

98-148 XXXXXXXXXXXX

IN THE MATTER OF
XXXXXXXXXXXX
PROPOSED CORPORATE INCOME TAX ASSESSMENT
DOCKET NO. 98-148
Tax Years 1994, 1995 and 1996
\$XXXXXXXXXXXX
TOM CLARK, ADMINISTRATIVE LAW JUDGE

Dennis W. Johnson, Tax Auditor, XXXXXXXXXXXX Arkansas Office of Field Audit, completed the Corporate Income Tax Audit on May 15, 1998. He determined adjustments for Tax Year ending December 31, 1996, to be tax of \$XXXXXXXXXXXX, plus interest of \$XXXXXXXXXXXX for a total of \$XXXXXXXXXXXX. On June 18, 1998, XXXXXXXXXXXX through its attorney, protested the assessment with a request for an administrative hearing.

APPEARANCES

XXXXXXXXXXXX, Attorney, appeared on behalf of XXXXXXXXXXXX. William E. Keadle, Attorney, Office of Revenue Legal Counsel, appeared on behalf of the Department of Finance and Administration. This matter was reviewed based on Stipulations of Fact, briefs and written documents.

ISSUES

Two issues are presented for consideration:

- Whether the capital gains from the sale of XXXXXXXXXXXX, a division of XXXXXXXXXXXX, is subject to apportionment? Yes.
- Whether the Arkansas apportionment of capital gains from the sale of XXXXXXXXXXXX, a division of XXXXXXXXXXXX, as business income is constitutional? Yes.

FINDING OF FACTS

After reviewing the record, I find the following:

1. XXXXXXXXXXXX (XXXXXXXXXXXX) was a multinational corporation with a network of holdings in the United States and Europe. XXXXXXXXXXXX was the Parent Corporation of XXXXXXXXXXXX (Taxpayer) and XXXXXXXXXXXX. Until 1996, XXXXXXXXXXXX was composed of two divisions.
2. In 1996, XXXXXXXXXXXX arranged to sell XXXXXXXXXXXX to XXXXXXXXXXXX. The XXXXXXXXXXXX was to be included in the sale. XXXXXXXXXXXX established XXXXXXXXXXXX, which purchased all XXXXXXXXXXXX related assets from XXXXXXXXXXXX. From this sale, XXXXXXXXXXXX realized a \$XXXXXXXXXXXX capital gain on the transaction. On its 1996 Arkansas Income Tax Return, XXXXXXXXXXXX classified the proceeds of the sale as nonbusiness income allocable to its commercial domicile.
3. The Arkansas Department of Finance and Administration conducted a Corporate Income Tax Audit. The capital gains from the sale of XXXXXXXXXXXX were reclassified as apportionable business income.
4. XXXXXXXXXXXX has paid under protest to the State of Arkansas tax and interest as assessed. No penalty was assessed.

5. Until 1996, there were two divisions of XXXXXXXXXXXX: (1) the XXXXXXXXXXXX with its primary manufacturing facility in XXXXXXXXXXXX, and (2) the XXXXXXXXXXXX with its primary manufacturing facility in XXXXXXXXXXXX.
6. Both XXXXXXXXXXXX and XXXXXXXXXXXX were operational divisions.
7. Each division separately kept books on its operations, managed its own sales and purchasing accounts, and hired hourly wage earners.
8. XXXXXXXXXXXX, President of XXXXXXXXXXXX and XXXXXXXXXXXX reviewed division operations four times a year.
9. The operations review by XXXXXXXXXXXX, President of XXXXXXXXXXXX and XXXXXXXXXXXX, included sales policies, budgeting, and annual salary increases.
10. XXXXXXXXXXXX cash management system swept bank accounts of each division daily and returned funds to cover expenses as incurred.
11. Operation funds had to be requested by the divisions as needed from XXXXXXXXXXXX.
12. Large expenditures or the creation of substantial debt had to be requested from and approved by XXXXXXXXXXXX for continued operation.
13. XXXXXXXXXXXX prepared taxes for each division at the corporate level.
14. Both XXXXXXXXXXXX and XXXXXXXXXXXX received continual parental oversight and control.
15. XXXXXXXXXXXX filed Arkansas Corporation Income Tax Returns in 1996 and former years. All income from XXXXXXXXXXXX was apportioned under the Uniform Division of Income for Tax Purposes Act (UDITPA), Ark. Code Ann. §26-51-701 (Repl. 1997) et seq., except the capital gains in issue.
16. The capital gains from the sale of XXXXXXXXXXXX were approximately fifty-eight and seven tenths percent (58.7%), or almost fifty-nine percent (59%) of the Taxpayer's federal taxable income on line 30 of Federal Form 1120 for Tax Year 1996.

CONTENTIONS OF THE PARTIES

- Taxpayer counsel wrote in the Statement of Protest, as follows: gain in the amount of \$XXXXXXXXXX was deducted from "Income Per Federal Return" in arriving at "Total Apportionable Income" on the Taxpayer's 1996 Coporate Income Tax Return. This gain arose from the sale of 100% of the assets of the Taxpayer's XXXXXXXXXXXX headquarters in XXXXXXXXXXXX. The XXXXXXXXXXXX did not conduct any business operations in the State of Arkansas. Gain from the sale of assets of the XXXXXXXXXXXX is not subject to apportionment to Arkansas under existing Arkansas law or regulations or principles of United States constitutional law. Accordingly the transaction included in the Arkansas corporate income tax assessment which is the subject of this Protest is excluded from tax according to Arkansas and United States law.
- The agency counsel wrote in the Answers to Information Request, as follows: the plant, property, and equipment for the XXXXXXXXXXXX were included in the property factor of the UDITPA three factor formula for apportioning income, as was the XXXXXXXXXXXX's sales in the sales factor, and its employee's wages in the payroll factor. In addition, since this was a division of XXXXXXXXXXXX, the XXXXXXXXXXXX was under the control of the same board of directors. Therefore, the sale of the XXXXXXXXXXXX was classified as business income subject to apportionment by the UDITPA three factor formula.

LAW

- Administrative Hearing to consider taxpayer's liability is provided for under the Arkansas Tax Procedure Act, Ark. Code Ann. § 26-18-101 et seq.

- The Uniform Division of Income for Tax Purposes Act is codified at Ark. Code Ann. §26-51-701 et seq.

CONCLUSIONS OF LAW

After reviewing the facts and law, I conclude:

1. XXXXXXXXXXXX has a presence in Arkansas, and thus has nexus with the State for imposition of the Arkansas Corporate Income Tax.
2. All business income must be apportioned to Arkansas. Any change of the apportionment method must follow the procedure set out in Ark. Code Ann. § 26-51-718.
3. Auditor's notes and the Stipulations of Fact were not probative in determining the operational relationships of funds that were acquired from Taxpayer, and then utilized by XXXXXXXXXXXX.
4. DFA conceded that the sale of XXXXXXXXXXXX would not qualify under the transactional test as a transaction in the regular course of XXXXXXXXXXXX's business. However, the functional test is applicable.
5. Taxpayer apportioned income for the divisions prior to 1996. XXXXXXXXXXXX filed Arkansas Corporation Income Tax Returns in 1996 and former years. The capital gains from XXXXXXXXXXXX in 1996 were allocated to Taxpayer's commercial domicile.
6. Capital gains and losses from sales of intangible personal property are allocable to this state if: (1) The property had a situs in the state at the time of the sale; or (2) The Taxpayer's commercial domicile is in this state; or (3) The property has been included in depreciation which has been allocated to this state; in which event gains or losses on those sales shall be allocated on the percentage that is used in the formula for allocating income to Arkansas during the year of those sales. See Ark. Code Ann. § 26-51-706 (b).
7. "Business income means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." See Ark. Code Ann. § 26-51-701.
8. The tax return reflects an amount of income from capital gains that is "integral" to the business.
9. XXXXXXXXXXXX and the XXXXXXXXXXXX were horizontally related divisions with control by and support from XXXXXXXXXXXX and XXXXXXXXXXXX.
10. Both divisions looked to the Board of Directors of XXXXXXXXXXXX who exercised rights of ownership, including final approval for the creation of substantial debt and for large capital expenditures.
11. Both divisions looked to XXXXXXXXXXXX, President of XXXXXXXXXXXX and XXXXXXXXXXXX for review and leadership for the division and corporate operations.
12. XXXXXXXXXXXX, President of XXXXXXXXXXXX, provided control of the business divisions. He gave oversight of the two divisions. The divisions did not have complete autonomy. Control of the purse strings of both operations cannot be minimized. XXXXXXXXXXXX scrutinized all money matters including large corporate decisions as a matter of parental operational expertise, control and overall operational strategy.
13. "In order to exclude certain income from the apportionment formula, the company must prove that the income was earned in the course of activities unrelated to (those carried out in the taxing) State." See Allied-Signal, Inc. v. Director, Div. Of Taxation reaffirming Exxon Corp. v. Department of Revenue of Wis., 447 U.S., at 223 quoting Mobil Oil Corp. v. Commissioner of Taxes of Vt., 445 U.S. at 439. In this matter, the XXXXXXXXXXXX did not meet its burden of proof.

14. This matter falls within the functional test discussed by the Arkansas Supreme Court in the case of Pledger v. Getty Oil Exploration Co., 309 Ark. 257, 831 S.W.2d 121 (1992). This income resulted from the acquisition, management, and disposition of property that constitutes integral parts of the Taxpayer's regular business.
15. When the capital gains income is a significant constituent part of the Taxpayer's overall income, then it is "integral" within the meaning of the statute. The capital gains from the sale of XXXXXXXXXXXX of almost fifty-nine percent (59%) of the Taxpayer's federal taxable income on line 30 of Federal Form 1120 for Tax Year 1996 are significant and integral to both divisions.
16. The gain from the sale of the XXXXXXXXXXXX is business income under Arkansas Corporate Income Tax Law, and is apportionable to the State of Arkansas.
17. Interest was assessed in accordance with Ark. Code Ann. § 26-18-508.
18. The taxing statute is presumed constitutional. The statute was applied in a constitutional manner.

ORDER

The proposed assessment is sustained in whole. This decision shall be effective and become the action of the agency unless the Commissioner of Revenue revises it. The Commissioner may revise the decision within twenty days without any request from the taxpayer.

The taxpayer may request the Commissioner to review the decision. The taxpayer must make the request within twenty days from the date the Board mailed the decision. The taxpayer shall present the request for review as follows: Assistant Commissioner John Theis, Department of Finance and Administration, Revenue Division, P. O. Box 1272, Room 215, Little Rock, Arkansas 72203-1272.

If taxpayer receives an unfavorable decision from the Commissioner, taxpayer may appeal the final assessment to Chancery Court under Ark. Code Ann. § 26-18-406.

OFFICE OF HEARINGS & APPEALS

H. Thomas Clark, Jr.
Administrative Law Judge
Mailed: February 4, 2000