

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

ADMINISTRATIVE DECISION

IN THE MATTER OF

ACCT. NO.: [REDACTED]

**REFUND CLAIM
DISALLOWANCES
(Corporate Income Tax)**

DOCKET NOS.: 16-267
16-268
16-269

**TAX YEAR ENDING: 03/11
(\$ [REDACTED])
TAX YEAR ENDING: 03/12
(\$ [REDACTED])
TAX YEAR ENDING: 03/13
(\$ [REDACTED])**

RAY HOWARD, ADMINISTRATIVE LAW JUDGE

This case is before the Office of Hearings and Appeals upon a written protest dated September 15, 2015, signed by [REDACTED] on behalf of [REDACTED] the Taxpayer. The Taxpayer protested the denial of refund claims by the Department of Finance and Administration (“Department”). The Audit ID Number is [REDACTED].

A telephone hearing was held on March 2, 2016, at 10:00 a.m., in Little Rock, Arkansas. The Department was represented by Gina Dougherty, Attorney at Law, Office of Revenue Legal Counsel (“Department’s Representative”). Present for the Department were Robert Trinidad - Tax Auditor, Faye Husser - Audit Supervisor, and Scott Fryer – Manager/Corporate Income Tax Section. The Taxpayer was represented by [REDACTED] and [REDACTED] ([REDACTED] collectively, “Taxpayer’s Representatives”). The record remained open until May 4, 2016, for the submission of additional letter briefs.

FINDINGS OF FACT/CONTENTIONS OF THE PARTIES

The Taxpayer is engaged in the business of selling [REDACTED] and [REDACTED]

[REDACTED]. The Department's Answers to Information Request provided, as follows:

. . . The Taxpayer sells the services both within and without the State of Arkansas.

[REDACTED] filed amended returns for the tax years ending March 31, 2011, March 31, 2012 and March 31, 2013 to change their method of calculating the Arkansas numerator in the sales factor from a market based sourcing method to a cost of performance sourcing method. Commensurate with the filing of the amended returns, the Taxpayer requested refunds for the tax years in question.

The Department denied the refunds requested on the amended returns. The Department's position is that the method of sourcing services income on the Taxpayer's original returns more clearly and accurately reflected the Taxpayer's business activity in Arkansas for the sales related to those services than the cost of performance method used by the Taxpayer when it amended its returns.

. . .

. . . The Taxpayer states that all of its costs related to the income producing activities from the provision of services occur outside the State of Arkansas. Therefore, the Taxpayer adjusted the sales apportioned to the State of Arkansas to remove receipts from any activities occurring outside of Arkansas.

This is not the law. It appears that at least one of several revenue streams the Taxpayer derives from Arkansas is being excluded from the numerator of the sales factor on the amended returns. Thus, the Taxpayer seems to argue that the cost of performance test is an all or nothing test. This methodology results in a distortion of income by ignoring the location of the Taxpayer's customers and where its [REDACTED] are being used. While cost of performance may be an accepted accounting principle to determine where income is earned, allocating income solely to states having the Taxpayer's employees and property is unreasonable.

The Department is well within its discretion under Ark. Code Ann. § 26-51-718 to require the Taxpayer to continue to use the market-based sales sourcing method it has used in the past. The Taxpayer cannot demonstrate how its proposed new method of calculating its sales factor based upon cost of performance for income apportionment purposes accurately reflects the Taxpayer's business activity in Arkansas. Until it can and does, the Taxpayer's former method of calculating its sales factor under the market-based approach for income apportionment more accurately reflects the Taxpayer's business activity in Arkansas. [P. 2-5].

The Taxpayer's Answers to Information Request provides, in pertinent part, as follows:

. . . While Taxpayer performs installation services at a customer's location, it performs the activities associated with [REDACTED] at locations outside the State of Arkansas. None of the activities associated with [REDACTED] occur within Arkansas, nor are any costs or expenses associated with these services incurred in Arkansas.

The following descriptions set forth the definition of [REDACTED], including the activities associated with each. Each of these services is billed separately to Taxpayer's customers and Taxpayer separately accounts for each revenue item.

. . .

[REDACTED] include, but are not limited to, [REDACTED], [REDACTED], and [REDACTED]. Customers pay an initial fee and an annual [REDACTED] so that Taxpayer employees continually monitor the functionality and performance of [REDACTED]. During this analysis, employees constantly repair, maintain, and fix the [REDACTED] to ensure optimum performance for customers who are able to [REDACTED] these measures into [REDACTED].

. . .

Taxpayer employees provide [REDACTED] to customers to allow customers to [REDACTED] create [REDACTED] for submission to certain approved [REDACTED] and/or [REDACTED].

. . .

Taxpayer also offers [REDACTED] which include the use of [REDACTED] to outsource [REDACTED]. These [REDACTED] services are provided using Taxpayer's out-of-state [REDACTED] and employees.

...

In Arkansas, Taxpayer's employees located in the state do not perform any services related to [REDACTED]. The revenue generated from the Arkansas employee activities, and expenses incurred relating to the employee activities, are not being excluded in Taxpayer's refund request — only revenue generated from the aforementioned services performed outside the state.

...

Taxpayer readily admits that it has payroll in the state of Arkansas, but this payroll is not associated with the individual items of income Taxpayer seeks to source outside the state. Taxpayer directly engages in activities associated with [REDACTED] wholly outside the state of Arkansas. All costs of personnel, personal property, real property, and other expenses, including the physical activities required to perform these services, are conducted outside of Arkansas.

...

From its response to Taxpayer's request for refund seeking to correctly apportionment income from other than tangible personal property according to Arkansas law, it appears the Department seeks to invoke alternative apportionment but without providing an argument why it seeks to invoke alternative apportionment. The Department simply claims that it is Taxpayer's burden to illustrate why Taxpayer should be allowed to correctly apportion its income according to Arkansas statute and claiming that the Department thinks sourcing receipts to the market that receives the benefit is correct. First, it is the Department that seeks to alternatively apportion receipts and deviate from Arkansas statute, so it is the Department's burden to show why this is appropriate. Second, seeking alternative apportionment would be contrary to the legislature's intent when legislating how to apportion income and should only be invoked when statutory apportionment runs afoul of constitutional limitations or in "unusual cases."

...

Quite simply, it is the Department's duty to show by clear and convincing evidence, if not more, that alternative apportionment is warranted in this matter. Taxpayer's business activities are fairly reflected by the current apportionment methodology, because the

sales factor includes revenue derived from [REDACTED] services actually performed in the state and from sales of tangible personal property in the state, among other items sourced to Arkansas based upon Taxpayer's income producing activities occurring in the state. Removal of revenue derived from [REDACTED] [REDACTED] is in keeping with the law and the legislature's intent that sales be apportioned to the state based upon the taxpayer's business activities and not the market that receives the benefit.

The Department's position is arbitrary and capricious and seeks to undermine both the intent of the legislature and the intent of UDITPA. Until the Department can meet its burden to show otherwise, Taxpayer has no burden to show that it is not entitled to a refund based upon a corrected apportionment methodology that is in line with Arkansas law regarding the receipts derived from other than tangible personal property. [P. 2-7].

The Department's Supplement to Answers to Information Request provided, in part:

The method originally used by the Taxpayer effects an equitable allocation and apportionment of the Taxpayer's income. . . . [The Department's] position that the Taxpayer continue to employ the method it has used in the past has a rational basis.

. . .

Indeed, were it not for the fact that the Taxpayer has some revenue streams that require it to source some sales to Arkansas and that it has payroll in Arkansas, the Arkansas sales factor would be zero, which would obviously not be a clear reflection of the extent of the Taxpayer's business activity in Arkansas. The Taxpayer is now saying that three of their four revenue streams have no income producing activity in Arkansas so therefore do not have to apportion those sales to Arkansas at all. Sourcing zero sales from those revenue streams that are clearly not protected from taxation by Federal Public Law 86-272 is not a better reflection of the Taxpayer's business activities in Arkansas.

Ark. Code Ann. § 26-51-717 provides that an average apportionment factor is calculated for all activity in Arkansas excluding the sales from intangibles or services and then that average factor is applied to intangible and service sales. It is clear from the additional evidence that the Taxpayer is using a more traditional approach of an all or nothing cost of performance test for some of their revenue

streams rather than recalculating the sales factor for those items at an average apportionment factor derived from the other revenue streams. [P. 2-3].

The Taxpayer's Representatives asserted the Department does not contest the fact that all of the services, related to the sales that have been removed from the sales numerator, are performed outside of the State of Arkansas. The Department's Representative agreed with the assertion.

The Department argued that if the Taxpayer's customers did not purchase [REDACTED] the customers would not be able to obtain any services from the Taxpayer. The Taxpayer's Representatives stated that there would be no reason for the services to be provided without the [REDACTED] but the Taxpayer's Representatives could not say for sure that customers cannot obtain services without having the [REDACTED].

The Manager of the Corporate Income Tax Section testified that: (1) initially the Department denied the refund claims based upon a lack of information; (2) the Taxpayer has now provided information to explain the reasons for the amended returns; (3) in the amended returns, the Taxpayer is sourcing one revenue stream to Arkansas based on the location of customers and the other revenue streams for services are based on where the income producing activities occurred and none of that income was apportioned to Arkansas; (4) the amended returns would effectively exempt the revenue streams for services from income taxation in Arkansas even though no such exemption exists under the statutory law of Arkansas; (5) the Department determined that there should be an alternative method to apportion income to Arkansas because there is no exemption for the relevant services allowed in Arkansas; (6) the Department

concluded that a market-based sourcing method is the more accurate method because there is no exemption for services provided in Arkansas so there must be an expectation that some of the income must be apportioned and taxed in Arkansas since the Taxpayer has customers in Arkansas who need the Taxpayer's [REDACTED] to access other services; (7) a market-based sourcing fairly represents the Taxpayer's interaction with its customers in Arkansas and there is factor relief for the income-producing activities through the property and payroll factors (those factors are still counted as one-half of the apportionment in Arkansas since there is a double-weighted sales factor and those factors would be zero since the activities do not occur in Arkansas); (8) with respect to the service-related income sources, since the Taxpayer does not have property or payroll in Arkansas those factors have already been pulled out of the apportionment formula; (9) members of the Multistate Tax Commission, such as Arkansas, have experienced more and more cases where alternative apportionment has to be used because the statutory method results in a distortion of the business activity of a taxpayer (either too much or too little) and market-based sourcing has been the solution to more fairly represent the business activity of the taxpayer; (10) in some cases, use of the statutory method of allocation will over-allocate income to a certain state; (11) use of alternative allocation does not always result additional tax liability; (12) in this case, the Taxpayer would be apportioning zero income from the three [3] sources under the proposed amended returns; (13) there is no hard and fast rule for use of market-based sourcing rather than cost of performance, a case-by-case analysis is utilized; (14) if income is not exempt it must be subject to tax and fairly apportioned and if the statutory method results

in zero, that is a defacto exemption; (15) with respect to goods, there is an exemption provided by federal law if a taxpayer does not have nexus with a state but services are not covered by the federal law; (16) an equitable apportionment is required for services and if the statutory method gives a taxpayer the same result as an exemption, that result is not what the statute intends because the income from the services is subject to income tax; (17) an apportionment should fairly represent a taxpayer's business activity; and (18) in this case, the result of the statutory method unfairly reflected the Taxpayer's income earned in Arkansas.

The arguments presented by the Taxpayer, the arguments presented by the Department, and a legal analysis are set forth below.

ISSUE

Whether the Department's denial of the Taxpayer's claim for refunds should be sustained? Yes.

CONCLUSIONS OF LAW

Standard of Proof

Ark. Code Ann. § 26-18-313(c) (Supp. 2015) addresses the burden of proof to be applied to matters of fact and evidence in this case and states, 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**. [Emphasis added].

A preponderance of the evidence means the greater weight of the evidence.

See 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 that:

[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.

Ark. Code Ann. § 26-18-507 (Repl. 2012) provides for a refund of any state taxes erroneously paid in excess of the taxes lawfully due. The Taxpayer bears the burden of proving by a preponderance of the evidence that the claimed refund was erroneously paid and in excess of the taxes lawfully due.

Refund Claims

The State of Arkansas has adopted the Uniform Division of Income for Tax Purposes Act (“UDITPA”). See Ark. Code Ann. § 26-51-701 et seq. (Repl. 2012). 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.

Pursuant to Ark. Code Ann. § 26-51-718 (Repl. 2012), a taxpayer may petition for or the Director of the Department may require a taxpayer to utilize an alternative apportionment method when the UDITPA provisions do not fairly

represent a taxpayer's Arkansas business activities. Ark. Code Ann. § 26-51-718 (Repl. 2012) 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 Director 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. See Leathers v. Jacuzzi, Inc., 326 Ark. 857, 935 S.W. 2d 252 (1996).

As a discretionary function of the Director's office, the action of the Director 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 arbitrary and capricious. Leathers v. Jacuzzi, Inc., 326 Ark. 857, 935 S.W. 2d 252 (1996).

In the instant case, by refusing to process the Taxpayer's amended returns, the Department is requiring the Taxpayer to utilize the market-based method of apportionment in lieu of the applicable statutory apportionment method. Under the facts and circumstances of this case, the testimony of the Manager of the Corporate Income Tax Section established that: (1) the cost of performance

methodology would not fairly and accurately represent the Taxpayer's business activity in the State of Arkansas; and (2) the market-based sourcing method originally used in the Taxpayer's tax returns, for pertinent years, more accurately reflects the Taxpayer's business activity in this state.

The Taxpayer's post-hearing brief discussed the relevant streams of income and stated, in part:

The Taxpayer has identified four separate items (streams) of income that it derives from Arkansas customers. It has then applies Regulations 1.26-51-717.1 and 1.26-51-717.2 to each item (stream) of income. None of the income producing activity is performed in Arkansas for the three items (streams) of income that the Taxpayer has excluded from the numerator of its Arkansas apportionment factor. [P. 3].

The Department's post-hearing brief addressed the Taxpayer's allocation of income and stated, as follows:

The Taxpayer admits that it makes numerous sales of [REDACTED] into the state. The Taxpayer attempts to report only the initial installation of [REDACTED] to Arkansas customers in the sales factor, but excludes sales from the continuing use of that [REDACTED], which facilitates customer [REDACTED] provided by the Taxpayer. The Department's allocation of income provides a more accurate reflection of the Taxpayer's business activity in Arkansas because it includes all four revenue streams earned from Arkansas customers in the Arkansas numerator. The Taxpayer's proposed allocation method ignores its interactions with its Arkansas customers for three out of four of those revenue streams. [P. 1].

It is undisputed that the market-based methodology for calculating the Taxpayer's income tax is consistent with the methodology used by the Taxpayer in its original income tax returns for the relevant periods. The fact that the Taxpayer originally used this apportionment method would suggest that the Department's request for the Taxpayer to calculate its returns based on market-

based sourcing of its interstate sales of services is not an unreasonable methodology to utilize. The testimony of the Manager of the Corporate Income Tax Section established that it was reasonable for the Department to require the Taxpayer to utilize the market-based method of apportionment in lieu of the applicable statutory apportionment method.


The evidence did not establish that the Department abused its discretion by requiring the use of the market-based apportionment method to calculate the Taxpayer's Arkansas Corporation Income Tax liability. Consequently, the Taxpayer failed to prove entitlement to the requested refunds by a preponderance of the evidence.

DECISION AND ORDER

The refund claim denials 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 (Supp. 2015), 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 - Policy & Legal, P.O. Box 1272, Rm. 2440, Little Rock, Arkansas 72203. 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. The Taxpayer may seek relief from the final decision of the Administrative Law Judge or the Commissioner of Revenues on a final notice of a denial of a claim for

refund by following the procedure set forth in Ark. Code Ann. § 26-18-406 (Supp. 2015).

OFFICE OF HEARINGS & APPEALS

A handwritten signature in cursive script, appearing to read "Ray Howard", is written over a horizontal line.

RAY HOWARD
ADMINISTRATIVE LAW JUDGE

DATED: June 21, 2016