

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

ADMINISTRATIVE DECISION

IN THE MATTER OF

(ACCT. NO.: ██████████)

DOCKET NOS.: 19-311

19-312

**INDIVIDUAL INCOME
TAX ASSESSMENTS**

**TAX YEAR: 2013
(\$ ██████████)¹**

**TAX YEAR: 2014
(\$ ██████████)²**

RAY HOWARD, ADMINISTRATIVE LAW JUDGE

APPEARANCES

This case is before the Office of Hearings and Appeals upon written protests dated November 30, 2016,³ submitted by ██████████, the Taxpayer. The Taxpayer protested assessments of Individual Income Tax resulting from an audit conducted by Wade Gambill, Tax Auditor – Individual Income Tax Section, for the Department of Finance and Administration (“Department”). The Letter ID Numbers are ██████████ and ██████████.

A telephone hearing was held in Little Rock, Arkansas, on February 14, 2019, at 1:30 p.m.⁴ The Department was represented by Nina Carter, Attorney at

¹ The reflected amount includes tax (\$ ██████████) and interest (\$ ██████████) with credit for payments of \$ ██████████.

² The reflected amount includes tax (\$ ██████████) and interest (\$ ██████████) with credit for payments of \$ ██████████.

³ Stamped “Received” by Revenue Legal Counsel on January 19, 2017.

⁴ The telephone hearing was originally scheduled for January 4, 2019, at 10:00 a.m., but the hearing was continued in order for the Taxpayer to submit relevant documentation prior to the hearing.

Law, Office of Revenue Legal Counsel (“Department’s Representative”). Present for Department was the Tax Auditor. The Taxpayer appeared at the hearing, via telephone, and represented himself.

The record remained open for sixty (60) days for the Taxpayer to submit additional documentation. The matter was submitted for a decision on April 22, 2019.

ISSUE

Whether the assessments made by the Department against the Taxpayer for Tax Years 2013 and 2014 (“audit period”) should be sustained? Yes.

FINDINGS OF FACT/CONTENTIONS OF THE PARTIES

The Department’s Representative filed an Answers to Information Request on February 8, 2019, which provided, in pertinent part, as follows:

During the relevant time periods at issue in this protest, [REDACTED] (“Taxpayer”) was an employee of [REDACTED] and provided services to the youth in his community in his spare time. Taxpayer filed timely individual income tax returns with the Department for the calendar years 2013 and 2014.

On July 27, 2016, Tax Auditor Wade Gambill from the Individual Income Tax Section sent letters to Taxpayer requesting documentation to support or substantiate the Schedule C deductions claimed for the tax periods 2013 and 2014. See letters attached as **Exhibit 1 and 2**. Taxpayer did not respond to the inquiry.

A. Tax Year 2013

For tax year 2013, Taxpayer reported \$ [REDACTED] in wages from [REDACTED], of which \$ [REDACTED] were withheld for Arkansas state income tax. See 2013 W-2 attached as **Exhibit 3**. Taxpayer claimed \$ [REDACTED] in business expenses. See Taxpayer’s 2013 Arkansas Income Tax Return, including Schedule C, attached as **Exhibit 4**.

As Taxpayer did not provide any documentation to substantiate the deductions, the auditor disallowed the claimed expenses. Taxpayer initially received a refund in the amount of \$ [REDACTED], resulting in the assessment of individual income tax in the amount of \$ [REDACTED]. An Explanation of Tax Adjustment was sent to the Taxpayer on October 25, 2016, and a Notice of Proposed Assessment was sent on November 1, 2016. See **Exhibits 5 and 6**.

B. Tax Year 2014

For tax year 2014, Taxpayer reported \$ [REDACTED] in wages from [REDACTED], of which \$ [REDACTED] were withheld for Arkansas state income tax. See 2014 W-2 attached as **Exhibit 7**. Taxpayer claimed \$ [REDACTED] in business expenses and \$1,031 in business income on the Schedule C. See Taxpayer's 2014 Arkansas Income Tax Return, including Schedule C, attached as **Exhibit 8**.

As Taxpayer did not provide any documentation to substantiate the deductions, the auditor disallowed the claimed business income and expenses which resulted in the assessment of individual income tax in the amount of \$ [REDACTED]. An Explanation of Tax Adjustment was sent to the Taxpayer on October 25, 2016, and a Notice of Proposed Assessment was sent on November 1, 2016. See **Exhibits 9 and 10**.

The Taxpayer timely protested the assessment to the auditor and asked to provide supporting documents for the expenses claimed for Schedule C. See **Exhibit 11**. Along with the Protest, Taxpayer included spreadsheets that detailed the expenses claimed on the Schedule C for both 2013 and 2014. However, the spreadsheet alone is not adequate to substantiate the expenses. Taxpayer did not provide a basis for his protest, nor did he include any documentation substantiating the deductions taken.

Upon further communication with counsel, Taxpayer submitted additional documents as support for Schedule C. See **Exhibit 12**. Three of the documents submitted by Taxpayer consisted of bank statements to show payments to PayPal but Taxpayer could not produce receipts to detail the actual purchases. The Auditor conducted a review of the submitted documentation and determined that the documents were insufficient to substantiate the amounts claimed. See Auditor's Report, attached as **Exhibit 13**.

...

In the Protests filed against the proposed assessments, Taxpayer asked for an opportunity to provide supporting documents for the expenses claimed on the Schedule C for 2013 and 2014. Taxpayer

included spreadsheets with expenses for the years 2013 and 2014 with the Protest submission. Taxpayer submitted four additional documents: 1) bill of sale for a [REDACTED] sold on 3/1/15; 2) page from May 2013 bank statement; 3) page from February 2013 bank statement; 4) page from June 2014 bank statement. The bank statements have asterisks by charges listed for PayPal, but Taxpayer has not produced a single itemized or detailed invoice or receipt identifying what was actually purchased on these occasions or for what purpose. Similarly, Taxpayer did not provide any appropriate supporting documentation[Footnote 1 stated, “It is not clear whether any documentation submitted by Taxpayer would survive an inquiry of whether the activity is engaged in for profit under IRC § 183.”] with the spreadsheets that list the expenses for 2013 and 2014. In the email sent by Taxpayer on 8/22/2017, he stated that he did not have receipts.

The Taxpayer failed to provide the necessary records to establish entitlement to the deductions claimed. The absence of records requires that the claimed deductions be disallowed. In the absence of any proof, the Department was correct in disallowing the claimed deductions.

The Department made an assessment of individual income tax due based upon the best information and documentation available. The burden of refuting the assessment is on the Taxpayer. As reflected by the facts above, the Taxpayer could not produce sufficient or adequate documentation to support or substantiate entitlement to certain income tax expense deductions taken on his individual income tax return for tax year 2013 and 2014. [Footnote 2 omitted, P. 2-5].

The Tax Auditor authenticated the Department’s exhibits and presented testimony consistent with the contentions in the Department’s Answers to Information Request. The Tax Auditor also testified that: (1) he reviewed the Taxpayer’s income tax returns; (2) he requested proof of the Taxpayer’s reported business expenses; (3) the Taxpayer did not provide records to support the expenses so he disallowed all of the expenses on the Taxpayer’s Schedule C’s; (4) the Taxpayer was employed by [REDACTED] during the audit period; (5) for Tax Year 2013, the Taxpayer claimed a business loss of \$ [REDACTED] related to

expenses for “Youth Activities” (the Schedule C did not reflect a business name) and reported no gross sales or gross income;⁵ (6) since the expenses were not substantiated, he disallowed the expenses and adjusted the Taxpayer’s return⁶ for Tax Year 2013; (7) for Tax Year 2014, the Taxpayer claimed a business loss of \$ [REDACTED] related to expenses for “Youth Activities” (the Schedule C did not reflect a business name) and reported gross sales or gross income of \$ [REDACTED];⁷ (8) since the expenses were not substantiated, he disallowed the expenses and adjusted the Taxpayer’s return⁸ for Tax Year 2014; (9) the spreadsheets submitted by the Taxpayer with his protest were inadequate to substantiate business-related expenses because they are not reliable to prove what was purchased (or if something was purchased) so receipts are required; (10) the bank statements submitted by the Taxpayer may establish proof of payment but there is no indication of what was purchased (personal or business) so receipts are required; (11) he has not determined if the amounts on the bank statements and the spreadsheets balance because there is no indication of a business purpose; (12) he cannot determine if something is an allowable business deduction without a receipt; (13) the expenditure of \$ [REDACTED] to PAYPAL, which is designated with an asterisk on the bank statement for 2013 (Department Exhibit 12 – P. 2), is insufficient to prove a business expense (he would need to see a receipt to determine what was purchased); (14) it was hard to determine what the Taxpayer’s business was, if he was reselling items, or if the items were personal; (15) the Taxpayer indicated that his business was to service the youth within the

⁵ See Department Exhibit 4.

⁶ A standard deduction was applied.

⁷ See Department Exhibit 8.

⁸ A standard deduction was applied.

community (See Department Exhibit 12 – P. 1); and (16) in his opinion, the Taxpayer was not engaged in a business to make a profit.

The Taxpayer testified that: (1) he presented documents to the Department's Representatives (such as data sheets) but not receipts from vendors; (2) he stopped collecting information because he did not have receipts from vendors; (3) he has handwritten receipts but there was no point sending more information if everything was going to be denied; (4) he was told that receipts had to be on a letterhead; (5) he did not get vendor information from PAYPAL since everything he submitted was being denied so he just stopped sending information; (6) he did not receive the letter regarding Tax Year 2013 until more than 2 years after the return was filed so he needed time to get records together; (7) when it comes to Youth Activities, he bought items from groups and organizations not just stores and he received discounts; (8) \$ [REDACTED] in a year dealing with a youth organization is not a lot of money; (9) he was helping the kids in the community and the church; and (10) the gross sales or gross income of \$ [REDACTED] in 2014 was from fundraisers (money was given) and he did not record where the money came from but put the money back into the business.

The Department's Representative contended that: (1) the expenditure of \$ [REDACTED] which is designated with an asterisk on the bank statement for 2013 (Department Exhibit 12 – P. 2) does not correspond with an expense listed on the spreadsheet for 2013 (Department Exhibit 11 – P. 4); (2) the Taxpayer has the burden of proving entitlement to a deduction; (3) she told the Taxpayer that he needed to submit receipts and detailed proof of expenses; and (4) she did not say anything to the Taxpayer about letterheads or vendors.

CONCLUSIONS OF LAW

Standard of Proof

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

Individual Income Tax Assessments

The State of Arkansas imposes an income tax upon “the entire income of every resident, individual, trust, or estate. The tax shall be levied, collected, and paid annually upon the entire net income as defined and computed in this chapter at the following rates” See Ark. Code Ann. § 26-51-201(a) (Supp. 2017). “Net income” is derived from adjusting gross income by any allowed deductions. See Ark. Code Ann. § 26-51-403 (Repl. 2012).

Tax deductions and credits, like tax exemptions, exist as a matter of legislative grace. See Cook, Commissioner of Revenue v. Walters Dry Good Company, 212 Ark. 485, 206 S.W.2d 742 (1947); and Kansas City Southern Ry. Co. v. Pledger, 301 Ark. 564, 785 S.W.2d 462 (1990). A taxpayer claiming a deduction or credit bears the burden of proving that it is entitled to the deduction or credit by bringing herself or himself clearly within the terms and conditions imposed by the statute that contains the deduction or credit. See Weiss v. American Honda Finance Corp., 360 Ark. 208, 200 S.W.3d 381 (2004).

Ark. Code Ann. § 26-51-424 (Supp. 2017) allows a deduction from income for losses incurred in a trade or business. For the purpose of computing net income, the State of Arkansas has adopted Internal Revenue Code § 162 as in effect on March 30, 2010, regarding the deduction of trade and business expenses. See Ark. Code Ann. § 26-51-423(a)(1) (Supp. 2017).

IRC §§ 162 and 274 (adopted by Ark. Code Ann. § 26-51-423(a)(1) and (b) (Supp. 2017)) allow deductions for ordinary and necessary expenses (and travel

expenses) incurred in carrying on a trade or business. An expense is “ordinary” if it is “normal, usual, or customary” in a taxpayer’s trade or business. See Deputy v. du Pont, 308 U.S. 488, 495 (1940). An expense is “necessary” if it is “appropriate and helpful” in a taxpayer’s business, but it need not be absolutely essential. Commissioner v. Tellier, 383 U.S. 687, 689 (1966) (citing Welch v. Helvering, 290 U.S. 111, 113 (1933)). No deduction is allowed for personal, living, or family expenses. See IRC § 262(a). Whether an expense is deductible under IRC § 162 is a question of fact to be decided on the basis of all the relevant facts and circumstances. See Cloud v. Commissioner, 97 T.C. 613, 618 (1991). Whenever an expense has substantial business and personal components, allocation of that expense between the business and personal uses is necessary. William L. Heuer, Jr. v. Commissioner, 283 F.2d 865 (C.A. 5, 1960), affirming per curiam 32 T.C. 947 (1959); Clarence J. Sapp, 36 T.C. 852 (1961), affirmed per curiam 309 F.2d 143 (C.A. 5, 1962); Hal E. Roach Studios, 20 B.T.A. 917 (1930).

Ark. Code Ann. § 26-18-506(a) (Repl. 2012) requires the Taxpayer to maintain suitable records and states:

(a) It is the duty of every taxpayer required to make a return of any tax due under any state tax law to keep and preserve suitable records as are necessary to determine the amount of tax due or to prove the accuracy of any return.

In Leathers v. A & B Dirt Movers, Inc., 311 Ark. 320, 844 S.W.2d 314 (1992), the Arkansas Supreme Court discussed the absence of appropriate documentation in the context of an assessment, and stated:

In short, we find Mr. Nabholz’s testimony insufficient, standing alone, to meet the taxpayer’s statutory burden in refuting the reasonableness of the assessment. To hold otherwise would be to permit a taxpayer to maintain scant records and after an

unsatisfactory tax audit, avoid taxation by merely verbalizing his transactions unsupported by appropriate documentation made at the time of the transactions or by testimony from other parties to the transactions.

Id. at 330, 844 S.W.2d at 319.

During the period of time the record remained open after the hearing, the Taxpayer did not submit any additional documentation. The Taxpayer has provided evidence of various transactions with PAYPAL. See Department Exhibits 11 and 12. The Taxpayer asserted that those transactions had a business purpose even though that purpose is not readily apparent from the bank statements or spreadsheets and was not adequately explained by the Taxpayer during the administrative hearing. The burden of proving entitlement to a deduction is upon the Taxpayer and the Taxpayer failed to present sufficient evidence to establish a business purpose for the expenses denied by the Department.⁹ Consequently, the Department correctly assessed Arkansas Individual Income Tax against the Taxpayer for Tax Years 2013 and 2014.

Interest

Subject to the limitation in Ark. Code Ann. § 26-18-405(d)(1)(C) (Supp. 2017), interest was properly assessed upon the tax deficiencies for the use of the State's tax dollars. See Ark. Code Ann. § 26-18-508 (Repl. 2012).

DECISION AND ORDER

Subject to the limitation in Ark. Code Ann. § 26-18-405(d)(1)(C) (Supp. 2017), the proposed assessments are sustained. The file is to be returned to the

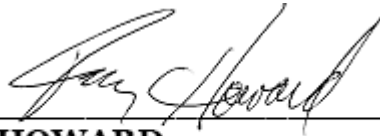
⁹ In light of this conclusion, it is not necessary to address the issues of profit motive or hobby losses.

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.¹⁰

OFFICE OF HEARINGS & APPEALS



RAY HOWARD
ADMINISTRATIVE LAW JUDGE

DATED: April 25, 2019

¹⁰ See Board of Trustees of Univ. of Arkansas v. Andrews, 2018 Ark. 12.