

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

IN THE MATTER OF [REDACTED]
[REDACTED]
ACCT. NO.: [REDACTED]

**INDIVIDUAL INCOME TAX
ASSESSMENTS
AUDIT ID:** [REDACTED]
**AUDIT PERIOD: JANUARY
2017 THROUGH DECEMBER
2018**

**DOCKET NOS.: 21-139 (2017)
21-140 (2018)**

[REDACTED]¹
[REDACTED]²

**TODD EVANS, ADMINISTRATIVE LAW JUDGE
APPEARANCES**

This case is before the Office of Hearings and Appeals upon a written protest signed June 17, 2020, signed by [REDACTED] [REDACTED] (“Taxpayers’ Representative”) on behalf of [REDACTED], the Taxpayers. The Taxpayers protested assessments issued by the Department of Finance and Administration (“Department”). The Department was represented by Caroline Calvert, Attorney at Law, Office of Revenue Legal Counsel (“Department’s Representative”).

At the request of the Taxpayer, this matter was taken under consideration of written documents. A briefing schedule was established for the parties by letter dated November 10, 2020. The Department’s Representative filed her Opening Brief on December 11, 2020. The Taxpayers’ Representative did not file a response, but the protest was received into evidence. The record was closed and this matter was submitted for a decision on February 9, 2021.

¹ This amount represents [REDACTED] (tax) and [REDACTED] (interest).

² This amount represents [REDACTED] (tax) and [REDACTED] (interest).

ISSUES

Whether the assessments issued against the Taxpayers should be sustained. Yes.

FACTS/CONTENTIONS OF THE PARTIES

Opening Brief

Within her Opening Brief, the Department's Representative provided her understanding of the facts and some analysis stating as follows³:

[REDACTED] ("Taxpayers") timely filed Arkansas full year resident individual income tax returns (AR100F) for the years 2017 and 2018 using the filing status "Married Filing Separately on the Same Return." Taxpayers are engaged in a timber-related activity. The issue in this case is whether the Department properly disallowed Taxpayers' claims of Schedule F losses on their 2017 and 2018 Arkansas individual income tax returns.

In 2017, Taxpayer [REDACTED] claimed an adjusted gross income of [REDACTED], including [REDACTED] in wages from [REDACTED], a loss of [REDACTED] in farm income from his Schedule F, and a depreciation difference of [REDACTED] from his [REDACTED]. See Taxpayer's 2017 Arkansas Individual Income Tax Return, **Exhibit 1**. Taxpayer [REDACTED] claimed an adjusted gross income of [REDACTED]. Taxpayers claimed a total combined adjusted gross income of [REDACTED]. Taxpayers also claimed itemized deductions in the amount of [REDACTED] for primary income and [REDACTED] for spouse's income. This resulted in a combined net taxable income of [REDACTED] and net taxes in the amount of [REDACTED].

In 2018, Taxpayer [REDACTED] claimed an adjusted gross income of [REDACTED], including [REDACTED] in wages from [REDACTED] in [REDACTED], a loss of [REDACTED] in farm income from his Schedule F, and a depreciation difference of [REDACTED] from his [REDACTED]. See Taxpayer's 2018 Arkansas Individual Income Tax Return, **Exhibit 2**. Taxpayer [REDACTED] claimed an adjusted gross income of [REDACTED]. Taxpayers claimed a combined adjusted gross income of [REDACTED]. Taxpayers also claimed itemized deductions in the amount of [REDACTED] for primary income and [REDACTED] for spouse's income. This

³ Except as noted, all exhibits support the statements for which they are cited.

resulted in a combined net taxable income of [REDACTED] and net taxes in the amount of [REDACTED]

On or about January 3, 2020, the Department sent Taxpayer an Audit Appointment Confirmation, stating their intent to audit Taxpayer with respect to certain business activities related to expenses and losses claimed from their timber farm for the period of January 1, 2017 to December 31, 2018. See Audit Appointment Confirmation, **Exhibit 3**. The auditor for the Department, Dakota Cowart reviewed the Taxpayer's federal and state returns, 1099's, depreciations schedules, real and personal property information, and supporting documentation.

After review of the documentation, the auditor determined that the timber-related activity could not be considered "farming" under Arkansas law. The auditor therefore disallowed the losses from farm income claimed on Taxpayers' federal Schedule F for both 2017 and 2018. This resulted in an increase in adjusted gross income of [REDACTED] for 2017 and [REDACTED] for 2018. See Summary of Findings, **Exhibit 4**.

The increase in adjusted gross income affected bases used in Taxpayers' itemized deductions. Additionally, because the auditor determined the timber activity was an investment, some expenses from Taxpayer's Schedule F were carried over onto Taxpayers' form AR3. See Auditor Prepared Itemized Deductions for 2017 and 2018 **Exhibit 5**. Specifically, the auditor carried over expenses for repairs, chemicals, supplies, and a portion of the depreciation for the assets he determined were used for purposes related to the business. See Auditor Prepared Depreciation Schedules for 2017 and 2018, **Exhibit 6**.

The adjustments made to itemized deductions and adjusted gross income created an increase in net taxable income and resulted in an additional liability of [REDACTED] in tax and [REDACTED] in interest for 2017. For tax year 2018, the adjustments resulted in an additional liability of [REDACTED] in tax and [REDACTED] in interest. Accordingly, the Department sent Taxpayers a Notice of Proposed Assessment on April 28, 2020, reflecting that Taxpayers owed a total of [REDACTED] as a result of the audit. **Exhibit 7**.

Taxpayers' representative timely protested the assessment on June 17, 2020, disagreeing with the disallowance of the Schedule F losses. Taxpayers representative stated:

I disagree with the disallowance of Schedule F. Time is a qualified farm. No, it will not have income every year it will have expenses. Proof of expense was submitted.

Taxpayers' representative supported her arguments with documentation showing that expenses from timber farms should be reported federally on Schedule F.⁴

Arkansas does not include tree farms in the definition of a "farm" except those bearing fruit or nuts for purposes of calculating Arkansas individual income tax. See Arkansas Income Tax Regulation 9.26-51-404(a)(1). Accordingly, the Department's disallowance of Schedule For Taxpayers' Arkansas income tax return was proper and the assessment of tax and interest against Taxpayers should be sustained.

Within her opening brief, the Department's Representative asserted that, since the Taxpayers were engaged in tree farming, they could not claim their losses as farm losses under Arkansas Comprehensive Individual Income Tax Rule § 9.26-51-404(a)(1), warranting the disallowance of the Schedule F losses. She further declared the assessment of interest to be warranted under Ark. Code Ann. § 26-18-508 (Repl. 2020).

After a general discussion of the burdens of proof in tax proceedings, a legal analysis with associated conclusions shall follow.

CONCLUSIONS OF 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.

⁴ The Taxpayer's Representative included form for the Taxpayer's 2018 income tax return with statement that timber farms do not earn income every year and that the timber farm is not a hobby. She further noted that depreciated contract block was used to maintain roads, fire lines, and inspection of timber tracts. She additionally included a printout from a website () that instructs timber business expenses should be reported upon a Schedule C or F (for farmers) or Form 1120, 1065, 1065s, etc.

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).

Legal Analysis

Initially, it appears that the parties agree that the Taxpayers are engaged in a timber production activity as a business but disagree on whether the associated deductions may be claimed upon a Schedule F.

Arkansas income tax applies to the entire income of all state residents. Ark. Code Ann. § 26-51-201 (Repl. 2020). Ark. Code Ann. § 26-51-424(a)(1) (Repl. 2020) allows a tax deduction from income for losses incurred in a trade or business. The Secretary of the Department is authorized to promulgate rule for enforcement of the Arkansas Individual Income Tax. Ark. Code Ann. § 26-18-301 (Repl. 2020). Additionally, this Office has repeatedly noted that the promulgated rules are binding primary authority for this Office and may not be overturned or ignored.

The instruction booklets for the 2017 and 2018 Arkansas Income Tax Forms provide that a farmer should calculate his annual farm income using the Federal Schedule F. *See* Arkansas Instruction for AR1000F and AR1000NR (2017 and 2018) p.13 and 12 of the respective instructions. The Federal Schedule F is solely limited to the reporting of farm income and expenses. Instructions for Form 1040, Schedule F (2017 and 2018) p. F-1.

Further, Arkansas Comprehensive Individual Income Tax Regulation § 6.26-51-424(a)(1) addresses Farm Losses and states the following in pertinent part:

Losses incurred in the operation of farms as business enterprises are deductible from gross income. . . . If any individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure.

However, Arkansas Comprehensive Individual Income Tax Regulation § 9.26-51-404(a)(1) defines a “farm” as follows: “The term farm includes stock, dairy, poultry, fruit and truck farms, plantations, ranches and all land used for farming

operations. **The term farm does not include tree farms except those farms that have trees bearing fruit or nuts.**” Emphasis supplied.

Here, the Department’s argument that a timber operation does not qualify as a “farm” under Arkansas income tax laws and, thus, should not be deducted upon a Schedule F is persuasive. That conclusion is mandated by the binding Arkansas individual income tax rules. Consequently, the Department correctly denied the expenses related to the timber operation claimed upon the Taxpayers’ Schedule F.⁵ The assessment is sustained at this point in the administrative process.

Interest

Interest must be assessed upon tax deficiencies for the use of the State’s tax dollars. Ark. Code Ann. § 26-18-508 (Repl. 2020). Consequently, the assessment of interest on the tax balance is sustained.

DECISION AND ORDER

The assessments 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 (Repl. 2020), unless the Taxpayers request 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,

⁵ This decision is solely limited to the question as to whether these expenses are deductible upon the Taxpayers’ Schedule F as this is the only contention raised by the Taxpayers in favor of their deductibility and, thus, the only issue currently before this Office.

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 Taxpayers have 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.⁶

OFFICE OF HEARINGS & APPEALS



TODD EVANS
ADMINISTRATIVE LAW JUDGE

DATED: March 1, 2021

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