



STATE OF ARKANSAS  
**Department of Finance  
and Administration**

**OFFICE OF THE DIRECTOR**  
1509 West Seventh Street, Suite 401  
Post Office Box 3278  
Little Rock, Arkansas 72203-3278  
Phone: (501) 682-2242  
Fax: (501) 682-1029  
<http://www.state.ar.us/dfa>

July 18, 2019

[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]

RE: Request for Revision  
In the Matter of [REDACTED].  
Docket Nos: 19-185 (2014) & 19-186 (2015)

[REDACTED]:

This letter is prepared in response to your request on behalf of your client, [REDACTED], for a revision of the administrative decision entered on April 1, 2019. Your letter dated April 19, 2019, is considered a timely-filed request for revision and this letter will be the final decision of the Department of Finance and Administration (the "Department") under Ark. Code Ann. § 26-18-405 (Supp. 2017). In addition, you requested a meeting to discuss your request for revision, which was held on May 7, 2019. Following the May 7 meeting, a review of your revision request letter, the administrative hearing decision, and the documentation contained in the case file, the Administrative Decision is sustained in full.

### FACTS

[REDACTED] ("[REDACTED]"), incorporated in [REDACTED] in 1992, is an Arkansas based corporation headquartered in [REDACTED], Arkansas. [REDACTED] sells motor fuel products and convenience store merchandise through a large chain of retail gas stations located primarily in 26 states throughout the Southwest, Southeast, and the Midwest.

[REDACTED] separated from its parent, [REDACTED] (the "Parent") in August of 2013. In connection with the separation, [REDACTED] obtained third-party long-term debt to finance a cash dividend of \$650 million to the Parent. This debt resulted in interest expense to [REDACTED] in the amount of \$36,471,781 for tax year ending 2014, and \$33,484,102 for tax year ending 2015.

On or about March 15, 2018, [REDACTED] amended its Arkansas corporate income tax returns for periods 2014 and 2015. As part of the amendment, [REDACTED] requested refunds of \$2,107,599 and \$1,897,800 claiming that the interest expense for the respective tax periods should have been classified as non-business expense allocable to Arkansas. The Department denied [REDACTED] refund requests for both tax periods. [REDACTED] then filed a timely protest and requested an administrative hearing before the Office of Hearings and Appeals.

The administrative hearing was held on November 28, 2018 in Little Rock, Arkansas. Tommy Burns, Tax Auditor, Faye Husser, Auditor Supervisor, and Scott Fryer, Assistant Administrator/Corporate Income Tax Section, appeared for the Department. ██████████, which was represented by ██████████, ██████████ (Attorney at Law), ██████████ (Tax Accountant), and ██████████ (Associate General Counsel – ██████████), did not produce any witnesses. The Arkansas Tax Procedure Act provides that at a hearing on a proposed assessment or on the denial of a refund, a taxpayer may be represented by an authorized representative and may “present evidence in support of his or her position.” Ark. Code Ann. § 26-18-405(d)(2) (Supp. 2017). Neither of these provisions is mandatory. Nevertheless, a taxpayer who declines to present any hearing testimony and who relies solely on the assertions of its representatives, as the Taxpayer did in this case, does so at its peril. The unsworn factual assertions of a taxpayer’s representatives, presented without any supporting evidence, are not entitled to any evidentiary weight.

The hearing officer upheld the Department’s denial of the refund claims for the tax periods at issue. In addition to the following three arguments, which will be discussed in turn below, ██████████’s revision request letter reiterates the arguments previously presented. The letter states:

1. The Administrative Decision improperly concludes that the business/nonbusiness test set forth in Uniform Division of Income for Tax Purposes Act (“UDITPA”) applies only to income, not expenses;
2. The Administrative Decision improperly asserts that Department of Finance and Administration’s (the “Department”) interpretation of a statute or rule is entitled to deference unless the interpretation is clearly erroneous; and
3. The Administrative Decision errs in concluding the Taxpayer has not proven entitlement to its refund.

### **RELEVANT LAW**

Arkansas Code Annotated § 26-18-507 (Repl. 2012) provides for a refund of any state taxes erroneously paid in excess of the taxes lawfully due. When a taxpayer claims to be entitled to a refund under the terms of the state law, the taxpayer bears the burden of proving by a preponderance of the evidence that the claimed refund was erroneously paid in excess of the taxes lawfully due.

Arkansas allows for the deduction of business expenses as provided for by 26 U.S.C. § 162. *See* Ark. Code Ann. § 26-51-423(a)(1) (Repl. 2012). Under § 162, “[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in

carrying on a trade or business.” *Id.* Arkansas Income Tax Rule 1.26-51-423(a) provides that, to be deductible as a trade or business expense, the expense must be:

- (1) An ordinary and necessary expense of the taxpayer’s trade or business,
- (2) Paid or incurred during the tax year when it is deducted,
- (3) Connected with a trade or business conducted by the taxpayer.

The State of Arkansas has adopted the Uniform Division of Income for Tax Purposes Act (“UDITPA”) codified at Ark. Code Ann. § 26-51-701 *et seq.* (Repl. 2012). The UDITPA governs the way Arkansas imposes income and franchise taxes on the earnings of multistate and multinational corporations doing business in the State. Under Ark. Code Ann. § 26-51-701(a) (Repl. 2012):

“Business income” means 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.

The definition of “business income” under Ark. Code Ann. § 26-51-701(a) provides two tests for purposes of deciding if income is business income: a transactional test and a functional test. *See Hoechst Celanese Corp. v. Franchise Tax Board*, 25 Cal.4<sup>th</sup> 508 (2001). The Arkansas Supreme Court approved the Department’s application of the two tests in *Pledger v. Getty Oil Exploration Co.*, 309 Ark. 257, 831 S.W.2d 121 (1992), and stated:

[B]usiness 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.

## DISCUSSION

Because the facts do not appear to be in dispute, the factual findings made by the hearing officer are adopted for purposes of responding to this request. The hearing officer incorporated and referenced all evidence into his written decision, including the written briefs and the testimony presented by the parties at the hearing. *See* Administrative Decision at 2-14. In addition, the hearing officer detailed the arguments made by both ██████████ and the Department and considered those arguments in the rendering of his decision. *Id.*

**1. The business / nonbusiness test set forth in the Uniform Division of Income for Tax Purposes Act (“UDITPA”) applies to income, not expenses.**

██████████ claims that the Administrative Decision improperly concluded that the business/nonbusiness test set forth under the UDITPA applies only to income, not expenses. This argument by ██████████ is incorrect.

The Administrative Decision reflects that deductible expenses associated with nonbusiness income must be added back as non-deductible expenses under Ark. Code Ann. § 26-51-431. Arkansas Code Annotated § 26-51-431(c)(3) (Repl. 2012) provides that “[f]or the purpose of computing Arkansas corporation income tax liability, no deduction shall be allowed for expenses otherwise allowable as deductions which are allocable to nonbusiness income.” Put simply, expenses follow income.

When a taxpayer has no nonbusiness income, an expense is allowed as a business expense deduction to offset that taxpayer’s business income. For example, a taxpayer may have nonbusiness-related expenses that exceed nonbusiness income (resulting in a nonbusiness income loss). Without any income or expected income, it would not be possible to evaluate the business/nonbusiness nature of the expense, which is the basis of the UDITPA analysis. The Corporate Income Tax Instructions provides some guidance to taxpayers concerning this issue because it can be difficult to match expenses to specific income when nonbusiness expenses are combined with other business expenses. See Corporation Income Tax Instruction for 2015, Page 9, which provides:

*[E]xpenses otherwise allowable as deductions which are related to non-business income.*

*Example a: (interest expense): avg. non-tax assets avg. / total assets X interest expense = disallowed expense*

*Example b: (non-business income): % X non-bus. inc. = disallowed expense.*

*Taxpayer must justify % used and submit schedule. State may increase % if justification can be made.*

If the interest expense is not an ordinary and necessary expense to the business, it would not be allowed as any type of deduction. If the interest expense is not a business-related expense and not associated with an effort to generate some nonbusiness-related income, then the expense is not necessary and therefore not deductible. To the extent ██████████ contends that the borrowing of money to pay a dividend to itself is a necessary expense, such expense should qualify as a normal business expense, otherwise it would not be deductible at all. It appears ██████████ is attempting to separate itself from its Parent as though this was an unrelated party transaction. Until the separation is complete, ██████████’s Parent controls everything, including its subsidiaries’

decision to enter into an agreement to borrow money to pay the Parent (itself) a dividend. The record does not indicate that ██████████ produced any witnesses or provided any other evidence to rebut the auditor’s testimony.

Based on a review of the Administrative Decision, the hearing officer sufficiently analyzed and correctly applied the law to the facts given by the parties and determined that the UDITPA “does not contemplate the additional independent categorization of expenses under the test for discerning business and nonbusiness income.” *See* Administrative Decision at 12.

**2. The Department of Finance and Administration’s interpretation of Arkansas tax statutes and rules is entitled to deference.**

██████████ claims that the Administrative Decision improperly asserts that the Department’s interpretation of a statute or rule is entitled to deference unless the interpretation is clearly erroneous. Further, ██████████ claims that the hearing officer “essentially created a burden of proof that is expressly contrary to the statutory provisions contained in Ark. Code Ann. § 26-18-313(c).” These arguments by ██████████ are incorrect.

The standard of proof for a taxpayer to prove entitlement to an exemption, **deduction**, or credit, is by a preponderance of the evidence. Ark. Code Ann. § 26-18-313 (Supp. 2017). When a taxpayer claims to be entitled to a tax exemption, **deduction**, or credit under the terms of the state tax law, the statute providing the tax exemption, **deduction**, or credit shall be strictly construed in **limitation** of the exemption, **deduction**, or credit. Ark. Code Ann. § 26-18-313(b) (Supp. 2017).

The Arkansas Supreme Court has recognized that administrative agencies are often required to interpret statutes and rules. *See Walnut Grove School Distr. No. 6 of Boone County v. County Board of Education*, 204 Ark. 354, 162 S.W.2d 64 (1942). In that case, the Court stated, in part:

The administrative construction generally should be **clearly wrong** before it is overturned. Such a construction, commonly referred to as practical construction, although not controlling, is nevertheless entitled to considerable weight. It is highly persuasive. *Id.* at 359, 162 S.W.2d at 66. (Emphasis added).

In *Holbrook v. Healthport, Inc.*, 2014 Ark. 146, at 10, 432 S.W.3d 593, 599, the Court stated that “there is a presumption in favor of the taxing power of the State, and all tax exemption provisions must be strictly construed against the exemption.” The taxpayer has the burden of proving sufficient facts to establish the right to an exemption by a preponderance of the evidence. Ark. Code Ann. § 26-18-313(c) (Supp. 2015); *see also, Weiss v. Bryce Co., LLC*, 2009 Ark. 412, at 3-4, 330 S.W.3d 756, 757.



deduction, or credit. *Id.* at (b) (Supp. 2017). The hearing officer applied the proper standard of proof required by ██████████ to prove entitlement to the claimed deduction.

██████████ claims that the hearing officer failed to properly analyze the business/nonbusiness tests in the UDITPA. This argument by ██████████ is also incorrect. The hearing officer set out in detail both parties' arguments concerning the tests and considered those arguments in the rendering of his decision. The Administrative Decision at 13, ¶ 1, provides:

Though the Taxpayer has shown that the business/nonbusiness test has been applied to the categorization of certain expenses in court cases from other jurisdictions, those cases are not binding and appear to involve instances where the parties consented to that approach. Those citations are not persuasive based on the above analysis.

The hearing officer addressed a UDITPA analysis of business/nonbusiness income and expenses and determined that an analysis of the interest expense under the transactional and functional tests was not warranted under Arkansas law or the facts of this case. ██████████ has not submitted additional testimony or arguments regarding the hearing officer's determinations. The claim of error is not supported by the request for a revision of those decisions.

Following Arkansas law and controlling precedent, the hearing officer correctly concluded that the interest expense at issue should not be classified as non-business expense allocable to Arkansas. The facts and the law discussed herein allow for no other conclusion.

### CONCLUSION

The hearing officer considered the facts and evidence and applied current Arkansas case law. ██████████ did not prove entitlement to the refund claims herein. The administrative decision is sustained. This concludes Taxpayer's administrative remedies under the Tax Procedure Act. Relief from this decision may be sought per the procedure in Ark. Code Ann. § 26-18-406 (Supp. 2017).

Sincerely,

Walter Anger  
Deputy Director and Commissioner of Revenue