

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

**IN THE MATTER OF [REDACTED]
ACCOUNT ID: [REDACTED]**

DOCKET NOS.: 22-154 (2014)

22-155 (2015)

22-156 (2016)

**CORPORATE INCOME TAX
ASSESSMENTS**

[REDACTED]¹

AUDIT NO.: [REDACTED]

LETTER ID: [REDACTED]

[REDACTED]²

AUDIT NO.: [REDACTED]

LETTER ID: [REDACTED]

[REDACTED]³

AUDIT NO.: [REDACTED]

LETTER ID: [REDACTED]

**TODD EVANS, ADMINISTRATIVE LAW JUDGE⁴
APPEARANCES**

This case is before the Office of Hearings and Appeals upon written protests dated September 10, 2021, signed by [REDACTED], Tax Director, on behalf of [REDACTED], the Taxpayer. The Taxpayer protested assessments of corporate income tax issued by the Department of Finance and Administration (“Department”). The Department was represented by Brad Young, 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 September 24, 2021. The Department’s Representative filed his Opening

¹ This amount represents [REDACTED] (tax), [REDACTED] (failure to file penalty) and [REDACTED] (interest).

² This amount represents [REDACTED] (tax), [REDACTED] (failure to file penalty), and [REDACTED] (interest).

³ This amount represents [REDACTED] (tax), [REDACTED] (failure to file penalty), and [REDACTED] (interest).

⁴ This matter was originally assigned to Ray Howard, Administrative Law Judge, but was reassigned on March 16, 2022.

Brief on October 22, 2021. The Taxpayer did not file a response brief but its protest was received into evidence. On December 6, 2021, the Department's Representative informed this Office that he did not intend to file a reply brief. The record was closed and this matter was submitted for a decision on December 7, 2021.

ISSUE

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

FACTUAL AND LEGAL CONTENTIONS OF THE PARTIES

A. Tax Director's Protest

Initially, the Tax Director questioned whether the Taxpayer had nexus with the State of Arkansas since it did not have business operations within Arkansas or deploy capital or resources within the State during the audit period. The Tax Director also asserted that, even if nexus was present, sales would be sourced outside of Arkansas under the costs of performance methodology. He explained that the Taxpayer receives revenue from the performance of services, particularly the provision of an [REDACTED]. He explained that all activities performed by the Taxpayer to [REDACTED] occur outside of Arkansas. He deemed the activities of end customers to be irrelevant to the sourcing of the Taxpayer's sales. Finally, the Tax Director contended that the costs of performance method fairly reflected the Taxpayer's business activity within Arkansas since the Taxpayer had no business activity within Arkansas.

B. Opening Brief

Within his Opening Brief, the Department's Representative provided a general overview of this matter, stating as follows⁵:

This protest arises from a Multistate Tax Commission ("MTC")⁶ audit of the books and records of [REDACTED].⁷ The Taxpayer is a [REDACTED] The audit included tax years 2014-2016.

The Taxpayer provides an [REDACTED] [REDACTED] The Taxpayer does not charge a fee to list items on [REDACTED] The Taxpayer earns income by [REDACTED] on every completed sale. The Taxpayer provided the MTC with a schedule of sales by state, which included Arkansas sales. The MTC used this taxpayer-provided information to calculate the assessment.⁸

The MTC completed its audit report on July 2, 2021.⁹ On July 19, 2021, the Department accepted the MTC report and issued Summaries of Findings.¹⁰ The Department issued Notices of Proposed Assessment on July 20, 2021.¹¹ The Taxpayer timely filed this protest.

Addressing the issue of nexus, the Department's Representative asserted that taxpayers generally create nexus once their activities exceed mere solicitation of orders, citing 15 U.S.C. § 381. He highlighted the various ways that ecommerce has complicated physical presence within a state as discussed within *South Dakota v. Wayfair, Inc.*, 138 S.Ct. 2080 (2018). He emphasized that physical presence is not required for a finding of nexus for income tax cases, noting that nexus may be established under the significant economic presence

⁵ All Exhibits support the statements for which they are cited.

⁶ In a footnote, the Department's Representative provided additional detail regarding the nature of the MTC that is not necessary for a decision in this matter.

⁷ The Department's Representative cited Exhibit 1.

⁸ The Department's Representative cited Exhibit 1.

⁹ The Department's Representative cited Exhibit 1.

¹⁰ The Department's Representative cited Exhibits 2 through 4. Based on the totality of the record, it appears that assessed income [REDACTED] was apportioned to Arkansas based on the location of end customers for purchases through the marketplace.

¹¹ The Department's Representative cited Exhibits 5 through 7.

test that considers the degree of exploitation of a local market, the type and amount of economic presence, and the frequency and systematic nature of an entity's economic contacts. He emphasized that more than [REDACTED] in income was generated through sales with Arkansas customers over the audit period and the constant and systematic access maintained for Arkansas customers. He explained that the income was generated [REDACTED] earned on [REDACTED] [REDACTED] The Department's Representative concluded that substantial nexus with Arkansas existed.

Addressing the sourcing of sales revenue from digital products, the Department's Representative stated the Taxpayer must apportion such sales based upon the location where end consumers access and purchase the items that are sold (characterized as the income producing activity), citing Ark. Code Ann. § 26-51-717 (Repl. 2020). He rejected the Taxpayer's argument that the activities of purchasers are irrelevant because those activities are not performed by the Taxpayer. The Department explained that, if the activities of the end customers did not occur, no commissions would be earned by the Taxpayer. The Department's Representative emphasized that the mere posting of items for sale does not earn any income for the Taxpayer. The Department's Representatives concluded that the Department's approach was more in line with *DIRECTV, Inc. v. S.C. Dep't of Revenue*, 421 S.C. 59, 804 S.E.2d 633 (S.C. Ct. App. 2017) which only considered actual income producing activities, not income anticipatory activities, for purposes of apportionment. In further support of his position, the Department's Representative cited *AT&T Corp. v. Dept. of Revenue*, 357 Or. 691,

358 P.3d 973 (2015). He reiterated that the income is only earned when

[REDACTED].

In the alternative, the Department's Representative contended that the assessment methodology would otherwise be appropriate as an alternative apportionment method under Ark. Code Ann. § 26-51-718 (Repl. 2020). He averred that the non-inclusion of any of the income in Arkansas would not fairly represent the Taxpayer's business activity in the state since the income is earned as a result of intrastate activities. As a discretionary action of the Department, he instructed that the assessment methodology must be upheld so long as it is not arbitrary, capricious, or fraudulent. Additionally, he argued that the Department's assessment is similar to the alternative apportionment methodologies and assessments upheld in Docket Nos. 19-420 and 21-408.

After a general discussion of the burdens of proof in tax proceedings, a legal analysis 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.

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).

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). Ark. Code Ann. § 26-51-102(17) (Supp. 2021) defines the term “taxpayer” to include any individual, fiduciary, or corporation subject to the Arkansas income tax.

1. Nexus

Nexus is a term used to describe the connection existing between a taxing authority and an out-of-state taxpayer to constitutionally allow the imposition of a state tax upon the out-of-state taxpayer. The legitimacy of a state's tax imposition on an out-of-state taxpayer is tested for corporate income tax purposes under the Commerce Clause of the U.S. Constitution. See *KFC Corporation v. Iowa Department of Revenue*, 792 N.W.2d 308 (2010).¹² Initially, 15 U.S.C. § 381 prevents application state income taxes when a taxpayer's intrastate activities are limited to mere solicitation of orders. Here, the record supports a finding that the Taxpayer created an [REDACTED]
[REDACTED]
[REDACTED]. These activities exceed the mere solicitation of orders within Arkansas. Consequently, the requirements of 15 U.S.C. § 381 have been satisfied.

For Arkansas Corporate Income Tax purposes, the “significant economic presence test” established in *Tax Commissioner of the State of West Virginia v. MBNA America Bank*, 220 W.Va. 163, 640 S.E.2d 226 (2006), cert. denied 551 U.S. 1141 (2007), is used to determine the existence of substantial nexus under the Commerce Clause. See *MBNA v. Indiana Dep't of State Rev.*, 895 N.E.2d 140 (Ind. Tax 2008); *Bridges v. Geoffrey, Inc.*, 984 So.2d 115 (La.App. 1 Cir. 2008); *Lanco, Inc. v. Dir. Of Taxation*, 908 A.2d 176 (N.J. 2006); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004); *Geoffrey, Inc. v. Oklahoma Tax*

¹² The Taxpayer’s Representative correctly noted that *South Dakota v. Wayfair*, 138 S.Ct. 2080 (2018) was not decided until after the audit period. The concept of nexus through significant economic presence, however, was well established during the audit period.

Comm'n, 132 P.3d 632 (Okla. Civ. App. Div. 1 2005); *Capital One v. Comm'r of Rev.*, 899 N.E.2d 76 (Mass. 2009); and *Geoffrey, Inc. v. Comm'r of Rev.*; 899 N.E.2d 87 (Mass. 2009). The “significant economic presence test” requires the analysis of the following factors: the degree to which an entity exploited a local market; the quality and quantity of the entity’s economic presence; and the frequency, quantity, and systematic nature of the entity’s economic contacts with the taxing jurisdiction. *MBNA*, 640 S.E.2d, at 234. Trivial, infrequent, and inconsequential contacts are de minimis in nature failing to meet the substantial economic presence requirement. Utilizing these factors, nexus determinations are made on a “case by case” basis.

Here, the record establishes that the Taxpayer [REDACTED] with Arkansans [REDACTED]. It appears that [REDACTED] to Arkansas customers during the audit period. Further, [REDACTED] [REDACTED] with Arkansas customers [REDACTED]. I cannot dismiss the Taxpayer’s activities as trivial, infrequent, or inconsequential. Consequently, a sufficient showing of nexus has been established.

2. Apportionment of Commissions

The State of Arkansas has adopted the Uniform Division of Income for Tax Purposes Act (“UDITPA”). Ark. Code Ann. § 26-51-701 et seq. (Repl. 2020). In *Pledger v. Getty Oil Exploration Co.*, 309 Ark. 257, 831 S.W.2d 121 (1992), the Court stated that:

[UDITPA] governs the manner in which Arkansas may impose income and franchise taxes on the earnings of multistate and multinational

corporations doing business in the State. UDITPA is designed to fairly apportion among the states in which a corporation does business the fair amount of regular business income earned by the corporation's activities in each state. Under UDITPA, net taxable business income of a corporate taxpayer involved in a multistate business is apportioned by a well-recognized three-factor formula consisting of tangible property, payroll, and sales.

Id. at 261 - 262, 831 S.W.2d at 124.

Even if I accept (but do not approve) the Taxpayer's argument that [REDACTED]

[REDACTED] should be considered in the costs of performance analysis under the statutory apportionment methodology, the Department's secondary argument that alternative apportionment would be warranted is persuasive and supports sustaining this portion of the assessment.

Pursuant to Ark. Code Ann. § 26-51-718 (Repl. 2020), a taxpayer may petition for or the Secretary of the Department may require a Taxpayer to utilize an alternative apportionment method when Arkansas's UDITPA provisions do not fairly represent a taxpayer's Arkansas business activities and provides as follows:

If the allocation and apportionment provisions of this subchapter do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Director 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 of the factors;
- (c) The inclusion of one (1) or more additional factors which 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 income.

The Arkansas Supreme Court has explained that the Secretary of the Department has "discretionary power" to employ an alternative method of

apportionment if the statutory apportionment method does not fairly represent the extent of the Taxpayer's business activity in the State of Arkansas. *Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 865, 935 S.W. 2d 252, 256 (1996). As a discretionary function of the Secretary's office, the action of the Secretary will only be set aside should there be an abuse of that discretion. *Kale v. Arkansas State Medical Board*, 367 Ark. 151 (2006). Discretionary actions must be sustained unless those actions are shown to be fraudulent, arbitrary, or capricious. *Leathers v. Jacuzzi, Inc.*, 326 Ark. 857, 866, 935 S.W. 2d 252, 257 (1996).

Here, the Taxpayer's Representative asserted that the Taxpayer has no business activity within the state. That characterization, however, ignores the presented evidence that the Taxpayer [REDACTED]

[REDACTED]
[REDACTED]
[REDACTED] The record demonstrates that the Taxpayer's revenue is determined by the [REDACTED] including those individuals located within Arkansas. Additionally, based on the Taxpayer's interpretation of the statutory apportionment, none of the [REDACTED]
[REDACTED] from Arkansas customers would be apportioned to Arkansas. Such a result would not reflect an apportionment of the Taxpayer's income that fairly reflects its business activities within Arkansas. This finding is also in line with prior decisions from this Office that were based upon similar fact patterns. See Docket Nos. 19-420 and 21-408.

Apportionment of the sales commissions based on the end customers' locations is a reasonable method. Ark. Code Ann. § 26-51-718 (Repl. 2020) allows the Department to utilize a reasonable apportionment methodology and does not require a perfect methodology. As a discretionary action, the Department's apportionment method must be upheld so long as it was not performed capriciously, arbitrarily, or fraudulently. The record does not support a finding that any of these requirements were met. Consequently, the Department's alternative apportionment of the commissions is sustained even if the apportionment of that income to Arkansas contradicted the statutory method.¹³

Failure to File Penalty

A Failure to File Penalty was assessed for the relevant tax years. Ark. Code Ann. § 26-18-208(1) (Repl. 2020) provides as follows:

In the case of a taxpayer's failure to file any return required by any state tax law on or before the date prescribed determined with regard to any extension of time for filing the return, unless it is shown that the failure is due to reasonable cause and not to willful neglect, there shall be added to the amount required to be shown as tax on the return five percent (5%) of the amount of the tax if the failure is 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

Under the above analysis, the Taxpayer was required to timely file Arkansas income tax returns to report its taxable income for the relevant tax years but failed to do so. Additionally, lack of knowledge of publicly available statutes and rules cannot be recognized as a defense to their application. 29 Am. Jur. 2d Evidence 290; see also *Edward v. US*, 334 F.2d 360 (1964) and *Jellico*

¹³ Since this conclusion resolves the assessment of this type of income, the Department's alternative argument for sustaining the assessment of this income shall not be addressed as it is rendered moot.

Coal Min. Co. v. Commonwealth, 96 Ky. 373, 29 S.W. 26 (Ky. App. 1895). The assessment of the Failure to File Penalty for the relevant tax years is sustained based on the presented record.

Interest

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 tax balance is sustained.

DECISION AND ORDER

The assessment issued against the Taxpayer 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.¹⁴

OFFICE OF HEARINGS & APPEALS



TODD EVANS

ADMINISTRATIVE LAW JUDGE

DATED: March 24, 2022

¹⁴ See *Board of Trustees of Univ. of Arkansas v. Andrews*, 2018 Ark. 12.