

**STATE OF ARKANSAS  
DEPARTMENT OF FINANCE AND ADMINISTRATION  
OFFICE OF HEARINGS & APPEALS  
ADMINISTRATIVE DECISION**

<b>IN THE MATTER OF</b> [REDACTED] [REDACTED] <b>ACCT. NO.:</b> [REDACTED]	<b>CORPORATE INCOME TAX REFUND CLAIM DENIALS</b>
<b>DOCKET NOS.: 19-185 (2014)</b>  <b>19-186 (2015)</b>	<b>AMOUNT DENIED:</b> [REDACTED] <b>LETTER ID:</b> [REDACTED] <b>AMOUNT DENIED:</b> [REDACTED] <b>LETTER ID:</b> [REDACTED]

**TODD EVANS, ADMINISTRATIVE LAW JUDGE  
APPEARANCES**

This case is before the Office of Hearings and Appeals upon written protests dated August 29, 2018, submitted by [REDACTED] on behalf of [REDACTED], the Taxpayer. The Taxpayer protested refund claim denials issued by the Department of Finance and Administration (“Department”).

An administrative hearing was held in this matter on November 28, 2018, at 10:00 a.m. in Little Rock, Arkansas. The Department was represented by Lisa Ables (“Department’s Representative”), Alicia Austin Smith, David Scott, and Brad Young, Attorneys at Law, Revenue Legal Counsel. Present for the Department was Tommy Burns, Auditor; Faye Husser, Audit Supervisor; and Scott Fryer, Assistant Administrator. The Taxpayer was represented by [REDACTED], CPA<sup>1</sup>, and [REDACTED], Attorney at Law (“Taxpayer’s Representatives”). Present for the Taxpayer was [REDACTED], Tax Accountant, and [REDACTED], Associate General Counsel – [REDACTED]

<sup>1</sup> Prior to the filing of the Taxpayer’s final post-hearing reply brief, [REDACTED] was replaced by [REDACTED].

The record remained open for the submission of post-hearing briefs. The Taxpayer's initial post-hearing brief was filed on January 2, 2019. The Department's post-hearing response brief was filed on February 5, 2019. The Taxpayer's final post-hearing reply brief was filed on March 5, 2019. The record was closed and the matter was submitted for a decision on March 6, 2019.

### **ISSUE**

Whether the refund denials issued by the Department should be sustained.  
Yes.

### **FACTUAL AND LEGAL CONTENTIONS OF THE PARTIES**

#### **Prehearing Filings**

Within her Answers to Information Request, the Department's Representative provided certain factual allegations, stating as follows in relevant part<sup>2</sup>:

[REDACTED] ("Taxpayer"), incorporated in Delaware in [REDACTED], is an Arkansas based corporation headquartered in [REDACTED], Arkansas. Taxpayer sells [REDACTED] and [REDACTED] through a [REDACTED] located primarily in [REDACTED] throughout the [REDACTED].

Taxpayer separated from its parent. [REDACTED] (the "Parent") in [REDACTED]. In connection with the separation, Taxpayer obtained third-party long-term debt to finance a cash dividend of [REDACTED], which resulted in interest expense of [REDACTED] for tax year ending 2014 and [REDACTED] for tax year ending 2015.

On or about March 15, 2018, Taxpayer amended its Arkansas corporate income tax returns for periods 2014 and 2015 and requested refunds of [REDACTED] and [REDACTED] claiming that the interest expense for the respective tax periods should have been classified as non-business expense allocable to Arkansas. The Department did not agree.

On July 5, 2018, the Department denied Taxpayer's refund claims in full. See Notices of Claims Denials attached as **Exhibits 1 & 2**, respectively. The Taxpayer timely protested the refund claim denials and

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<sup>2</sup> All exhibits support the statements for which they are cited.

requested an administrative hearing in Little Rock. See Protest of Refund Claim Denials attached as **Exhibits 3 & 4**, respectively.

██████████ provided the initial basis for Taxpayer's objection to the refund claim denials, stating as follows:

██████████ disagrees with, objects to, and protests the Arkansas Department of Finance and Administration's assertion that interest expense related to third-party long-term debt, where such proceeds from the third-party long-term debt were used to finance a cash dividend related to the separation of ██████████ from its former parent, ██████████, is an apportionable business expense. For the reasons set forth in the attached protest, the interest expense should be treated as a nonbusiness expense and should be separately allocated under Ark. Code Ann. § 26-51-707.

Within her Answers to Information Request, the Department's Representative asserted that: (1) the business/nonbusiness test under Uniform Division of Income for Tax Purposes Act ("UDITPA") is not applicable to categorization of expenses; (2) even if the business/nonbusiness distinction is applicable, the incurred expense satisfies the transactional test; and (3) even if the transactional test is not met, the incurred expense satisfies the functional test.

Within their Answers to Information Request, the Taxpayer's Representatives asserted that the interest expense should be considered a nonbusiness expense because it meets neither the transactional nor functional test for business income. They contended that the expense fails to meet the transactional test because the associated transaction was an "extraordinary, one-time event" and was not part of the Taxpayer's regular business activities. They noted that the expense fails to meet the functional test because the loan proceeds associated with the expense were not utilized within the business nor was the acquisition, management, or disposition of the proceeds integral to the

Taxpayer's business. They concluded their analysis asserting that nonbusiness interest must be allocated to Arkansas (the Taxpayer's commercial domicile) under Ark. Code Ann. § 26-51-707 (Repl. 2012).

## **Hearing Testimony**

### **1. Auditor's Testimony**

The Auditor testified that he reviewed the Taxpayer's amended returns for the 2014 and 2015 tax years. He explained that the Taxpayer is an Arkansas based corporation that [REDACTED]. In [REDACTED], the Taxpayer separated from its parent and obtained third-party loans to finance a cash dividend to [REDACTED] in the amount of [REDACTED]. As a result of these loans, the Taxpayer incurred significant interest expense for the tax years 2014 and 2015. The Taxpayer deducted interest expense of [REDACTED] in 2014 and [REDACTED] in 2015.<sup>3</sup> Within the Taxpayer's original returns, the Taxpayer deducted the interest expense from its apportionable business income. He stated that this approach was correct because the interest expense is not allocable to nonbusiness income.

Within the amended returns, the Taxpayer reclassified its interest expense as a nonbusiness expense that was allocable 100% to the State of Arkansas. As a result of this change, the Taxpayer requested refunds of [REDACTED] for 2014 and [REDACTED] for 2015. The Taxpayer considered the loans to represent a one-time corporate occurrence and not an apportionable business expense. The Department denied the refund claims because the loans were utilized by the Taxpayer to perform a business activity, the spin off or separation. A change in a

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<sup>3</sup> Copies of the original and amended returns were entered as Department's Exhibits 3 through 6.

company's organizational structure (though infrequent) is still a normal business activity. He further noted that the Taxpayer had no reported nonbusiness income during the 2014 and 2015 tax years, so he asserted that it was evident that the expense was not associated with the generation of nonbusiness income. Under Arkansas Corporate Income Tax Regulation § 2.26-51-707, any transaction that is dependent upon or contributes to the Taxpayer's business is part of the Taxpayer regular course of business and integral thereto. Since the separation was dependent upon the payment of the dividend, he reasoned the Taxpayer's interest expenses were appropriately classified as apportionable business expenses. A dividend payment is typically treated as a normal business activity by his office even though he is unaware of how often the Taxpayer paid dividends.

## **2. Assistant Administrator's Testimony**

The Assistant Administrator testified that he is the administrator of the Corporate Income Tax Department. He is not certain that Arkansas law allows an expense to be considered nonbusiness when it is not associated with pursuit of nonbusiness income. Even applying the nonbusiness/business classification scheme associated with apportionable income, however, he stated the interest expense would still be considered a business expense. He acknowledged the Taxpayer has supplied its credit agreements which set aside the borrowed funds exclusively for payment of the separation dividend. The interest expense payments at issue appear to him to be regularly incurred and paid by the Taxpayer, meeting the transactional test if applicable. He explained that interest expense is an ordinary and necessary business expense regularly incurred by corporations. A corporation may only finance its startup operations through debt

or equity. These loans were acquired for a business purpose and regularly paid by the Taxpayer. If the functional test is to be applied, his office would look to the underlying debt as the item that is being managed by the company. He asserted the functional test is met because the acquisition, management, and disposition of the debt is an important part of the Taxpayer's business.

Since the interest expense has reduced over the two periods at issue, he assumed that some portion of the principal is also being retired by the Taxpayer. He expressed concern that the Taxpayer has not consistently treated this expense as a nonbusiness expense across its various annual tax returns filed with the State of Arkansas or its income tax returns filed with other states. If the Taxpayer was allowed to wholly deduct the relevant interest expense in Arkansas without amending its remaining returns within other states, he stated the Taxpayer would receive a windfall. The majority of the states' laws would necessitate the removal of this expense if it was properly classified as nonbusiness. He conceded that states utilize various approaches to determine whether business income or expenses should be sourced to a state. If another state chooses to treat the Taxpayer's interest expense as a nonbusiness expense that should be sourced to Arkansas, he believes that state is in error and should not bar the Department from taking a contrary position if appropriate. He noted *Pledger v. Getty Oil Exploration Co.*, 309 Ark. 257, 831 S.W.2d 121 (1992) addressed the classification of interest income and not interest expense and asserted that it is distinguishable from the current facts.

### **3. Hearing Assertions of Department's Representative**

The Department's Representative argued that the business/nonbusiness test is not applicable to nonbusiness expenses. Under UDITPA, she asserted that neither a business expense nor a nonbusiness expense is defined. She averred that UDITPA simply requires expenses to follow income and does not authorize a separate classification of expenses. Since the Taxpayer did not have nonbusiness income during the relevant years, she reasoned it cannot have incurred expenses associated with nonbusiness income. She concluded stating the relevant expense is associated with the Taxpayer's apportionable business income because the Taxpayer would not exist but for its separation from the parent.

#### **4. Hearing Assertions of the CPA**

The CPA contended that the interest expense at issue should be allocated as a nonbusiness expense to the State of Arkansas. The CPA explained that, during an audit by another state, it was determined that the interest expense should be treated as a nonbusiness expense. Within the *Getty Oil* case, he noted the Arkansas Supreme Court looked to the originating event that created the income (i.e. the one-time, extraordinary issuance of a loan) and not the regularity of the payment when it concluded that the income was nonbusiness income. The CPA did not intend to call any witnesses since the facts were not in dispute and relied on his analysis within the initial filings. In exchange for the dividend payment, the parent company relinquished its ownership interest in the Taxpayer. He does not know why the parent decided to spin off the Taxpayer. He concluded by stating that other courts have utilized the business/nonbusiness distinction to classify expenses and argued that Arkansas should follow that approach.

### **Post-Hearing Filings**

Within the Taxpayer's initial post-hearing filing, the Taxpayer's Representatives asserted the distinction between business and nonbusiness income is limited to the transactional and functional test as explained by the Arkansas Supreme Court within *Getty* decision. They further reasserted that the transactional test cannot be met if a transaction results from an extraordinary, nonrecurring event, which they asserted was represented with regards to the current expense incurred as part of a reorganization. They restated that the loan proceeds were not utilized within the business nor was the acquisition, management, or disposition of the proceeds integral to the Taxpayer's business. The filing concluded by asserting that expenses (similar to income) must also be allocated pursuant to the business/nonbusiness distinction.

Within her Post-Hearing Response Brief, the Department's Representative reasserted that the tests for business/nonbusiness income was not applicable to expenses and that expenses simply followed their associated income during the calculation of the net business and nonbusiness income. Since the Taxpayer did not generate any nonbusiness income during the relevant tax periods, she reasoned that the interest expense generated from the Taxpayer's separation was appropriately included in the calculation of the net business income to which the apportionment factor was applied. If the business/nonbusiness test was applicable, she argued that the transactional test was met since the obtaining of the loan occurred in the regular course of the Taxpayer's business and its obtainment, though a rare activity, was neither extraordinary nor unusual and contributed to the Taxpayer's business activities. She further reasserted that,



even if the transactional test was not met, the functional test was otherwise met under the analysis contained within her Answers to Information Request.

Within the Taxpayer's final post-hearing reply brief, the Taxpayer's Representatives contended that business expenses must be categorized between business or nonbusiness. Since neither the transactional nor functional test was satisfied, the Taxpayer's Representative averred that the expense should be deemed to be nonbusiness and sourced to Arkansas.

After a discussion of the burdens of proof for tax proceedings, a legal analysis with associated factual and legal conclusions shall follow.

## **CONCLUSIONS OF LAW**

### **Standard of Proof**

Ark. Code Ann. § 26-18-313(c) (Supp. 2015) provides, in pertinent part, 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.

A preponderance of the evidence means the greater weight of the evidence.

*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:

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 tax 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.

### **Corporate Income Tax**

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). The State of Arkansas has adopted the UDITPA. Ark. Code Ann. § 26-51-701 *et seq.* (Repl. 2012). Ark. Code Ann. § 26-51-702 (Repl. 2012) (emphasis supplied) provides: “Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a public utility or the rendering of purely personal services by an individual, shall **allocate and apportion his net income** as provided in this Act.”

Nonbusiness income items are similarly taxed based on their net amounts.

Ark. Code Ann. § 26-51-705 (Repl. 2012). In *Getty Oil*, 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 (emphasis supplied).

"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).

Under the above citations, the apportionment fraction is applied to a taxpayer's net business income. Additionally, nonbusiness income types are also taxed based on the net amounts. The Department has interpreted the governing provisions to utilize the distinction between business and non-business items for the determination of business income and not expenses. After the classification of the income, expenses are then matched with their associated income types.

The Department's interpretation of a statute or rule is entitled to deference unless the interpretation is clearly erroneous. The Arkansas Supreme Court has

recognized that administrative agencies are often required to interpret statutes and rules. In *Walnut Grove School Distr. No. 6 of Boone County v. County Board of Education*, 204 Ark. 354, 162 S.W.2d 64 (1942), the court's opinion 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.

Here, business and non-business is defined only with respect to income.<sup>4</sup> While expenses are included in the calculation of net income for an income type, it is not evident that UDITPA contemplates the additional independent categorization of expenses under the test for discerning business and nonbusiness income. Under the governing statutes, it is evident that the parsing of expenses occurs only after business and nonbusiness income is determined to ensure the associated expenses remain with their respective income type and not as a wholly independent pursuit. Further, Ark. Code Ann. § 26-51-431(c)(3) (Repl. 2012) appears to support the Department's approach by denying otherwise allowable deductions that are allocable to nonbusiness income<sup>5</sup> rather than requiring a separate inquiry of whether an expense served a business or nonbusiness purpose. The Department's interpretation is reasonable and not clearly wrong. Further, the Taxpayer bears the burden of proving entitlement to a refund claim.

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<sup>4</sup> While the Taxpayer also noted that nonbusiness interest is allocated to a taxpayer's commercial domicile, that code section is likewise limited to income.

<sup>5</sup> This subsection appears to refer to nonbusiness income that is not apportioned to Arkansas. In that instance, the expenses for the nonbusiness income would improperly offset apportionable business income if still allowed even though those expenses were associated with income not taxed within the State.

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.<sup>6</sup> Those citations are not persuasive based on the above analysis. While the *Getty Oil* case has also been cited by the Taxpayer's Representatives, that case addressed the classification of interest income and does not address the appropriateness of the application of the business/nonbusiness test to classify expenses as an independent review.

In this matter, the parties agree that the incurred expense was a necessary and ordinary business expense that appropriately reduced the Taxpayer's total net income. That expense however has not been linked to the generation of nonbusiness income that is directly sourced to the State. In fact, it does not appear that the Taxpayer earned nonbusiness income or losses during the relevant tax years after review of the original tax returns. The Taxpayer's assertion that the incurred expense should be reclassified as a nonbusiness expense and wholly deducted on its Arkansas income tax return even though the expense is not associated with the pursuit of nonbusiness income is not

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<sup>6</sup> See *In re Kroger Co.*, 270 Kan. 148, 1152 P.3d 889, 893 (2000) (stating "Both parties agree that only the transactional test applies to determine whether Kroger's expense during the audit period is a business or nonbusiness expense.") See also *Leslie's Holdings, Inc. & Subs.*, Case No. 955278, at 4 (Cal. St. Bd. Eq.) (stating, "Appellant contends that business income includes income or expenses 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."). See also *Leslies*, at 10 (stating, "Respondent asserts that, pursuant to R&TC section 25120, nonbusiness income is defined in relation to business income, and that the distinction between income and expense is irrelevant with respect to characterization of the item as business or nonbusiness.")

persuasive. Consequently, the Taxpayer has not proven entitlement to its refund and the Department correctly denied the Taxpayer's refund claims.<sup>7</sup>

### **DECISION AND ORDER**

The refund denials are 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 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](mailto: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.<sup>8</sup>

DATED: April 1, 2019

OFFICE OF HEARINGS & APPEALS

  
TODD EVANS  
ADMINISTRATIVE LAW JUDGE

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<sup>7</sup> The Department's remaining arguments for sustaining its refund claim denials shall not be addressed as they are rendered moot by this conclusion.

<sup>8</sup> See *Board of Trustees of Univ. of Arkansas v. Andrews*, 2018 Ark. 12.