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

ADMINISTRATIVE DECISION

IN THE MATTER OF [redacted] **(ACCT. NO.: [redacted])**	**CORPORATE INCOME TAX ASSESSMENT**
DOCKET NO.: 21-313 (2015)	**[redacted][1] ([redacted])**

TODD EVANS, ADMINISTRATIVE LAW JUDGE

APPEARANCES

This case is before the Office of Hearings and Appeals upon a written protest dated January 24, 2017, sent by [redacted] ("Tax Director") on behalf of [redacted] the Taxpayer. The Taxpayer protested an assessment issued by the Department of Finance and Administration ("Department").

A hearing was held in this matter on April 16, 2021, at 9:00 a.m. in Little Rock, Arkansas. The Department was represented by Lauren Ballard, Attorney at Law, Office of Revenue Legal Counsel ("Department's Representative"). Also present for the Department was Tommy Burns, Auditor, and Fay Husser, Audit Supervisor. The Taxpayer's Representative appeared at the administrative

[1] This amount represents [redacted] (tax), [redacted] (late payment penalty), and [redacted] (interest) after application of a payment in the amount 0f [redacted].

hearing and represented the Taxpayer. Also present on behalf the Taxpayer is [redacted], Senior Vice President.

ISSUE

Whether the assessment issued against the Taxpayer is correct under Arkansas law? Yes, in part.

FACTUAL AND LEGAL CONTENTIONS OF THE PARTIES

Prehearing Filings

A. Department's Filing

The Department's Representative provided her rendition of the alleged facts and contentions within her Answers to Information Request writing as follows[2]:

> [redacted] ("Taxpayer") filed a return for the tax period ending January 31, 2015 reporting [redacted] tax liability after claiming an Arkansas net operating loss (NOL) of [redacted] for period ending December 2015. A copy of Taxpayer's originally filed AR1100CT is attached as **Exhibit 1**. A review by the Department's auditor revealed that the amount of NOL claimed by Taxpayer for the 2012 tax period was incorrect, because Taxpayer did not add back non-taxable income in its computation of NOL. A copy of the auditor's NOL Carry Forward Adjustment explanation letter, along with Taxpayer's 2012 Corporation Income Tax Return is attached as **Exhibit 2**. Accordingly, only [redacted] was established by the Taxpayer and available to claim leaving a consolidated net taxable income of [redacted] and resulting in a total assessment against Taxpayer (including tax, penalty, and interest) of [redacted]. An Explanation of Tax Adjustment was mailed to Taxpayer on November 14, 2016 (**Exhibit 3**), and a Notice of Proposed Assessment was mailed on November 1, 2016 (**Exhibit 4**). The Taxpayer timely

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

protested the assessment and requested an administrative hearing (**Exhibit 5**).

In its letter of protest dated January 25, 2017, Taxpayer alleges that it properly allocated deductions pursuant to Arkansas Corporation Income Tax Regulation 1.26-51-802(b) and that add back of partnership income to determine NOL amounts to a double taxation of its partnership income.

Within her Answers to Information Request, the Department's Representative explained that corporations doing business within the State of Arkansas are subject to the Arkansas income tax under Ark. Code Ann. § 26-51-205 (Repl. 2020). She acknowledged that a deduction is allowed for qualifying net operating loss carryovers; however, she highlighted that any nontaxable income (less associated expenses) in Arkansas must be added back to that calculation under Ark. Code Ann. § 26-51-427(2)(A) (Repl. 2020). She instructed that partnership income must be directly allocated under Ark. Code Ann. § 26-51-802(c)(1)(2) (Repl. 2020) and asserted that any partnership income not allocated to Arkansas would represent non-taxable income within Arkansas that must be added back to the deductible net operating loss carryforward deduction. She averred that the Taxpayer bore the burden of proof for its deduction. She further declared that the Department's treatment best complies with Arkansas Supreme Court precedent, citing *Kansas City Southern Ry. Co. v. Pledger*, 301 Ark. 564, 785 S.W.2d 462 (1990) and *St. Louis Southwestern Railway v. Ragland*, 304 Ark. 1, 800 S.W.2d 410 (1990). She reasoned that the legislative intent is to limit the net operating loss deduction to the Arkansas deductions in excess of the Arkansas reported income. She dismissed the assertion that this approach results in double taxation as Arkansas was not attempting to doubly tax the Taxpayer's income.

B. Taxpayer's Filing

The Taxpayers' Representative provided his rendition of the alleged facts and an analysis within his Answers to Information Request writing as follows[3]:

> Arkansas DOR is attempting double taxation on income by apportioning the same income to the state of Arkansas twice.
>
> Taxpayer [redacted] is a corporation with an ownership stake in [redacted] having income sourced to Arkansas. For Federal tax purposes the taxable income of [redacted] is allocated to the owning corporation, [redacted] and included in taxable income for Federal tax purposes. For Arkansas purposes [redacted] separately reported all partnership income apportioned to Arkansas and allocated to the owning corporation, while also separately apportioning all corporation income or loss to Arkansas. This was done in accordance with Arkansas Reg 1.26-51-802(b).
>
> Arkansas Reg 1.26-51-802(b) requires corporations with an interest in a partnership which has gross income from sources within Arkansas to directly allocate the partnership's Arkansas income to Arkansas, rather than including partnership income and apportionment factors in the corporation's income and apportionment formula. If the taxpayer's operations are multistate all partnership income must be deduction on Schedule A, Part A, "Deduct Adjustments" line. The partnership's Arkansas income should then be deducted on Schedule A, Part C, "Direct Income Allocated To Arkansas" line of form AR1100CT.
>
> [redacted] correctly reported all partnership income apportioned to Arkansas and allocated to the owning corporation, [redacted] separately on Form AR1100CT, Schedule A, Section C, line 2 - Add: Direct Income Allocated to Arkansas. Owning corporation, [redacted] then proceeded to deduct all multistate partnership income reported in the Federal return of owning corporation. [redacted], on Schedule A, Section A, line 3 as prescribed in Arkansas Reg 1.26-51-802(b).
>
> The Arkansas Department of Revenue is disallowing the deduction of multi-state partnership income already apportioned and allocated to

[3] All exhibits support the statements for which they are cited.

Arkansas and the owning corporation, [redacted], in Schedule A, Section A, line 3. This partnership income is already apportioned to Arkansas and allocated to [redacted] and properly reported separately on Schedule A, Section C, line 2 - Add: Direct Income Allocated to Arkansas.

The disallowance of this deduction results in the multi-state partnership income being allocated to Arkansas twice and subject to double taxation as a result.

The justification of this deduction disallowance by the Department of Revenue incorrectly relies on Arkansas Code Section 26-51-427(2)(A) which states:

26-51-427(2) As used in this section, "net operating loss" means the excess of allowable deductions over gross income for the taxable year, subject to the following adjustments:

> *(A) There shall be added to gross Income all nontaxable income not required by law to be reported as gross income less any expenses properly and reasonably incurred in earning nontaxable income, which expenses would otherwise be nondeductible;*

Section 26-51-427(2)(A) identifies the need to add-back "all nontaxable income not required by law to be reported". Note that the deduction [redacted] is taking of multi-state partnership income on Schedule A, Section A, line 3 as prescribed in Arkansas Reg 1.26-51-802(b) does not fit the definition of non-taxable income, as it is taxable in nature, reportable and allocated appropriately in accordance to multi-state apportionment of income law and regulations

. . .

A - Arkansas Reg 1.26-51-802(b) requires corporations with an interest in a partnership which has gross income from sources within Arkansas to directly allocate the partnership's Arkansas income to Arkansas, rather than including partnership income and apportionment factors in the corporation's income and apportionment formula. If the taxpayer's operations are multistate, all partnership income must be deducted on Schedule A, Part A. "Deduct Adjustments" line. The partnership's Arkansas income should then be entered on Schedule A, Part C, "Direct Income Allocated To Arkansas" line of Form AR 1100CT.

(Eff. for tax years beginning on and after 1-1-98.)

B - Arkansas Department of Revenue incorrectly applying Arkansas Tax Code 26-51-427(2)

Hearing Testimony

A. Auditor's Testimony

The Auditor testified that he reviewed the relevant assessment and certified the exhibits attached to the Department's Answers to Information Request. The Taxpayer filed a corporate income tax return for tax year 2015. The Department adjusted the Net Operating Loss claimed upon that income tax return. The Net Operating Loss was adjusted to remove partnership income that was not allocated to and taxed within Arkansas during a prior tax year. The Taxpayer initially claimed a [redacted] NOL deduction, and the Department reduced the Net Operating Loss by [redacted]. Only [redacted] of Net Operating Loss was allowed. The Department sent the Taxpayer a letter explaining the NOL adjustment.

The Auditor defined nontaxable income to include any income that was not reported as gross income within Arkansas, even if it was reported as gross income elsewhere. The Department issued a Notice of Proposed Assessment to collect the additional tax due. The loss that was adjusted derived from the 2012 tax year and carried forward to the 2015 income tax return. He disallowed [redacted] in claimed partnership income for the 2012 income tax return that was allocated to states other than Arkansas. He allowed the deduction of out of state partnership income for the 2012 tax year but noted that any Arkansas nontaxable income must be removed from the calculation of the Net Operating Loss Carryforward calculation.

The Auditor deemed nontaxable income to be any income that is not taxable within Arkansas, not only generally exempt income like municipal bond interest or military income. The Department did not tax any of the partnership income allocated to other states, because it was deducted and removed from the Arkansas taxable income. Partnerships are required to allocate income to their partners. The Net Operating Loss Carryforward calculation is a separate calculation that must be performed by taxpayers under Arkansas law. The Taxpayer correctly completed its 2012 income tax return but failed to properly calculate the Net Operating Loss Carryforward which requires removal of income not taxable in Arkansas. The mere inclusion of out-of-state partnership income prior to deducting it out does not equate to taxation of those proceeds within Arkansas. The Net Operating Loss Carryforward was a deduction claimed by the Taxpayer. The Department did not adjust the Taxpayer's reported income.

B. Assertions of the Tax Director

The Director asserted that the Taxpayer should not be double taxed on its income. The deduction resulted from losses calculated within a prior tax year. He asserted that the out-of-state partnership income is taxable income because it is taxed in other states, even if that income is not taxed within Arkansas. Nontaxable income only includes income that is taxed by no other jurisdiction, like municipal bond interest. He also stated that the out of state partnership income was allocated to Arkansas even if later deducted out of the gross income for Arkansas. The Tax Director calculated the Taxpayer's taxable income based on the governing rules. He noted that the Department agreed with the Taxpayer's calculation of net income/loss on the 2012 income tax return. The Department never requested detail regarding where the out of state income was allocated.

C. Assertions of Department's Representative

The Department's Representative initially conceded that an adjustment to interest was required under Ark. Code Ann. § 26-18-405(d)(1)(C) (Repl. 2020). She highlighted that the adjustment at issue involved a tax deduction. As a tax deduction, she declared that the Taxpayer bore the burden of proof in this matter with doubts resolved against the application of the deduction. Only the claimed Net Operating Loss Carryforward Deduction was adjusted on the 2015 income tax return. The out of state partnership income was removed and not taxed within Arkansas for the 2012 tax year due to its exclusion from Arkansas gross income. The Department does not know whether the out of state partnership income was actually taxed in other jurisdictions. She asserted that the governing code provision is clear that such income must be removed during the calculation of the carryforward deduction. She concluded by asserting that this matter was decided by the Arkansas Supreme Court in the decision of *St. Louis Southwestern Railway v. Ragland*, 304 Ark. 1, 800 S.W.2d 410 (1990).

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 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 ("UDITPA") 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 is addressed in Ark. Code Ann. § 26-51-427(2) (Repl. 2020), which states the following in relevant part:

> (2) As used in this section, "net operating loss" means the excess of allowable deductions over gross income for the taxable year, subject to the following adjustments:
> (A) **There shall be added to gross income all nontaxable income not required by law to be reported as gross income less any expenses properly and reasonably incurred in earning nontaxable income, which expenses would otherwise be nondeductible;**
> (B) In the case of a taxpayer other than a corporation, deductions, not including federal income taxes, not attributable to the operation of the trade or business, are eliminated from the deductions otherwise allowable for the taxable year to the extent that they exceed gross income not derived from trade or business. Personal exemptions and credit for dependents are not a deduction for the purpose of computing a net operating loss;
> (C) A net operating loss deduction shall not be allowed; and
> (D) In the case of a taxpayer other than a Subchapter C corporation, as defined in 26 U.S.C. § 1361, as in effect on January 1, 1985;
> (i) The amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includable on account of gains from sales or exchanges of capital assets; and

(ii) The deduction for long-term capital gains provided by 26 U.S.C. § 1202 [repealed], as in effect on January 1, 1985, shall not be allowed; and . . .. [Emphasis supplied.]

Additionally, Ark. Code Ann. § 26-51-802(c) (Repl. 2020) addresses the apportionment of partnership income, stating:

(1) A partnership that files an Arkansas partnership return and has income from both within and without Arkansas shall apportion income to Arkansas under the Uniform Division of Income for Tax Purposes Act, § 26-51-701 et seq.
(2) Subject to the provisions of § 26-51-202(e), all partnership income from activities within this state shall be allocated to this state by each partner as determined and reported on the Arkansas partnership return.
(3) If the apportionment of income by a partnership having income from both within and without Arkansas does not fairly represent the extent of the partnership's business activity in this state, the partnership may petition for or the Secretary of the Department of Finance and Administration may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
   (A) Separate accounting;
   (B) The exclusion of any one (1) or more factors;
   (C) The inclusion of one (1) or more additional factors that will fairly represent the taxpayer's business activity in this state; or
   (D) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's partnership income.

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 § 1.26-51-802(b) states the following:

1.26-51-802(b) Corporations with Partnership Interest

Any taxpayer with an interest in a partnership which has gross income from sources within Arkansas must directly allocate the partnership's Arkansas income to Arkansas, rather than include partnership income and apportionment factors in the taxpayer's apportionment formula.

Example:

Partnership Total Income	$100,000
Partnership Income Directly Allocated to Arkansas	$50,000
Corporation A's Ownership	10%
Corporation B's Ownership	90%

Corporation A: $50,000 x .10 = $5,000
Corporation B: $50,000 x .90 = $45,000

The amount of partnership income directly allocated to Arkansas will be entered on page 1 of the "Other Income" line or on page 2, Schedule A, Part C, "Direct Income Allocated To Arkansas" line of Form AR1100CT.

If the taxpayer's operations are multistate, all partnership income must be deducted on Schedule A, Part A, "Deduct Adjustments" line. The partnership's Arkansas income should then be entered on Schedule A, Part C, "Direct Income Allocated To Arkansas" line of Form AR1100CT.

Further, in *Kansas City Southern Ry. Co. v. Pledger*, 301 Ark. 564, 785 S.W.2d 462 (1990), the Arkansas Supreme Court addressed the non-inclusion of nontaxable intercompany dividend income received from an subsidiary (which filed a separate Arkansas income tax return) in the calculation of a taxpayer corporation's calculation of its net operating loss. In that instance, such dividends were specifically excluded from the definition of gross under Arkansas law. Since the intercompany dividends were exempted under Arkansas law, the Arkansas Supreme Court asserted that such income must be added back in the calculation of the Arkansas net operating loss.

In *St. Louis Southwestern Railway v. Ragland*, 304 Ark. 1, 800 S.W.2d 410 (1990), the Arkansas Supreme Court addressed whether nonbusiness income allocated to other states under the Uniform Division of Income for Tax Purposes Act and excluded from gross income within Arkansas needed to be added back for the calculation of a Net Operating Loss Carryforward for Arkansas income tax purposes. The Arkansas Supreme Court specifically rejected the argument that "nontaxable income" for purposes of calculation of a Net Operating Loss Carryforward did not include income that, though excluded from taxation within Arkansas, had to be reported to other jurisdictions as income. *Id.* at 3-4, 800 S.W.2d at 412. In rejecting that taxpayer's argument, the Court stated the following:

> The result we reach is identical to our recent decision in *Kansas City So. Ry. Co. v. Pledger,* 301 Ark. 564, 785 S.W.2d 462 (1990). At issue in *Pledger* was certain dividend income specifically excluded from the term "gross income," and thus nontaxable, under section 26–51–404(b). We held that section 26–51–427 mandates inclusion of all nontaxable income in the calculation of net operating loss.
>
> Likewise, under our reasoning above, the income at issue here was nontaxable and was not required to be reported as gross income for Arkansas tax purposes under the UDITPA. The difference lies only in the statute which makes the income nontaxable and excludes it from gross income reporting.

Id. at 3-4, 800 S.W.2d at 412.

Similar to the nonbusiness income at issue in *St. Louis Southwestern Railway*, the partnership income at issue in this matter was not taxed within Arkansas but allocated to other states. As such, it would qualify as nontaxable income within Arkansas even though such income may or may not be taxable in the other jurisdictions. As nontaxable income, it must be added back during the calculation of the Net Operating Loss Carryforward under the binding authority of Ark. Code Ann. § 26-51-427(2)(A) (Repl. 2020) and the *St. Louis Southwestern Railway* case.

The Taxpayer's Representative asserted that the Taxpayer is being subjected to double taxation of the partnership income; however, that assertion is not persuasive. The record does not support a finding that the partnership income at issue was taxed by the State of Arkansas. Further, even if double taxation was implicated, administrative tribunals, such as the Office of Hearings and Appeals, do not have jurisdiction or authority to overturn a statute based on constituionality. See generally *Arkansas Tobacco Control Bd. v. Sitton*, 357 Ark. 357, 166 S.W.3d 550 (2004).

Failure to Pay Penalty

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

> In case of failure to pay the amount shown as tax on any individual income tax return required to be filed, 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 one percent (1%) of the amount of the tax if the failure is for not more than one (1) month, with an additional one percent (1%) 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, based on the presented evidence, the Taxpayer failed to properly calculate and remit its Arkansas tax liability. That error was contrary to clear statutory language and on point decisions from the Arkansas Supreme Court. The lack of knowledge of a publicly stated legal requirement cannot be recognized as a defense to its enforcement as all individuals are presumed to know the law. *Barlow v. US*, 32 U.S. 404, 411 (1833); *see also State v. Simmons*, 1 Ark. 265, 266 (1839). The assessment of the failure to pay penalty is sustained with respect to the assessment.

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).

DECISION AND ORDER

Subject to the adjustment required under Ark. Code Ann. § 26-18-405(d)(1)(C) (Repl. 2020), 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 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 (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.[4]

OFFICE OF HEARINGS & APPEALS

TODD EVANS
ADMINISTRATIVE LAW JUDGE

DATED: April 26, 2021

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