

**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
ASSESSMENT**
AUDIT ID: [REDACTED]¹
LETTER ID.: [REDACTED]

**DOCKET NO.: 21-167 (2014)
21-168 (2015)
21-169 (2016)
21-170 (2017)
21-171 (2018)**

[REDACTED]²
[REDACTED]³
[REDACTED]⁴
[REDACTED]⁵
[REDACTED]⁶

**TODD EVANS, ADMINISTRATIVE LAW JUDGE
APPEARANCES**

This case is before the Office of Hearings and Appeals upon a written protest dated August 5, 2020, sent by [REDACTED], (“Taxpayers’ Representative”) on behalf of [REDACTED], the Taxpayers. The Taxpayers protested an assessment issued by the Department of Finance and Administration (“Department”).

A hearing was held in Little Rock, Arkansas⁷, on April 27, 2021, at 10:00 a.m. The Department was represented by Brad Young, Attorney at Law, Office of Revenue Legal Counsel (“Department’s Representative”). Present for the Department was Shelia Towery (“Auditor T”), Elizabeth Cogbill (“Auditor C”), Michael Carver (“Audit Supervisor”), and Melissa Guinn (“District Manager”).

¹ The current assessed amounts do not include concessions agreed to by the Department.

² This amount represents [REDACTED].

³ This amount represents [REDACTED].

⁴ This amount represents [REDACTED].

⁵ This amount represents [REDACTED].

⁶ This amount represents [REDACTED].

⁷ All parties appeared by telephone.

The Taxpayers' Representative appeared at the hearing and represented the Taxpayers.

ISSUE

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

FACTUAL AND LEGAL CONTENTIONS OF THE PARTIES

Prehearing Filings

The Department's Representative provided his rendition of the relevant events within his Answers to Information Request writing as follows⁸:

[REDACTED] (Taxpayers) are full year residents of the State of Arkansas. [REDACTED] worked [REDACTED] [REDACTED] during part of the audit period. [REDACTED] was the principal of a business called [REDACTED] which was located at [REDACTED] Arkansas. That business closed in [REDACTED] On [REDACTED] at the same location, [REDACTED].⁹ That business closed on or about [REDACTED]

The Taxpayers were involved in a previous individual income tax audit for the period January 1, 2012 through December 31, 2013. That audit arose from a sales tax audit of another their previous businesses, [REDACTED], which they later renamed [REDACTED]. The audit period for the prior individual income tax audit was January 31, 2007 through April 30, 2015.

During the course of this audit, the auditor reviewed the following documents provided by the Taxpayers:

- (a) Bank statements for accounts:

[REDACTED]

⁸ Except as noted, all exhibits support the statements for which they are cited.

⁹ The Department's Representative noted that this entity has protested a sales and use tax assessment in Docket Nos. [REDACTED].

[REDACTED]

- (b) Purchase invoices; and
- (c) Other miscellaneous invoices.

The Taxpayers filed their **2014** individual income tax returns on or about March 17, 2015.¹⁰ The auditor adjusted the Taxpayer's 2014 state income tax returns because the taxpayers did not include business income for [REDACTED].

[REDACTED]

In 2014, [REDACTED] was an owner of [REDACTED].¹¹ The Taxpayers did not provide bank documents, QuickBooks, sales tax reports, invoices, or other business records of [REDACTED]. The auditor recorded the monthly reported sales from [REDACTED] state sales/use tax account as the total sales and added the reported tax amounts to arrive at the gross business profit. Next, the auditor deducted the reported tax to arrive at the net profit. Because [REDACTED] had [REDACTED], the auditor divided the net profit of the business by fifty percent to arrive at the net profit for [REDACTED].¹²

[REDACTED]

In 2014, [REDACTED] owned [REDACTED].¹³ The Taxpayers did not provide bank documents, QuickBooks sales reports, invoices, or other business records of [REDACTED]. The auditor recorded the monthly reported sales from [REDACTED] state sales/use tax account as the total sales and added the reported tax amounts to arrive at the gross business profit. Next, the auditor deducted the reported tax to arrive at the net profit.¹⁴

¹⁰ The Department's Representative cited Exhibit 1. This return is dated March 16, 2015; however the actual date of filing is uncertain based on the return.

¹¹ The Department's Representative cited Exhibit 2.

¹² The Department's Representative cited Exhibits 3 and 4.

¹³ The Department's Representative cited Exhibit 5.

¹⁴ The Department's Representative cited Exhibits 4 and 6.

After the auditor calculated the amount of unreported taxable income for [REDACTED] and [REDACTED], the auditor calculated the amount of tax due for 2014.¹⁵

The Taxpayers did not file a 2015 state income tax return. The auditor calculated the Taxpayer's income based on [REDACTED] W-2 for [REDACTED], the net profit from [REDACTED],¹⁶ and the net profit from [REDACTED]¹⁷ to arrive at total income. The auditor allowed itemized deductions,¹⁸ deductions for 2015 [REDACTED] paid on [REDACTED] behalf by [REDACTED] and mortgage interest based on information that the Taxpayers provided during the audit. After applying applicable deductions and credits,¹⁹ the auditor calculated the amount of tax due for 2015.²⁰

The Taxpayers did not file a 2016 state income tax return. Because the Taxpayers did not provide a Form W-2 for [REDACTED], the auditor used the [REDACTED] from [REDACTED] as reflected on the Taxpayers' bank records to calculate W-2 income. The auditor used the records that the Taxpayers provided for [REDACTED] to calculate additional unreported income.²¹ The auditor allowed itemized deductions,²² and mortgage interest based on information that the Taxpayers provided during the audit. After applying applicable deductions and credits,²³ the auditor calculated the amount of tax due for 2016.²⁴

The Taxpayers did not file a 2017 state income tax return. The auditor used the records that the Taxpayers provided for [REDACTED] [REDACTED] calculate additional unreported income.²⁵ The Taxpayer provided a monthly expense schedule, which the auditor used to calculate yearly expenses. The auditor deducted the reported tax and other expenses to arrive at the net profit. After applying applicable deductions and credits,²⁶ the auditor calculated the amount of tax due for 2017.²⁷

The Taxpayers did not file a **2018** state income tax return [REDACTED] employer, [REDACTED], reported wages to the State of Arkansas. After

¹⁵ The Department's Representative cited Exhibit 7.

¹⁶ The Department's Representative cited Exhibits 4 and 8.

¹⁷ The Department's Representative cited Exhibits 4 and 9.

¹⁸ The Department's Representative cited Exhibit 10.

¹⁹ The Department's Representative cited Exhibit 11.

²⁰ The Department's Representative cited Exhibit 12.

²¹ The Department's Representative cited Exhibits 4 and 13.

²² The Department's Representative cited Exhibit 14.

²³ The Department's Representative cited Exhibit 11.

²⁴ The Department's Representative cited Exhibit 15.

²⁵ The Department's Representative cited Exhibits 4 and 16.

²⁶ The Department's Representative cited Exhibit 11.

²⁷ The Department's Representative cited Exhibit 17.

applying applicable deductions and credits,²⁸ the auditor calculated the amount of tax due for 2018.²⁹

At the conclusion of the audit, the Department provided the Taxpayers with a Summary of Findings for tax years 2014-2018.³⁰ The Department issued a Notice of Proposed Assessment on April 30, 2020.³¹ The Taxpayers timely filed this protest.

On August 20, 2020, the Department requested that the Taxpayer provide any additional information that it wished for the Department to consider no later than September 30, 2020.³² As of the date of this filing, the Department has not received any additional documentation.

The Department's Representative asserted that, due to the lack of records and lack of filing of some of the returns, the Taxpayers bear the burden of refuting the estimated assessment. He stated that the Taxpayers have failed to provide evidence to support the arguments raised within their protest and prove entitlement to a cost of goods sold deduction. He further averred that the assessment of interest was appropriate under Ark. Code Ann. § 26-18-508 (Repl. 2020).

Within his Protest, the Taxpayers' Representative provided the following statement: "The auditor had bank statements and info for over a year and failed to thoroughly examine. She did not include any cost of goods."

Hearing Testimony

A. Auditor T's Testimony

Auditor T testified that she performed the relevant audit with Auditor C. The Auditor certified all exhibits attached to the Department's Answers to Information Request. The auditors reviewed all documents provided by the

²⁸ The Department's Representative cited Exhibit 11.

²⁹ The Department's Representative cited Exhibit 18.

³⁰ The Department's Representative cited Exhibit 19.

³¹ The Department's Representative cited Exhibit 20.

³² The Department's Representative cited Exhibit 21.

Taxpayers. No payroll documents were provided for the 2017 income tax year. The Taxpayers ultimately failed to provide all necessary documents to properly calculate their tax liability. A prior audit of the Taxpayers occurred for the 2012 and 2013 tax years. A portion of the income tax assessment arose from a related sales tax audit. During the relevant tax years, the Taxpayers received income from [REDACTED] [REDACTED] [REDACTED] [REDACTED] after a partnership ended. Due to significant underreporting, the audit was extended to five (5) years.

For the 2014 tax year, the Taxpayers timely filed their income tax returns. The reported income was adjusted to add income from [REDACTED] [REDACTED] did not have the associated income documents, so Auditor T utilized the monthly reported sales from the Department's sales tax records. She also used the associated sales tax reports to calculate [REDACTED] income. After all income was calculated, a tax due was determined. The Taxpayers never provided documentation to support their cost of goods sold or any other expenses. Only the reported sales taxes were available and allowed as a deduction. Auditor T acknowledged that Taxpayers likely had other business expenses but needed evidence to allow any other expenses. The Department has conceded some additional expenses that are not represented in the assessed amount. The Taxpayers' Representative provided evidence for the purchase of a building. That evidence was provided after the audit and was not reviewed by the Department.

For 2015, the Taxpayers were nonfilers. They earned income from [REDACTED] [REDACTED] employer), [REDACTED]. Auditor T allowed [REDACTED] as a deduction in the calculation of net income. [REDACTED] income was determined based on a W-2. [REDACTED] income was based on Taxpayer's documents from the audit that were divided in half due to the partnership. [REDACTED] [REDACTED] income was based on Taxpayer's documents from the audit. Deductions were allowed for [REDACTED] and mortgage interest.

For 2016, the Taxpayers were nonfilers. They earned income from [REDACTED] (determined from [REDACTED]) and [REDACTED] (determined based on the Taxpayer's documents from the audit). Some deductions were allowed.

For 2017, the Taxpayers were nonfilers. The Taxpayers earned income from [REDACTED] (determined from the documents submitted during the audit). Auditor T assessed the Taxpayer's net income. The Taxpayers' Representative provided a monthly expense schedule. The Department allowed certain expenses in the calculation of tax due. No records of payroll amounts were provided for [REDACTED]. The Taxpayers later stated that [REDACTED] [REDACTED].

For 2018, the Taxpayers were nonfilers. The Taxpayers earned income from [REDACTED] (determined from a W-2). Auditor T allowed certain deductions and calculated a tax due.

The Department reviewed all received documents multiple times during the audit. The lack of substantiating records was the primary issue and made the audit very difficult.

Auditor T noted that the cost of goods sold calculated by the Taxpayers' Representatives for 2016 and 2017 included [REDACTED] that were not fully explained. Those amounts included costs for [REDACTED]

B. Auditor C's Testimony

Auditor C remembered that the Taxpayers' Representative presented alleged inventory cost amounts. She noted that those amounts were estimated and not accepted by the Department without supporting evidence.

C. Taxpayers' Representative's Testimony

The Taxpayers' Representative testified that he sent proof of a [REDACTED] [REDACTED] (the amount of the purchase money loan and the purchase documents), deposits, and inventory amounts. The Taxpayers borrowed [REDACTED] and only paid [REDACTED] [REDACTED]. He believed that the excess in the borrowed amount should be treated as the inventory cost. While the depreciation is not much, it still should be allowed as an expense. Also, inventory should be expensed somewhere. The Taxpayers had costs in the operation of their business and the Department should allow some expenses. He tried to provide evidence of average industry net income percentage amounts as a basis for adjustment (even if more than doubled by the Department), but the Department did not agree. He requested a settlement.³³

The Taxpayers' Representative explained that, while he worked for acquaintances of the Taxpayers, the Taxpayers did not become his clients until

³³ The Taxpayers' Representative was informed that this Office does not have settlement authority and is limited to determining whether the assessment is legally correct under Arkansas law based on the record submitted by the parties.

after the audit was completed. If the Taxpayers earned the kind of income alleged by the Department, their business [REDACTED] He conceded that the Taxpayers had bad record keeping and were not [REDACTED].

The Taxpayers' Representative analyzed the Taxpayers' bank statements from September 2015 forward and created summaries for the Department. While the Taxpayers did not retain receipts, he asserted that some purchases (like those from [REDACTED]) are clearly related to their business and should be allowed. He attempted to calculate the Taxpayers' cost of goods sold. He utilized credit card statements and bank records. This process involved discerning between business and personal costs. At certain points, some guessing was required.

The Taxpayers' Representative does not have personal knowledge of the Taxpayers' businesses. He requested that the Department's Representative consider a settlement in this matter.

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

FINDINGS OF FACT AND 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.

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 Assessments

Initially, it is the duty of every taxpayer to make a return of any tax due under any state tax law and to preserve suitable records to determine the amount due. Ark. Code Ann. § 26-18-506(a) (Repl. 2020). A taxpayer’s records may be examined by the Department at any reasonable time, and, when a taxpayer fails to maintain adequate records, the Department may make an estimated assessment based on the information that is available. Ark. Code Ann. § 26-18-

506(b) and (d) (Repl. 2020). The burden is on a taxpayer to refute an estimated assessment and self-serving testimony, standing alone, is insufficient to refute an estimated assessment. Ark. Code Ann. § 26-18-506(d) (Repl. 2020); *cf. Leathers v. A. & B. Dirt Mover, Inc.*, 311 Ark. 320, 844 S.W.2d 314 (1992). Specifically, the Arkansas Supreme Court stated as follows when analyzing an estimated assessment:

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.

Here, the Taxpayers failed to maintain adequate records, requiring an estimated assessment based on other records. The Department’s audit method (in the absence of adequate records for the calculation of the Taxpayers’ tax liability) is a reasonable audit methodology. As an estimated assessment, the Taxpayer bears the burden of refuting the Department’s assessment.

Ark. Code Ann. § 26-51-201 (Repl. 2020) imposes the Arkansas individual income tax upon, and with respect to, the entire income of every resident, individual, trust, or estate regardless of whether that income is earned inside or outside the state. The tax is levied, collected, and paid annually upon the entire net income of the individual. Ark. Code Ann. § 26-51-102(16) (Repl. 2020) defines the term “taxpayer” to include any individual, fiduciary, or corporation subject to the Arkansas income tax. The presented evidence demonstrates that the Taxpayers earned taxable income within the state, and the Taxpayers have

not contested this fact. The Department has demonstrated that the Taxpayers earned taxable income within the State of Arkansas during the relevant tax years. That income is generally taxable unless the Taxpayers can demonstrate that a tax credit, deduction, or exemption is applicable.

IRC § 162(a) (adopted by Ark. Code Ann. § 26-51-423(a)(1) (Repl. 2020)) allows a taxpayer to deduct all ordinary and necessary expenses incurred in carrying on a trade or business. An expense is “ordinary” if it is “normal, usual, or customary” in the 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 the 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 § 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).

For the deductions not conceded by the Department, the Taxpayers’ Representative has produced schedules for at least a few of the relevant tax years that he asserts were reconstructed from bank and credit card records. The Taxpayers’ Representative also stated that he possessed records related to the

████████████████████ used in one of the Taxpayers' businesses. The source documents, however, were not submitted for the record. Without the alleged source documents, the accuracy of any schedules and the representative's testimony cannot be confirmed.³⁴ The schedules and assertions, standing alone, do not establish entitlement to any additional business deductions by a preponderance of the evidence. The claimed deductions were properly denied with the exception of those deductions that the Department has conceded. Consequently, at this stage of the administrative process, the Taxpayers have not rebutted the remaining estimated assessment of tax for the relevant tax years, and that assessment is sustained after the Department's concessions.

Based on the above analysis, the audit properly includes the earlier tax years under Ark. Code Ann. § 26-18-306(e) (Repl. 2020) due to the underreporting of twenty-five percent (25%) or more.

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 is sustained.

DECISION AND ORDER

The assessment is 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)

³⁴ This Office is unable to provide advice regarding what documents a taxpayer or the Department should or should not submit to prove their respective cases.

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 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.³⁵

OFFICE OF HEARINGS & APPEALS



TODD EVANS
ADMINISTRATIVE LAW JUDGE

DATED: April 29, 2021

³⁵ See *Board of Trustees of Univ. of Arkansas v. Andrews*, 2018 Ark. 12.