taxpayer in Arkansas retains the option of choosing to

apportion under the terms of the MTC, as adopted in Arkansas, or under other provisions of Arkansas law, including UDITPA.

The MTC is a contract between and among the states which have adopted the MTC. A question exists whether one state can modify a provision of the MTC when such a change has not been adopted by the other member states and incorporated into the MTC. The issue of the ability of Arkansas to amend a provision of the MTC, but retain the benefits of the other provisions of the MTC, has not been litigated in Arkansas. The California Supreme Court, in the Gillette Company vs. Franchise Tax Board, 62 Cal. 4th 468 (2015), determined that an amendment by the California legislature to the UDITPA apportionment formula also operated to amend the MTC apportionment formula, but that decision turned, in part, on an interpretation of portions of the Constitution of the State of California. That decision is not controlling in Arkansas.

Article I of the MTC sets forth the various purposes for which the MTC was established and adopted, among which is to "facilitate proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of appropriate disputes. . . ." The apportionment method used by the State to apportion income to [redacted] does not result in an equitable apportionment of tax, nor does it fairly represent the activity of [redacted] in the State of Arkansas. The United States Supreme Court has determined that "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." Container Corporation of America vs. The Franchise Tax Board, 463 U.S. 159, 170 (1983); *see also*, Complete Auto Transit. Inc, v. Brady. 430 U.S. 274 (1977). The apportionment method used by the State, including both the apportionment formula which utilizes the double-weighted sales factor and the application of the "throwback" rule in A.C.A. §§26-5-101 and 26-51-716(b) does not reflect [redacted] activity in Arkansas.

2. The products delivered from the [redacted] plant in Arkansas consist of [redacted] sold and delivered to [redacted]. Those [redacted] are made from various [redacted] which are delivered to [redacted] Arkansas facility from the plants of various subcontractors located in various parts of the United States. [redacted] employees assemble [redacted] into the [redacted] in Arkansas, perform [redacted] on the [redacted], and ship those [redacted] from the Arkansas facility to various [redacted] locations around the country, none of which are in Arkansas. The terms of the sale contracts are negotiated and administered from [redacted] offices which are not

> located in Arkansas. Nevertheless, because the [redacted] are shipped from the [redacted] plant in Arkansas to [redacted], the "throwback rule" (A.C.A. § 26-51-716) allocates the dollar value of all such sales to Arkansas. Following application of the "throwback rule", the State of Arkansas then doubles the dollar value of all such missile sales pursuant to the provisions of the double-weighted sales factor. Once these [redacted] [redacted] leave the [redacted] facility in [redacted] for delivery to the [redacted], they will never be used in Arkansas and will never return to the State. The apportionment method used by the state which includes the use of the double-weighted sales factor and the "throwback" provision does not fairly represent the activity of [redacted] in the State of Arkansas and is a violation of the Commerce Clause and the Due Process Clause of the United States Constitution, as well as the Due Process and Equal Protection clauses of the Arkansas Constitution, as applied. The use of the "throwback" rule singles out the sales by [redacted] to the [redacted] and then applies a double-weighted sales factor to increase the amount of taxes owed to the State of Arkansas which does not fairly represent the activities of [redacted] in the state.
>
> The adoption of the double-weighted sales factor by the State in 1995 was intended to, and had the effect of, downgrading the importance of the property and payroll factors and upgrading the effect of the sales factor in the apportionment formula as a way to export some of the State's tax burden to out-of-state businesses who deliver products from the State. The U.S. Supreme Court in the decision in Trinova Corp. vs. Michigan Department of Treasury, 498 U.S. 358, 386 (1991), observed that altering an apportionment formula with respect to corporate income taxes with a purpose of "exporting the tax" to out-of-state businesses could, in certain circumstances, not be in compliance with U.S. Constitutional standards. [P. 2-3].

The Department's final post-hearing brief addressed the Taxpayer's arguments regarding the apportionment formula and the throwback rule and stated, in part:

> The facts and issues in this proceeding are identical to those previously considered in Docket No. [redacted].
>
> . . .
>
> The Taxpayer takes issue with the Department's application of three statutes: Ark. Code Ann. § 26-51-709 (Apportionment), Ark. Code

Ann. § 26-51-716 (the "Throw-Back" rule), and Ark. Code Ann. § 26-18-208 (Underestimate Penalty). The Taxpayer does not allege that its income is not subject to corporate income tax in Arkansas. The Taxpayer does not allege that the Department improperly calculated its corporate income taxes due under these three statutes. Instead, the Taxpayer alleges that the statutes are unconstitutional or that the Taxpayer had the option of disregarding the statutes when calculating its corporate income tax due the State of Arkansas.

. . .

The Taxpayer has taken the position that it may use an equally weighted, three-factor apportionment formula to determine its Arkansas corporation income tax liability for tax year 2016 because of its claim that the Department cannot deviate from the equally weighted three-factor formula set forth in the Multistate Tax Compact. The Taxpayers in *The Gillette Co. v. Franchise Tax Bd.*, 62 Cal. 4th 468 (2015) attempted the same argument, which was rejected by the California Supreme Court. The Court held that the Multistate Tax Compact is not a binding agreement. *Id.*

In 1995, the Arkansas General Assembly amended the apportionment formula in Arkansas, codified in Ark. Code Ann. § 26-5-101 and Ark. Code Ann. § 26-51-709, to require a double-weighted sales factor in the calculation of business income. Acts of 1995, Act 682. The Taxpayer did not petition the Department for permission to use an alternative apportionment formula to calculate its corporation income tax liability as required under Ark. Code Ann. § 26-51-718. The filing of a return does not constitute a petition. *Leathers v. Jacuzzi,* 326 Ark. 857, 935 S.W.2d 252 (1996).

The Taxpayer filed its 2016 tax return using an equally-weighted three-factor apportionment formula instead of the three-factor formula with a double-weighted sales factor required under Arkansas law. The Department adjusted the Taxpayer's return to calculate its apportionment using the double-weighted sales factor as required under Ark. Code Ann. § 26-51-709. The Department's adjustment of the apportionment formula utilized by the Taxpayer in the Taxpayer's 2016 tax return was proper.

. . .

The Taxpayer's return for tax year 2016 included sales of tangible personal property to the [redacted] as required by Ark. Code Ann. § 26-51-716. Sales to the [redacted] shipped from an office, store, warehouse, factory, or other place of

> storage in Arkansas are properly sourced to Arkansas [redacted].
>
> The Taxpayer admits that it shipped tangible personal property [redacted] from Arkansas to the [redacted]. The sales were properly sourced to this state [redacted].
>
> The Department did not make any adjustments to the Taxpayer's 2016 return [redacted], otherwise known as the "throw-back" rule. The Notice of Claim Denial did not include any adjustments as a result of the "throw-back" rule. This issue is not ripe for protest. [Footnote omitted, P. 1-3].

The Department's arguments are persuasive. As provided in a prior Administrative Decision issued to the Taxpayer, the opinion of the Arkansas Supreme Court in Leathers v. Jacuzzi, 326 Ark. 857. 935 S.W.2d 252 (1996) supports the Department's position that a petition must be submitted in writing prior to the filing of an original return using an alternative apportionment formula under the provisions of Ark. Code Ann. § 26-51-718 (Repl. 2012). The Taxpayer did not file a petition for tax year 2016 (prior to utilizing an alternative apportionment formula); therefore, the Department correctly adjusted the Taxpayer's return using the apportionment formula in Ark. Code Ann. § 26-51-709 (Repl. 2012). Since the sales to the [redacted] were properly classified [redacted] and the Taxpayer failed to file a petition prior to filing a return using an alternative apportionment formula, the Department correctly adjusted the Taxpayer's 2016 return, correctly determined the Taxpayer's tax liability, and correctly denied the Taxpayer's refund claim.

To the extent the Taxpayer has raised constitutional challenges to Ark. Code Ann. §§ 26-51-709 (Repl. 2012) or 26-51-716 (Repl. 2012), the statutes are

presumed to be constitutional. See Parkman v. Sex Offender Screening and Risk Assessment Committee, 2009 Ark. 205 at 1 (2009). Furthermore, the Office of Hearings and Appeals does not have jurisdiction or authority to determine the constitutionality of a statute. See Arkansas Tobacco Control Bd. v. Sitton, 357 Ark. 357, 166 S.W.3d 550 (2004).[5]

Penalty

With respect to the penalty imposed in this case, the Department's initial post-hearing brief provided, in pertinent part, as follows:

> The Department's assessment of 10% underestimate penalty is in accordance with Arkansas statutory law, which provides as follows in relevant part:
>
> > If a taxpayer fails to make a declaration of estimated tax and pay on any quarterly due date the equivalent to at least ninety percent (90%) or the amount actually due, there shall be added a penalty of ten percent (10%) per annum to the amount of the underestimate. The ten percent (10%) per annum penalty shall be applied on a quarterly basis.
>
> Ark. Code Ann. § 26-18-208(6)(A). The Department adjusted [redacted] tax return to reflect the apportionment formula utilized in Arkansas. The adjusted return increased [redacted] net taxable income for tax year 2016 . . . which reduced the overpayment reported . . .. Underestimate penalty in the amount of $[redacted] ($[redacted]) was incurred as a result of the adjusted tax liability. *See* **Exhibit 5, [redacted] Adjusted AR 2220**. [redacted] had reported $0.00 in penalty on its return so the underestimate penalty affected [redacted] refund claim. The Department's adjustment of the reported penalty for underpayment of estimated tax was proper.
>
> The Department's adjustment of the apportionment formula utilized by the Taxpayer was proper under Ark. Code Ann. § 26-51-709 (Repl. 2012). Although not relevant to this proceeding, as requested during the administrative hearing, the Department

[5] See also Gillette Company et al. v. Franchise Tax Board, 62 Cal.4th 468 (2015) cert. denied, 137 S.Ct. 294 (2016), wherein the California Supreme Court upheld the apportionment formula requiring the double-counting of in-state sales.

calculated the underestimate penalty which would have been due by [redacted] if no adjustments had been made due to [redacted] use of an incorrect apportionment formula. [redacted] would have still owed $[redacted] in underestimate penalty even if those adjustments had not been made. See Exhibit 6. [P. 6-7].

The Taxpayer's post-hearing brief addressed the penalty imposed in this case and stated that:

> 3. The State has also imposed on [redacted] an underpayment penalty in the amount of $[redacted] which is excessive and not pursuant to the provisions of Arkansas statutes. In its brief and in Exhibits 2 and 5 to that Brief, the Department admits that [redacted] had an overpayment of estimated taxes in 2016 in the amount of $[redacted]. The Department then applied that overpayment "to Prior Year Debt" leaving a $0 overpayment for 2016 and then proceeded to assess the underpayment penalty of $[redacted] against [redacted]. In Exhibit 6 to its Brief, the Department admits that, if calculated correctly, the total underpayment penalty would be only [redacted].

In response to the Taxpayer's assertions regarding the penalty, the Department's final post-hearing brief stated, in part:

> Underestimate penalty was applied on a quarterly basis as required by Ark. Code Ann. § 26-18-208(6)(A). It is irrelevant whether the Taxpayer had an overpayment for the year, the Taxpayer is required to pay the equivalent of 90% of the amount actually due each quarter. The Taxpayer chose to calculate its corporation income tax liability utilizing an equally weighted, three-factor apportionment formula instead of the three-factor apportionment formula with a double-weighted sales factor required by Arkansas law. When the Department adjusted the Taxpayer's tax returns so that the proper formula was applied, the Department determined that the Taxpayer did not pay the equivalent of 90% of the amount due for the 1st and 2nd quarter. **Exhibit 5.** The Department applied a penalty of 10% as required by Ark. Code Ann. § 26-18-208(6)(A).[Footnote 2 stated that, "The Taxpayer's assertion that the penalty was incurred because the Department applied the Taxpayer's overpayment to the Taxpayer's prior year debt, effectively reducing the overpayment to $0.00, is not well taken. The penalty was incurred due to the Taxpayer's failure to properly estimate its 2016 corporate income taxes. The Department's application of the Taxpayer's overpayment

> to the Taxpayer's prior year debt did not affect the penalty calculation."]
>
> The Taxpayer simply calls the penalty applied "excessive." The Taxpayer provides no basis for this assertion. The Department's calculation of the underestimate penalty was reasonable and in accordance with the statute. [P. 3].

Based upon the determination that the Department correctly adjusted the Taxpayer's 2016 return and the calculations contained in Department Exhibit 5, a preponderance of the evidence supports a finding that the Department correctly assessed a penalty against the Taxpayer under Ark. Code Ann. § 26-18-208(6)(A) (Repl. 2012).

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. 2017), 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 Administrative 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.

Ark. Code Ann. § 26-18-406 (Supp. 2017) provides for the judicial appeal of a final decision of an Administrative Law Judge or the Commissioner of Revenues on a final assessment or refund claim denial; however, the constitutionality of that code section is uncertain.[6]

OFFICE OF HEARINGS & APPEALS

RAY HOWARD
ADMINISTRATIVE LAW JUDGE

DATED: March 7, 2019

[6] See Board of Trustees of Univ. of Arkansas v. Andrews, 2018 Ark. 12.