

11-313 XXXXXXXXXXXX

See Reply to Revision Request

IN THE MATTER OF
XXXXXXXXXXXX
CORPORATE INCOME TAX ASSESSMENT & REFUND CLAIM DENIAL
DOCKET NO. 11-312 01/01/06 THRU 12/31/06
11-313 01/01/06 THROUGH 12/31/06
ACC. NO. XXXXXXXXXXXX
\$XXXXXXXXXXXX (REFUND)
\$XXXXXXXXXXXX (ASSESSMENT)
RICK PRUETT, ADMINISTRATIVE LAW JUDGE

APPEARANCES

This case is before the Office of Hearings & Appeals upon a written protest dated July 24, 2009, signed by XXXXXXXXXXXX, on behalf of XXXXXXXXXXXX, the Taxpayer. The Arkansas Corporate Income Tax Assessment and Refund Claim Denial were made by the Department of Finance and Administration as the result of an audit conducted by Paul Allen, Auditor, Corporate Income Tax.

The hearing was held on Wednesday, June 8, 2011, at 1:30 P.M. in Little Rock, Arkansas. The Department was represented by David Alexander, Attorney at Law, Revenue Legal Counsel. Appearing for the Department were Dennis Chisom, Auditor; and Faye Husser, Audit Supervisor. The Taxpayer was represented by XXXXXXXXXXXX, Attorney at Law.

Post-hearing briefs were submitted by the Parties. The Taxpayer submitted a brief dated July 11, 2011. The Department filed an opening brief on August 11, 2011. A Rebuttal was submitted by the Taxpayer to which the Department filed a Response on September 19, 2011. This matter was submitted for decision on September 20, 2011.

ISSUE

Whether the Taxpayer has established entitlement to the claimed refund of Corporate Income Tax? No.

FINDINGS OF FACT

In 2006, the Taxpayer sold XXXXXXXXXXXX division to XXXXXXXXXXXX. The sale was consummated at the Taxpayer's headquarters in XXXXXXXXXXXX state. XXXXXXXXXXXX manufactured and sold consumer products such as over-the-counter drugs, health and beauty aids, etc. XXXXXXXXXXXX also licensed third-parties to use copyrights and patents to manufacture and sell similar products.

The Taxpayer timely filed an Arkansas Corporate Income Tax return for tax year ending December 31, 2006. The original return was amended on two (2) occasions, once in January 2008 and later in January 2009. Based on the amended return(s), the Taxpayer sought a refund of \$XXXXXXXXXXXX. Following an adjustment by the Department, the Department issued a Notice of Proposed Assessment in the amount of \$XXXXXXXXXXXX plus interest. The Taxpayer timely protested.

As originally filed, the Taxpayer reported a sale factor of .3083%. The amended return reported a sales factor of .2554%. The resulting change altered the overall formulary appointment percentage from .2297% to .2027%, a change which the Taxpayer regarded as de minimis. See Protest, Taxpayer Basis for

Objection to the Assessment. The second amended return was filed as the original return excluded the proceeds from the sale of XXXXXXXXXXXX.

CONCLUSIONS OF LAW

Applicable Law

The Arkansas Corporation Income Tax Rules provide, in part:

2.26-51-715. Exceptions.

1. Where substantial amount of gross receipts arise from an occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor if such receipts will materially distort the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.
2. Where the income producing with respect to business income from intangible personal property can be readily indentified, the income is included in the denominator of the sales factor and, if the income producing activity occurs in Arkansas, in the numerator of the sales factor as well. For example, usually the income producing activity can be readily identified with respect to interest income received on deferred payments on sales of tangible property and income from the sale, licensing or other use of intangible personal property.

Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible person property by the taxpayer, the dividends and interest shall be excluded from the denominator of the sales factor.

Analysis

The Arkansas Corporate Income Tax Rules contain two (2) sections. The first section numbered 1.26-51-715 are Rules applying to the sales factor generally. The second section numbered 2.16-51-715 are exceptions to the general rules. The Department cites to the second section as applicable law noting the one time sale of XXXXXXXXXXXX qualifies as the occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business. The disagreement of the parties arises as to what constitutes a "material distortion" under the Rule. The Taxpayer asserts the deviation in the total apportionment factor is only .02% as a result of the second amended return. The Department counters correctly that "material distortion" in the context of the Rule is referring not to the overall percentage of change in the formulary apportionment, but that of the sales factor itself. The calculation advocated by the Department compares the sales factor without the XXXXXXXXXXXX sale (.3083%) to the sales factor with the XXXXXXXXXXXX sale (.2027%), a deviation of 17.16%. A change of this amount is significant and thus material. Consequently, the Department was correct in excluding the proceeds from the XXXXXXXXXXXX sale from the sales factor.

Post hearing briefs were submitted regarding the differing tax treatment of tangible property and intangible personal property from the XXXXXXXXXXXX sale. Having excluded all proceeds from the sales factor, the classification of any proceeds into either category for inclusion into the numerator or

denominator is premature. The arguments presented by the parties presume facts that are not in evidence. Consequently, there is no need to decide issues raised in the post-hearing briefs.

DECISION AND ORDER

The refund claim denial is sustained; the assessment of tax is sustained. The file is to be returned to the appropriate section of the Department of Finance and Administration for further proceedings in accordance with this Administrative Decision and applicable law. Pursuant to Ark. Code Ann. § 26-18-405 (Supp. 2011), 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 - Policy & Legal, P.O. Box 1272, Rm. 2440, Little Rock, Arkansas 72203. The Commissioner, within twenty (20) days of the mailing of this Administrative Decision, may revise the decision regardless of whether the Taxpayer has requested a revision. A Taxpayer may seek relief from the final decision of the Administrative Law Judge or the Commissioner of Revenues on a final assessment of a tax deficiency by following the procedure set forth in Ark. Code Ann. § 26-18-406 (Supp. 2011).

OFFICE OF HEARINGS & APPEAL
RICK PRUETT
ADMINISTRATIVE LAW JUDGE
DATED: September 30, 2011

Reply to Revision Request
January 20, 2012

XXXXXXXXXX
Tax Advisor/Associate Tax Counsel
XXXXXXXXXX
XXXXXXXXXX
XXXXXXXXXX
RE: IN THE MATTER OF: XXXXXXXXXXXX
DOCKET NOS. 11-312, 11-313

Dear XXXXXXXXXXXX:

This is in response to your letter of October 17, 2011 requesting a revision of the Administrative Decision entered in the above referenced cases on September 30, 2011. Your letter is considered a timely filed request for a revision, and this letter will constitute the final decision of the Department of Finance and Administration under Ark. Code Ann. §26-18-405. After a review of this decision and the documentation in the case file, it is determined that the Administrative Decision should be sustained.

XXXXXXXXXX (XXXXXXXXXX or Taxpayer) is a pharmaceuticals company based in XXXXXXXXXXXX. XXXXXXXXXXXX sold its XXXXXXXXXXXX to XXXXXXXXXXXX in 2006. XXXXXXXXXXXX manufactured and sold over-the-counter health and beauty aids including XXXXXXXXXXXX, XXXXXXXXXXXX, XXXXXXXXXXXX, XXXXXXXXXXXX, XXXXXXXXXXXX, XXXXXXXXXXXX, XXXXXXXXXXXX and many others. XXXXXXXXXXXX properly classified the income from the sale as business income. On XXXXXXXXXXXX 's first return, the proceeds were not included in the sales factor. XXXXXXXXXXXX filed a second amended return which included the proceeds of the sale of XXXXXXXXXXXX in the sales factor. XXXXXXXXXXXX claimed a refund pursuant to its amended return. Upon investigating the return, the Department disallowed the refund claim and assessed additional taxes. The Taxpayer protested the refund disallowance and additional assessment. An administrative hearing was held on June 8, 2011. An administrative decision was issued September 30, 2011 upholding the refund disallowance and assessment. You have asked that two revisions be made to the findings of the Administrative Decision, that the refund be allowed, and that the assessment of additional tax be withdrawn. In your revision request, you asked that the proceeds from the sale of XXXXXXXXXXXX be excluded from the sales factor. In a subsequent telephone conversation with Assistant Commissioner John Theis, you clarified that the revision request contained clerical errors and that you are asking that the proceeds from the sale of XXXXXXXXXXXX be included in the sales factor.

Under Arkansas tax law, as in several other states, the income from the sale of property used in a unitary business is subject to apportionment. *Pledger v. Getty Oil Exploration Co.*, 309 Ark. 257 (1992). For other states, see e.g. *Hoecsh Celanese v. Franchise Tax Board*, (Cal. Supreme Ct. 2001) . A unitary business may include separate divisions of a corporation (*Exxon v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980), *Butler Brothers v. Mc Colgan*, 315 U.S. 501 (1941)) or related corporations. However, in determining the proper apportionment formula, income from a sale of property used in the business may distort the sales factor and yield a result that is not representative of the Taxpayer's business activities. This is especially true where the property includes an entire division or subsidiary. See *In the Matter of the Appeal of Fluor Corporation*, 1995 WL 799363 (Cal.St.Bd.Eq.). Most jurisdictions that apportion such income have adopted regulations to avoid this type of distortion. See e.g. Multistate Tax Commission Model Regulation IV.18(c)(1) which has been adopted in several states. In Arkansas, the Director of the Department of Finance and Administration has the discretion, pursuant to Ark. Code Ann.

26-51-718, to depart from the standard apportionment formula if the standard formula does not fairly represent the taxpayer's business activity in this state. *Leathers v. Jacuzzi*, 326 Ark. 857, 935 S.W.2d 252 (1996). Rule 2.26-51-715(1) serves this purpose by preventing distortion of the sales factor in the case of an occasional sale of property used in a unitary business. The rule states:

Where substantial amounts of gross receipts arise from an occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor if such receipts will materially distort the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

The issue in this case is the proper application of Rule 2.26-51-715(1) to the proceeds from the sale of XXXXXXXXXXXX and, more generally, whether such proceeds should be included when calculating the sales factor. You are asking for two revisions to the Administrative Decision concerning this issue.

1. You ask that the Administrative Decision be revised to reflect that including the proceeds from the sale of the XXXXXXXXXXXX division in the sales factor would not result in a distortion. This was the only issue raised in the initial protest.

The following chart was included:

	As Originally Filed	As Amended
Payroll	.2530%	.2530%
Property	.0492%	.0492%
Sales	.3083%	.2554%
Total Factor	.2297%	.2027%

The Taxpayer argued in its initial protest that the proposed change in the sales factor resulted in a change of the apportionment formula of .02%. A change that the Taxpayer asserts cannot be material. The calculation is out of context and misleading. Whereas the change is a change of .02 percentile with respect to the entire apportionable income of XXXXXXXXXXXX, that is irrelevant to the question of distortion of the sales factor. In your post hearing brief you argued that because the change to the apportionment formula was less than 1% (i.e. less than 1 percentile of XXXXXXXXXXXX's entire taxable income) that the change was not material.

Considering that the Arkansas apportionment formula is less than 1% of XXXXXXXXXXXX's taxable income, this 1 percentile test for materiality is absurd on its face. Arkansas law will not support an absurdity.

[T]his court is duty bound to reject any interpretation of a statute that results in absurdity or injustice, leads to contradiction, or defeats the plain purpose of the law.

Weiss v. Central Flying Service, Inc., 326 Ark. 685, 934 S.W.2d 211, Ark. (1996).

The actual percentage change in the sales factor is a change of 17.16% for the reasons discussed in the administrative decision. To be material, a distortion of the sales factor must impact the final tax liability of the Taxpayer. The effect of the proposed change in the sales factor is a change in the Arkansas apportionment formula of 11.75% which yields a change in tax liability of \$XXXXXXXXXXXX. This is an important and meaningful change. Therefore, the distortion is material. The gain from the occasional sale of assets must be excluded from the sales factor pursuant to 2.26-51-715.

2. You asked that the Administrative Decision be revised to find that the proceeds derived from the sale of intangible assets are properly attributable to activities conducted in XXXXXXXXXXXX and thus should be included in Taxpayer's Arkansas sales factor. This request is based on your argument that Arkansas Corporate Income Tax Rule 2.26-51-715(1) is not applicable to the proceeds from intangible property. See Rule 2.26-51-715(1), quoted above.

Your argument is that the phrase "fixed assets" in Rule 2.26-51-715(1) should refer only to tangible property. However, there is no sound reason for distinguishing between tangible and intangible assets in the context of a sale of a division of a corporation. Both tangible and intangible assets sold in an occasional sale consist of assets held by the company for use in the ordinary course of business rather than for sale to customers. Thus, the fixed intangible assets have the same characteristics as the fixed tangible assets. Further, the proceeds from either are equally likely to distort the sales factor. As noted above, the purpose of Rule 2.26-51-715(1) is to prevent a distortion of the sales factor by excluding proceeds that are not proceeds from the sale of goods or products sold to a taxpayer's customers in the ordinary course of its trade or business. Therefore, the proceeds from the occasional sales of intangible assets must be excluded from the sales factor. That being the case, the hearing officer correctly refrained from analyzing the tangible and intangible property separately.

The administrative decision is sustained in full. This concludes your administrative remedies. If you wish to pursue this matter in court, you must follow the procedures for judicial relief set forth in Ark. Code Ann. §26-18-406.

Sincerely,

Tim Leathers, Deputy Director/
Commissioner of Revenue
Arkansas Department of Finance and Administration