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

ADMINISTRATIVE DECISION

IN THE MATTER OF [redacted]	**CORPORATE INCOME TAX ASSESSMENT**
ACCT. NO.: [redacted]	**LETTER ID:** [redacted]
	TAX YEAR: 2018
DOCKET NO.: 21-070	[redacted][1]

TODD EVANS, ADMINISTRATIVE LAW JUDGE

APPEARANCES

This case is before the Office of Hearings and Appeals upon a protest dated February 24, 2020, submitted by [redacted] ("CFO") on behalf of [redacted], the Taxpayer. The Taxpayer protested the assessment by the Department of Finance and Administration ("Department"). The Department was represented by John Theis, Attorney at Law, Revenue Legal Counsel ("Department's Representative"). The Taxpayer was represented at the administrative hearing by [redacted], Attorney at Law ("Taxpayer's Representative").

At the request of the parties, this matter was taken under consideration of written documents. A briefing schedule was established for the parties by a letter dated February 1, 2021. The Department's Representative filed his Opening Brief on March 3, 2021. The Taxpayer's Representative filed a Response Brief on April 6, 2021. The Department's Representative filed a Reply Brief on April 19, 2021.

[1] This amount represents [redacted] (Tax), [redacted] (Failure to Pay Penalty), and [redacted] (Interest).

The record was closed and this matter was submitted for a decision on April 26, 2021.

ISSUE

Whether the assessment should be sustained. Yes, in part.

FACTUAL AND LEGAL CONTENTIONS OF THE PARTIES

Stipulation of Facts

Initially, the parties stipulated to the following facts prior to the establishment of the briefing schedule:

1. [REDACTED] is a corporation having its headquarters in [REDACTED]
2. [REDACTED] was a corporation having its headquarters in the state of Arkansas.
3. [REDACTED] was merged into [REDACTED] effective [REDACTED] and [REDACTED] was the surviving organization resulting from the merger.
4. [REDACTED] operates various branch bank locations in the state of Arkansas that were operated by [REDACTED] prior to the merger.
5. [REDACTED] filed a short year final tax return with the Arkansas Department of Finance and Administration ("Department") on [REDACTED].
6. A copy of the short year final tax return filed by [REDACTED] for the period ending October 31, 2018 is attached as **Exhibit #1**.
7. [REDACTED] filed an Arkansas corporate income tax return for the fiscal year ending December 31, 2018 on October 14, 2019.
8. That return for fiscal year ending December 31, 2018 indicated that [REDACTED] was entitled to an Arkansas Net Operating Loss ("NOL") of [REDACTED].
9. A copy of the Arkansas corporate income tax return filed by [REDACTED] for the fiscal year ending December 31, 2018 is attached as **Exhibit #2**.
10. The total [REDACTED] income from its business activities per the federal income tax return filed by [REDACTED] for the fiscal year ending December 31, 2018 was [REDACTED].
11. After making adjustments required by Arkansas law, the total apportionable income from the [REDACTED] business activities of [REDACTED] as reported on the Arkansas income tax return for FYE 12/31/18, was [REDACTED].
12. The Arkansas income tax return filed by [REDACTED] for the FYE 12/31/18 apportioned [REDACTED] of its total apportionable income from its [REDACTED] business activities to Arkansas. That income apportioned to Arkansas was [REDACTED] [REDACTED]).

13. Neither computation of a apportionment percentage, nor its computation of its income apportioned to Arkansas of are in dispute.
14. The Arkansas corporate income tax return filed by for the fiscal year ending December 31, 2018 claimed a corresponding apportioned NOL to Arkansas of
15. As a result of claiming an NOL apportioned to Arkansas equal to its reported income apportioned to Arkansas, the Arkansas corporate income tax return filed by for the fiscal year ending December 31, 2018 reported that had no income taxable to Arkansas for that fiscal year.
16. The Department issued an Explanation of Tax Adjustment dated November 22, 2019 informing that the NOL claimed on its Arkansas corporate income tax return for the fiscal year ending December 31, 2018 had been adjusted by the Department that owed additional Arkansas corporate income tax of as a result of that adjustment.
17. A copy of the Explanation of Tax Adjustment dated November 22, 2019 is attached as **Exhibit #3**.
18. The Department issued a Notice of Proposed Assessment dated December 2, 2019 assessing tax of , interest of , and penalty of against for the fiscal year ending December 31, 2018.
19. A copy of the Notice of Proposed Assessment dated December 2, 2019 is attached as **Exhibit #4**.
20. After the Notice of Proposed Assessment was issued, provided additional information for consideration by the Department related to the NOL calculation.
21. The Department reviewed the additional information supplied by and allowed an NOL deduction of on the corporate income tax return filed for the fiscal year ending December 31, 2018 but the Department did not allow the NOL deduction amount claimed on that tax return as originally filed by
22. The Department issued a new Explanation of Tax Adjustment dated February 24, 2020 indicating that the amount of additional tax due from for the period ending December 31, 2018 had been reduced from to . This notice of Proposed Assessment allowed no NOL deduction.
23. A copy of the second Explanation of Tax Adjustment issued to is attached as **Exhibit #5**. It is this assessment that is before the Office of Hearings and Appeals for consideration.
24. timely protested the tax assessment issued by the Department first by letter dated December 9, 2019 after receiving the Notice of Proposed Assessment and again on by email dated February 24, 2020 after receiving a copy of the Explanation of Tax Adjustment dated that same date.

25. Copies of the protests filed by [redacted] are attached as **Exhibit #6** and **Exhibit #7**.
26. Arkansas Code Annotated § 26-51-427(3) (Repl. 2012) is the provision of state law applicable to the availability of a NOL by the acquiring corporation and is the controlling law with regard to the ability of [redacted] to claim a NOL deduction arising from the operations of [redacted]
27. A copy of Ark. Code Ann. § 26-51-427(3) (Repl. 2012), as was in effect during the tax year in question, is attached as **Exhibit #8**.
28. Arkansas Code Annotated § 26-51-427(3) was amended by Act 822 of the 2019 Arkansas General Assembly but those amendments are not relevant to a determination of this matter.
29. Arkansas Code Annotated § 26-51-427(3) (Repl. 2012) provides that when the assets of one corporation are acquired by another corporation, the acquiring corporation shall succeed to the NOL apportionable to Arkansas under the Uniform Division of Income for Tax Purposes Act that the acquired corporation could have claimed had it not been acquired, subject to certain statutory conditions.
30. The first condition outlined in Ark. Code Ann. § 26-51-427(3) that must be satisfied for the acquiring corporation to succeed to the NOL of the acquired corporation is that the NOL may not be carried forward to a taxable year which ends more than five (5) years after the taxable year.
31. [redacted] satisfies this first condition because the NOL [redacted] seeks to deduct occurred within the five (5) year time period required by Ark. Code Ann. § 26-51-427(3).
32. The second condition that must be satisfied for the acquiring corporation to succeed to the NOL of the acquired corporation is that the ownership of both the acquired and acquiring corporation is substantially the same.
33. [redacted] and [redacted] satisfies this second condition.
34. The third condition outlined in Ark. Code Ann. § 26-51-427(3) is that the acquiring corporation will be allowed to deduct the NOL of the acquired corporation only where the assets of the acquired corporation earn sufficient profits apportionable to Arkansas under Ark. Code Ann. §26-51-701 et seq. in the post-merger period to absorb the carryover losses claimed by the acquiring corporation.
35. [redacted] and the Department disagree regarding the application of this third condition to the claim by [redacted] for deduction of the NOL resulting from the business operation of [redacted] prior to its merger into [redacted]
36. The Department promulgated Corporate Income Tax Rule 1.26-51-427(3)(C).
37. A copy of Rule 1.26-51-427(3)(C) is attached as **Exhibit #9**.
38. Rule 1.26-51-427(3)(C) provides a formula for the sole purpose of determining whether the assets of the acquired corporation are producing income and, if so, the amount of income so produced is allocable to the entity that has gone out of existence.
39. The formula provided in Rule 1.26-51-427(3)(C) requires that the original cost of merged assets be divided by the original cost of all assets.

40. Rule 1.26-51-427(3)(C) provides that the quotient obtained by dividing the original cost of the merged assets by the original cost of all assets is to be multiplied by "Total Income".
41. The term "total income" is not defined by Rule 1.26-51-427(3)(C).
42. The quotient obtained by dividing the original cost of the assets of that were merged into by the original cost of all assets of equals .
43. computation of this asset percentage of is not in dispute.
44. multiplied that asset percentage of by the income derived from the multistate business activities of in the amount of to determine the Arkansas income produced during the tax year by the assets of that were merged into
45. The computation described in paragraph 44 of these Joint Stipulations resulted in determining that the assets of that were merged into produced income during the tax year of .
46. The multistate business activity income of that was apportioned to Arkansas on the corporate income tax return filed for fiscal year ending December 31, 2018 was .
47. claimed an NOL of on its Arkansas corporate income tax return for the fiscal year ending December 31, 2018.
48. A document showing NOL computation is attached as **Exhibit #10**.
49. The Department disagrees with the computation method employed by to determine the amount of NOL generated by the business activities of that were available to
50. The Department determined that the profits earned during the tax year by the assets of that were merged into by multiplying times income apportioned to Arkansas under the Uniform Division of Income for Tax Purposes Act of .
51. disagrees with the computation method employed by the Department to limit the use of the NOL.
52. Using the Department's method, the product of multiplying the income of Arkansas income of by is .
53. A document showing the Department's NOL computation is attached as **Exhibit #11**.

Opening Brief

Within his Opening Brief, the Department's Representative provided certain factual allegations and some analysis, stating as follows in relevant part[2]:

> (“Taxpayer”) is a having its headquarters in . Taxpayer did not conduct business in Arkansas prior to 2018 and did not file Arkansas corporate income tax returns prior to that time.
>
> Prior to November 1, 2018, operated as and filed Arkansas corporate income tax returns based on its Arkansas business activities. Those returns reflected that operated only in Arkansas and had no business activities outside this state. Effective November 1, 2018, Taxpayer acquired and the assets of were merged into the assets of Taxpayer. Taxpayer was the surviving corporate entity resulting from that merger.
>
> Following its merger into Taxpayer, filed a short-year final Arkansas corporate income tax return with the Arkansas Department of Finance and Administration (“DFA”) for the period of January 1, 2018 through October 31, 2018. At the conclusion of calendar year 2018, Taxpayer filed an Arkansas corporate income tax return covering the period of January 1, 2018 through December 31, 2018. The tax return filed by Taxpayer revealed that it operates as a multistate corporation having business activities both in Arkansas and outside this state. The returns filed by both and Taxpayer are attached to the Joint Stipulations filed in this matter as Exhibits # 1 and #2, respectively.
>
> Taxpayer's 2018 Arkansas corporate income tax return reported total apportionable income of resulting from its multistate business activities. This total apportionable income resulted from multistate business operations in the various states where Taxpayer operates. In addition, Taxpayer determined that of its total apportionable income from its multistate operations was apportionable to Arkansas. Accordingly, Taxpayer reported taxable income apportionable to Arkansas of
>
> Taxpayer's 2018 Arkansas corporate income tax return also reported that it had a net operating loss carryover (“NOL”) available for use as a deduction in the amount of . This NOL resulted from the Arkansas business activities of prior to its merger with the Taxpayer. Taxpayer then claimed a NOL deduction of , disregarding the fact that Arkansas law limits Taxpayer's available NOL deduction to the income earned by the assets of in the post-merger period that is

[2] All exhibits supports the statements for which they are cited.

apportionable to Arkansas. As DFA will demonstrate, the NOL deduction to which Taxpayer was entitled was $204,741.

Following its review of Taxpayer's 2018 corporate income tax return, DFA issued an Explanation of Tax Adjustment dated November 22, 2019 and a Notice of Proposed Assessment dated December 2, 2019. Copies of these documents are attached to the Joint Stipulations as Exhibits #3 and #4, respectively. The Explanation of Tax Adjustment and the Notice of Proposed Assessment indicated that DFA had disallowed the entire NOL claimed by Taxpayer. The Taxpayer subsequently provided additional information to DFA and a new Explanation of Tax Adjustment dated February 24, 2020 was issued reflecting that only that portion of the NOL claimed by Taxpayer in excess of [redacted] was disallowed. A copy of this second Explanation of Tax Adjustment is attached to the Joint Stipulations as Exhibit #5. Taxpayer timely protested the Notice of Proposed Assessment and the second Explanation of Tax Adjustment. Copies of Taxpayer's protests are attached to the Joint Stipulations as Exhibits #6 and #7.

. . .

Arkansas Code Annotated § 26-51-427 (Repl. 2012) provides a net operating loss carryover deduction. The language of Ark. Code Ann. § 26-51-427, as in effect during tax year 2018, is attached as Exhibit No. 8 to the Joint Stipulations filed by the parties. Act 822 of 2019 subsequently amended Ark. Code Ann. § 26-51-427 and redesignated some subdivisions of that section but those changes have no bearing on this case.

Ark. Code Ann. § 26-51-427(3) (Repl. 2012) provides that, in the case of the acquisition of the assets of one corporation by another, the acquiring corporation succeeds to, and may take into account, any net operating loss carryover apportionable to Arkansas under the apportionment provisions of Ark. Code Ann. § 26-51-701 et seq. that the acquired corporation could have used had it not been acquired. Certain conditions are placed on the ability of the acquiring corporation to use the NOL of the acquired corporation; however, the only condition at issue in this case if found in Ark. Code Ann. § 26-51-427(3)(C). That conditions provides:

> The carryover losses will be allowed only in those cases where the assets of the corporation going out of existence earn sufficient profits apportionable to Arkansas under§ 26-51-701 et seq. in the post-merger period to absorb the carryover losses claimed by the surviving corporation.

. . .

Disagreement between the parties arises with regard to the Taxpayer's computation of the NOL deduction claimed by Taxpayer on Schedule A, Section C, Line 3. That computation is shown on the third page of Exhibit No. 10 to the Joint Stipulations. Taxpayer first determined that the original cost of the merged assets owned by prior to the merger was . Taxpayer than determined that the original cost of all assets belonging to Taxpayer was and that the assets owned by prior to the merger represented of the total post-merger assets of Taxpayer. Taxpayer then multiplied the total income from its multistate operations of times to determine that the total income from its multistate operations generated by the assets owned by prior to the merger was . Because exceeded its Arkansas apportionable income of , Taxpayer incorrectly assumed it could offset its entire Arkansas apportionable income with the NOL arising from its acquisition of

The Arkansas Supreme Court considered the proper manner to determine the post-merger income earned by the assets owned by an acquired corporation prior to a merger in the case of *Jones v. Carter Construction Company, Inc.*, 266 Ark. 358, 583 S.W.2d 63 (1979). That case involved a situation where both the acquired corporation and the acquiring corporation were engaged in the construction business. The acquired corporation had incurred a net operating loss which, in the absence of the merger, it would have been able to deduct in future years. In *Carter*, as here, DFA and the Taxpayer disagreed concerning whether the assets of the acquired corporation earned sufficient income in the post-merger period to absorb the net operating losses claimed by the surviving corporation.

The accountant for *Carter* computed the income earned by the assets of the acquired corporation during the post-merger period by dividing the original cost of the assets belonging to the merged corporation by the original cost of all the equipment owned by the surviving corporation after the merger. This is the same methodology employed by Taxpayer in this case. The Supreme Court agreed that this was a reasonable method to determine the post-merger income earned by the assets of the merged corporation. Sometime after the *Carter* decision, DFA promulgated Income Tax Rule 1.26-51-427(3)(C) memorializing this method as the proper method for use in determining the income earned in the post-merger period by the assets of the merged corporation. A copy of the DFA Rule is attached to the Joint Stipulations as Exhibit #9.

One difference between the *Carter* case and the case at hand is that this case involves a multistate taxpayer. There is no indication that the taxpayer in *Carter* earned income from business operations outside Arkansas. Arkansas law requires taxpayers having income from business activity that is taxable both within and without this state to allocate and

> apportion its net income as provided in Ark. Code Ann. § 26-51-701 et seq. See Ark. Code Ann. § 26-51-702 (Repl. 2020). [redacted], such as Taxpayer, are required to apportion a share of their multistate income to Arkansas using the three-factor formula outlined in Ark. Code Ann.§ 26-51-1401, as in effect prior to January 1, 2021 (Repl. 2020). It is here that Taxpayer commits error in its computation of the NOL deduction to which it is entitled. Taxpayer wrongly computes the available NOL deduction based on the full, unapportioned, multistate income earned by the assets belonging to [redacted] prior to the merger rather than the multistate income earned by those assets that is apportioned to Arkansas as required by Ark. Code Ann. § 26-51-427(3)(C) (Repl. 2012).
>
> Taxpayer wrongly concluded that the assets of [redacted] earned income apportionable to Arkansas of [redacted] Instead, that is the amount of multistate income earned by the assets of [redacted] in all states where Taxpayer operates. As explained above, Taxpayer's total multistate income for 2018 was [redacted] Taxpayer's computations reveal that [redacted] of its multistate income was earned by the pre-merger assets of [redacted] Taxpayer's 2018 Arkansas corporate income tax return determined that [redacted] of its multistate income was apportionable to Arkansas. Accordingly, only [redacted] of the multistate income earned by the pre-merger assets of [redacted] or [redacted], is apportionable to Arkansas under Ark. Code Ann.§ 26-51-701 et seq. [redacted]).
>
> As previously explained, Ark. Code Ann. § 26-51-427(3)(C) provides that Taxpayer may not claim a NOL deduction exceeding the profits earned by the assets of [redacted] that are apportionable to Arkansas under § 26-51-701 et seq. in the post-merger period. Taxpayer's computation of the NOL deduction computes the deduction against the profits earned by the assets of [redacted] that are apportionable to all states where Taxpayer operates and not to just that portion of those profits that are apportionable to Arkansas. The computation employed by DFA to limit the NOL available to Taxpayer as required by state law is shown in Exhibit No. 11 of the Joint Stipulations. DFA's computation limits the NOL to the profits earned by the assets of [redacted] that are apportionable to Arkansas under§ 26-51-701 et seq. as required by the NOL deduction limitation contained in Ark. Code Ann. § 26-51-427(3)(C) (Repl. 2012).

The Department's Representative reiterated that the NOL merger deduction may not exceed the Arkansas apportionable profits allocated to the merged assets at the time of the merger (not the total multistate profits allocated to the merged assets), citing Ark. Code Ann. § 26-51-427(3)(C) (Repl. 2020).

Response Brief

Within his Response Brief, the Taxpayer's Representative provided his analysis and arguments, stating the following:

> **Burden of Proof and Statutory Construction**
>
> Taxpayer asserts that the burden of proof is on DFA since it has been stipulated that the Taxpayer is entitled to the use of a NOL Carryover, but the issue is how much NOL Carryover Taxpayer is entitled to utilize. If DFA's arguments depart from the plain and unambiguous meanings of Ark. Code Ann. § 26-51-427(3), then Ark. Code Ann. § 26-18-313(d) should apply. In the event that the Court determines that the burden is on the Taxpayer to prove its entitlement by a preponderance, the Taxpayer asserts that the clear, unambiguous language of Ark. Code Ann.§ 26-51-427(3)(c) applies, and there is no need to resort to Ark. Code Ann. § 26-18-313(f). See Rent-A-Center, supra.
>
> **NOL Carryover**
>
> Taxpayer meticulously followed all instructions promulgated by DFA in filing its return which correctly allows it to utilize its NOL Carryover against its apportioned income of [redacted] in the year 2018. It first consulted page 38 of DFA's Comprehensive Corporation Income Tax Regulations 1.26-51-427(3)(C) (the "Regulation") relating to "NOL Carryover Due to Merger" which provides:
>
>> It is stipulated that the asset percentage is [redacted] of Taxpayer's total income of [redacted].
>>
>> The Regulation's first test is establish through the formula that the merged corporation [redacted] is still producing income in Arkansas. The results of the formula are [redacted] times total income of Taxpayer of [redacted] which equals [redacted], the Asset Income Apportionment. The second test under the Regulation is to limit the use of the NOL Carryover to the profits apportionable to Arkansas under § 26-51-701 et seq. in the post-merger period to absorb the carryover losses claimed by the Taxpayer. This amount as shown on line C.1. of Schedule A to Taxpayer's amended AR 1100CT and as stipulated in item 46 of the Stipulated Facts is [redacted]. The plain meaning of the statute and the Regulation is that the only limitation on the use of the NOL Carryover is the amount determined under § 26-51-701, provided it is less than the amount derived under the asset percentage times total income formula. Any other interpretation has no basis. It is not supported by statute, regulation, or case law. The Arkansas assets produce revenue and

expenses, and the method chosen limits the use of NOL Carryovers by the amount determined pursuant to § 26-51-701, which is ██████, which is what the Taxpayer reported. Per the Regulation and the statute, this is the end of the inquiry, there are no other calculations or limitations to be made. DFA's assertion that there should be a further limitation under the Regulation or the law.

DFA's position on this issue has been a moving target. In the Initial Explanation and First Assessment, it indicated that Taxpayer was not entitled to use any NOL Carryover. Then in the Second Explanation, DFA bases the limitation on the use of the NOL Carryover to ██████ through a second limitation by multiplying ██████ the amount apportioned to Arkansas by Ark. Code Ann. § 26-51-701 times ██████ also. See page 6 of Taxpayer's Opening Brief, a copy of which is attached hereto before the Stipulations. DFA now contends that the second limitation is based upon a different fomula: ██████ which is product of the asset percentage times total income ██████ the percentage of utilized under Ark. Code Ann. § 26-51-701. Nowhere in the statute or the regulation is this second limitation mentioned. Each limits the NOL Carryovers to the profits apportionable to Arkansas under section 26-51-701 which is ██████ provided it is less than the Asset Income Apportionment. DFA in its brief creates a convoluted argument based upon a double apportionment figure (see Exhibit 11 to the Stipulations), and the ██████ figure asserts for the first time in DFA's brief. DFA cites *Jones v Carter Construction Company. Inc.*, 266 Ark 358, 583 S.W.2d 63 (1979), and it appropriately points out that in this case, there is a multi-state Taxpayer. What it fails to point out in this case is that in Carter like our case, the assets of the company that was merged out of existence are all in Arkansas. So 100% of the income apportioned to Arkansas under Ark. Code Ann. § 26-51-701 is available, and the limitation is applicable, i.e., ██████ The profits allocable to Arkansas under Ark. Code Ann. § 26-51-701 is ██████ This is the amount available for the NOL Carryover since Taxpayer has no other assets in Arkansas. It only Arkansas assets are from the merged corporation ███ The plain unambiguous language of Ark. Code Ann. § 26-51-701 indicates that the NOL Carryover is limited to the profits allocable to Arkansas under this section. That figure is $591,821, which is the limitation since this is less than ██████ which is the Asset Income Apportionment.

Conclusions

The NOL Carryovers arose from the pre-merger business activities of ███ in Arkansas. Taxpayer is seeking to claim those NOL Carryovers in the manner provided under the clear rendering of Ark. Code Ann. § 26-51-

427(3)(C) (Repl. 2012) and the Corporate Tax Income Regulation 1.26-51-427(3)(3) as demonstrated. DFA is seeking to limit Taxpayer's use of the NOL Carryovers in a manner not contemplated by the clear meaning of the statute and regulation.

Within his Reply Brief, the Department's Representative provided additional argument, stating:

NOL CARRYOVER

Taxpayer's Response Brief contends that it "meticulously followed" the instructions issued by the Department when computing the net operating loss deduction (NOL) allowable on its 2018 Arkansas corporate income tax return. It did not.

Taxpayer cites Arkansas Code Annotated § 26-51-427(3) and Department Rule 1.26-51-427(3)(C) in support of its NOL computation; however, the language contained in the law and the rule do not support Taxpayer's computation. Taxpayer failed to follow the provisions of either the law or the rule regarding the limits on the amount or NOL available. Both the law and the rule provide:

> The carryover losses are allowed only in those cases in which the assets of the corporation going out of existence earn sufficient profits **apportionable to Arkansas under the uniform Division of Income for Tax Purposes Act, § 26-51-701 et seq.,** in the post-merger period to absorb the carryover losses claimed by the surviving corporation. (Emphasis added).

Taxpayer seeks to apply the NOL carryover to the profits or all the assets of the surviving corporation that are apportionable to Arkansas in the post-merger period rather than limiting the NOL carryover to the profits earned in the post-merger period by the assets of the corporation going out of existence.

[REDACTED] ceased to exist following its merger with Taxpayer. The business activities of [REDACTED] resulted in a NOL that Taxpayer could use. However, Ark. Code Ann. § 26-51-427(3)(C) limits the amount of carryover losses available to a surviving corporation. That limit is equal to the profits earned during the post-merger period by the assets belonging to [REDACTED] prior to merger and apportionable to Arkansas under Ark. Code Ann. § 26-51-701 *et seq*. Arkansas Code Annotated § 26-51-701 *et seq*. requires multistate taxpayers to apportion their income among the states where it conducts business.

Taxpayer's erroneous computation of the available NOL began when it first computed the percentage or its post-merger assets represented by the pre-merger assets of [redacted] Both parties have agreed that this percentage is [redacted] See Joint Stipulation No. 42 and 43. Taxpayer then multiplied that percentage by its total multistate income of [redacted] and determined that the portion of its multistate income earned by the pre-merger assets of [redacted] during the post-merger period was [redacted]. *See* Joint Stipulation No. 46.

Next, Taxpayer computed the percentage of its total multistate income that was apportionable to Arkansas under Ark. Code Ann. § 26-51-701 *et seq.* This apportionment percentage reflected that [redacted] of Taxpayer's [redacted] income was earned in Arkansas. *See* Joint Stipulation No. 12. That percentage was then multiplied by Taxpayer's [redacted] income of [redacted]. Taxpayer then correctly concluded that its income apportioned to Arkansas from its multistate activities was [redacted]. *Id.* However, Taxpayer stopped its computation of the available NOL at this point and incorrectly concluded that it could claim a NOL deduction of [redacted]. Taxpayer failed to apply that portion of Ark. Code Ann. § 26-51-427(3)(C) or Rule 1.26-51-427(3)(C) that limits the NOL deduction to the profits earned by the assets belonging to [redacted] prior to the merger and that are "apportionable to Arkansas under the Uniform Division of income for Tax Purposes Act, §26-51-701 *et seq.*"

As previously stated, both parties agree that the portion of Taxpayer's multistate income apportionable to Arkansas is [redacted]. This apportioned income amount includes the post-merger income apportioned to Arkansas earned by all the assets belonging to Taxpayer, not just the income apportioned to Arkansas and earned by the pre-merger assets of [redacted] Both Ark. Code Ann. § 26-51-427(3)(C) and Department Rule 1.26-51-427(3)(C) limits the NOL deduction to the income apportioned to Arkansas and earned by the pre-merger assets of the corporation going out of existence ([redacted]

The Department properly computed the NOL available to Taxpayer by multiplying the total income apportioned to Arkansas from all post-merger assets of Taxpayer of [redacted] by the portion of those assets represented by asset belonging to [redacted] prior to the merger [redacted]). This computation revealed that the assets of [redacted] earned profits apportionable to Arkansas under Ark. Code Ann. § 26-51-701 *et seq.* in the post-merger period of [redacted] Taxpayer argues that this additional computation by the Department is not supported by law and claims that the NOL should be limited ". . . to the profits apportionable to Arkansas under section 26-51-701 . . .". See Taxpayer's Response Brief P. 8. However, the Taxpayer's argument ignores that part of the statute and the rule that specifically limits the NOL to the profits apportionable to

> Arkansas from the **profits earned by the assets of the corporation going out of existence** [redacted]

The Department's Representative additionally criticized the Taxpayer's argument that, since 100% of [redacted] pre-merger assets were located within Arkansas after the merger and represented the totality of the Taxpayer's Arkansas assets, the entire apportioned Arkansas income ([redacted]) was earned by the premerger assets. Specifically, he asserted that argument is not in compliance with Arkansas law that required the Taxpayer to apportion income to Arkansas based on a three-factor apportionment formula, not simply income that is directly sourced from Arkansas assets. He rejected the Taxpayer's citation to *Jones v. Carter Construction Company, Inc.*, 266 Ark. 358, 583 S.W.2d 63 (1979), noting that case did not implicate a multistate corporation earning multistate income, preventing the application of an multistate apportionment method. Consequently, he reasoned that the income apportioned to Arkansas ([redacted]) must be further reduced by the proportion of post-merger assets derived from [redacted] He further rejected the Taxpayer's assertion that the Department bore the burden of proof in this matter noting that a deduction was implicated, whose burden of proof is clearly placed on the Taxpayer under Ark. Code Ann. § 26-18-313(b) (Repl. 2020).

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

CONCLUSIONS OF FACT AND LAW

Standard of Proof

Ark. Code Ann. § 26-18-313(c) (Repl. 2020) 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) (Repl. 2020). 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) (Repl. 2020). 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) (Repl. 2020).

Tax deductions and credits, like tax exemptions, exist as a matter of legislative grace. *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 he or she is entitled to the deduction or credit by bringing himself or herself clearly within the terms and conditions imposed by the statute that contains the deduction or credit. *Weiss v. American Honda Finance Corp.*, 360 Ark. 208, 200 S.W.3d 381 (2004). Further, as stated above, tax deductions must be narrowly construed. Ark. Code Ann. § 26-18-313(a), (b), and (e) (Repl. 2020). Additionally, any doubts regarding the application of a deduction must be resolved against the application of the deduction. Ark. Code Ann. § 26-18-313(f)(2) (Repl. 2020).

Applicable Burden of Proof for Calculation of the Net Operating Loss

Initially, the Net Operating Loss Carryforward is properly characterized as a tax deduction. *See* Ark. Code Ann. § 26-51-427(1) (Repl. 2020). Ark. Code Ann. § 26-18-313 (Repl. 2020) governs the burdens of proof in tax proceedings and states as follows:

> (a) When the state seeks to impose a tax under the terms of a state tax law, then the statute imposing the tax shall be strictly construed in limitation of the imposition of the tax.
>
> (b) **When a taxpayer claims to be entitled to a tax exemption, deduction, or credit under the terms of a state tax law, then the statute providing the tax exemption, deduction, or credit shall be strictly construed in limitation of the exemption, deduction, or credit.**
>
> (c) 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.

(d) When the meaning of a state tax law is in controversy, **the burden of establishing the proper construction of the statute shall be on the party claiming application of the tax or benefit of the tax exemption, deduction, or credit.**

(e) Words used in statutes imposing a tax and in statutes providing for a tax exemption, deduction, or credit shall be given their plain and ordinary meaning, not their narrowest possible meaning.

(f)(1) Statutes imposing a tax and statutes providing a tax exemption, deduction, or credit shall be fairly and reasonably construed, taking into consideration the purpose and spirit of the tax, exemption, deduction, or credit and the public policy at the time the statute was passed.

(2) If after taking this section and other applicable rules of statutory construction into account, a well-founded doubt exists with respect to the meaning of a statute imposing a tax or providing a tax exemption, deduction, or credit, the rule of strict construction shall require that the doubt be resolved against the tax, exemption, deduction, or credit.

(g) This section is remedial and procedural and shall apply to all actions on and after October 1, 2015. [Emphasis supplied.]

The language above clearly intends to and so places the burden upon a Taxpayer to prove entitlement to a tax exemption, deduction, or credit. While the Taxpayer's Representative argued that the Department bore the burden of proof in this matter, that argument is not persuasive as the Taxpayer is attempting to claim a deduction and the burden of proving entitlement to the full amount of a tax deduction is upon a taxpayer under Ark. Code Ann. § 26-18-313(b) (Repl. 2020). Consequently, this decision shall proceed to consider whether the Taxpayer has proven entitlement to the total amount of the deduction that it has claimed.

Assessment

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. 2020). Further, the State of Arkansas has adopted the Uniform Division of Income for Tax Purposes Act for purposes of apportioning interstate business income. Ark. Code Ann. § 26-51-701 *et seq.* (Repl. 2020).

Ark. Code Ann. § 26-51-427(1)(A) (Repl. 2020) allows a five (5) year net operating loss carry forward deduction for tax years prior to January 1, 2020. The calculation of that deduction in cases of mergers is addressed in Ark. Code Ann. § 26-51-427(3) (Repl. 2020), which states the following:

> In the case of the acquisition of assets of one (1) corporation by another corporation, the acquiring corporation shall succeed to and take into account any net operating loss carryover apportionable to Arkansas, under the Uniform Division of Income for Tax Purposes Act, § 26-51-701 et seq., that the acquired corporation could have claimed had it not been acquired, subject to the following conditions:
>
> (A) The net operating loss may not be carried forward to a taxable year that ends more than three (3) years after the taxable year in which the net operating loss occurred if the net operating loss occurred in an income year beginning before January 1, 1987;
>
> (B) The net operating loss may not be carried forward to a taxable year that ends more than five (5) years after the taxable year in which the net operating loss occurred if the net operating loss occurred in an income year beginning on or after January 1, 1987, and before January 1, 2020;
>
> (C) The net operating loss may not be carried forward to a taxable year that ends more than the number of years stated in subdivision (1)(C) of this section after the taxable year in which the net operating loss occurred if the net operating loss occurred in an income year beginning on or after January 1, 2020; and
>
> (D) The net operating loss may be claimed only when the ownership of both the acquired and acquiring corporations is substantially the same in that not less than eighty percent (80%) of the voting stock of each corporation is owned by the same person or, before the acquisition, the acquiring corporation owned at least eighty percent (80%) of the voting stock of the acquired corporation. The carryover losses are allowed only in those cases in which the assets of the corporation going out of existence earn sufficient profits apportionable to Arkansas under the Uniform Division of Income for Tax Purposes Act, § 26-51-701 et seq., in the post-merger period to absorb the carryover losses claimed by the surviving corporation.

Further, the Department is authorized to promulgate rules for the enforcement of the Arkansas income tax. Ark. Code Ann. § 26-18-301(a)(1) (Repl. 2020). Arkansas Comprehensive Corporation Income Tax Regulations § 1.26-51-427(3)(C) states the following:

> In the case of a merger between two corporations that are owned by the same entity and that same entity owns at least 80% of the voting stock of each corporation, the formula for establishing that the assets of the merged corporation (that is, the corporation going out of existence) are still producing income is as follows:
>
> $$\frac{\text{Original Cost of Merged Assets}}{\text{Original Cost of All Assets}} \times \text{Total Income}$$
>
> The carryover losses will be allowed only in those cases where the assets of the corporation going out of existence earn sufficient profits apportionable to Arkansas under § 26-51-701 et seq. in the post-merger period to absorb the carryover losses claimed by the surviving corporation.

Here, the determinative issue in this matter is whether the limitation contained within Ark. Code Ann. § 26-51-427(3)(D) (Repl. 2020) should be determined by multiplication of the proportion of merged assets contained within the succeeding corporation by Taxpayer's total multistate income or the total income apportioned to Arkansas.

While "total income" is not defined within Arkansas Comprehensive Corporation Income Tax Regulations § 1.26-51-427(3)(C), the last paragraph explicitly states that assets of the corporation going out of existence must "earn sufficient profits **apportionable to Arkansas under § 26-51-701 et seq.** in the post-merger period to absorb the carryover losses claimed by the surviving corporation." Emphasis supplied. This language strongly indicates that the term ("total income") is a reference to the Arkansas apportionable income not the total

multistate income of the succeeding Taxpayer. Further, Ark. Code Ann. § 26-51-427(3)(D) (Repl. 2020) provides in relevant part that: "The carryover losses are allowed only in those cases in which the a**ssets of the corporation going out of existence earn sufficient profits apportionable to Arkansas under the Uniform Division of Income for Tax Purposes Act, § 26-51-701 et seq.**, in the post-merger period to absorb the carryover losses claimed by the surviving corporation."

The code section and rule state that the assets of the preceding corporation going out of existence must earn sufficient income apportionable to Arkansas. Applying the Taxpayer's proposed methodology would utilize the total income apportioned to Arkansas earned by all the assets of the succeeding corporation (including those not located within Arkansas), not just the apportioned income associated with the preceding company's Arkansas assets. The governing rule provides a methodology for calculating the amount of the preceding corporation's assets that are retained and producing income in the succeeding corporation. That percentage is then multiplied by the income "apportionable to Arkansas" to discern what amount of the apportioned Arkansas income was earned by the preceding company's assets. This approach complies with the requirements of both Ark. Code Ann. § 26-51-427(3)(D) and Arkansas Comprehensive Corporation Income Tax Regulations § 1.26-51-427(3)(C).

While the Taxpayer believed the *Carter Construction Company* case supported its approach, the Department's Representative correctly noted that case is distinguishable from the matter at hand. That case did not indicate that the surviving company earned multistate income. If the surviving company only

operated in Arkansas, all the surviving company's income would be taxable within Arkansas, wholly avoiding the additional step of determining the amount of the surviving company's net income that was taxable in Arkansas through multistate apportionment. Consequently, Taxpayer's assertion regarding this case is not persuasive.

If some ambiguity was deemed to exist by the rule's use of the term "total income" (potentially meaning total Arkansas income or [redacted]), Ark. Code Ann. § 26-18-313(b) and (f)(2) (Repl. 2020) instructs that deductions should be construed in limitation of their application with any doubts resolved against them. The Taxpayer bore the burden of proving entitlement to the total amount of claimed net operating loss deduction by a preponderance of the evidence and failed to do so. Consequently, the Department's assessment of tax is sustained.

Interest

Subject to the limitation in Ark. Code Ann. § 26-18-405(d)(1)(C) (Repl. 2020), interest must be assessed upon tax deficiencies for the use of the State's tax dollars. See Ark. Code Ann. § 26-18-508 (Repl. 2020). Consequently, the assessment of interest on the remaining tax balance is sustained after the adjustment required under Ark. Code Ann. § 26-18-405(d)(1)(C) (Repl. 2020).

Failure to Pay Penalty

With respect to the failure to pay penalty, Ark. Code Ann. § 26-18-208(2)(A) (Repl. 2020) provides as follows:

> In case of a failure to pay the amount shown as tax on any return required to be filed under any state tax law, except an individual income tax return, on or before the date prescribed for payment of the tax, unless it is shown

> that the failure to pay is due to reasonable cause and not to willful neglect, there shall be added to the amount shown as tax on the return five percent (5%) of the amount of the tax if the failure is for not more than one (1) month, with an additional five percent (5%) for each additional month or fraction of a month during which the failure continues, not to exceed thirty-five percent (35%) in the aggregate.

Here, the Taxpayer has explained that it attempted to follow the governing rule. It, however, misinterpreted the meaning of "total income" and the application of the limitation contained within the final paragraph of the applicable rule. While the above reasoning concludes that the Taxpayer was in error, it is not established by the record that the Taxpayer's error in interpretation resulted from a willful neglect of the tax laws by a preponderance of the evidence. Based on the totality of the record, the assessment of the failure to pay penalty is not sustained with respect to the assessment.

DECISION AND ORDER

The proposed assessment is sustained after the removal of the failure to pay penalty and the adjustment required under Ark. Code Ann. § 26-18-405(d)(1)(C) (Repl. 2020). 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 (Repl. 2020), 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.

Ark. Code Ann. § 26-18-406 (Repl. 2020) 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.[3]

OFFICE OF HEARINGS & APPEALS

TODD EVANS
ADMINISTRATIVE LAW JUDGE

DATED: April 27, 2020

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