04-126 XXXXXXXXXX

See Reply to Revision Request

IN THE MATTER OF
XXXXXXXXXX
DENIAL OF CORPORATE INCOME TAX REFUND
DOCKET NO. 04-126
Tax Year 2000
AMOUNT OF REFUND REQUEST
$XXXXXXXXXX
AMOUNT OF REFUND DENIAL
$XXXXXXXXXX
TOM CLARK, ADMINISTRATIVE LAW JUDGE

This matter arises from an amended Corporate Income Tax Return filed by XXXXXXXXXX (Taxpayer), wherein a refund of tax was requested. The Arkansas Corporate Income Tax Section denied Taxpayer's request. Taxpayer has protested the rejection of the amended return and the corresponding denial of the refund. An Administrative Hearing, pursuant to the Arkansas Tax Procedure Act, Ark. Code Ann. § 26-18-101 et seq., was held on February 11, 2004, to hear the protest of the refund denial.

APPEARANCES

XXXXXXXXXX, Attorney and Certified Public Accountant, appeared on behalf of XXXXXXXXXX. Michael J. Wehrle, Attorney, Office of Revenue Legal Counsel, appeared on behalf of the Department of Finance and Administration.

Also present at the Administrative Hearing were: XXXXXXXXXX of XXXXXXXXXX representing XXXXXXXXXX and XXXXXXXXXX; XXXXXXXXXX, XXXXXXXXXX; Scott Fryer DFA Tax Audit Supervisor; and Faye Hickman, DFA Tax Auditor.

Taking no part in the hearing, but present, were Kim Godfrey and Ronna Abshure, Attorneys, Office of Revenue Legal Counsel. Scott Fryer and XXXXXXXXXX gave sworn testimony.

ISSUES

1. May XXXXXXXXXX and XXXXXXXXXX (Taxpayer) exclude extraordinary receipts from the sale of company assets, known as the wireline sales, from the Arkansas sales factors? No.

2. May XXXXXXXXXX and XXXXXXXXXX deviate from the formulary apportionment as provided by law, without the Taxpayer first petitioning the Director of the Department of Finance and Administration for permission? No.

FINDING OF FACTS

I find the following:

1. The parties agreed to the following STIPULATION OF FACTS:

A. XXXXXXXXXX is a XXXXXXXXXX “domestic business” corporation with its principal place of business at XXXXXXXXXX.

B. On June 30, 2000, XXXXXXXXXX was acquired by XXXXXXXXXX.

C. As a result, XXXXXXXXXX filed two short period Arkansas corporate income tax returns for calendar year 2000. XXXXXXXXXX filed a return for the period January 1, 2000 to June 30, 2000 to reflect the Arkansas activities of the XXXXXXXXXX companies. XXXXXXXXXX also filed a return for the period January 1, 2000 to December 31, 2000 to reflect the Arkansas activities of the XXXXXXXXXX companies for the period July 1, 2000 to December 31, 2000 and the Arkansas activities of XXXXXXXXXX for the period January 1, 2000 to December 31, 2000.

D. Pursuant to the return filed for the period January 1, 2000 to December 31, 2000, XXXXXXXXXX’s return calculated net taxable income of $XXXXXXXXXX. XXXXXXXXXX’s taxable income as reported was primarily attributable to XXXXXXXXXX and XXXXXXXXXX.

E. Prior to XXXXXXXXXX’s acquisition of XXXXXXXXXX, XXXXXXXXXX and XXXXXXXXXX operated XXXXXXXXXX’s XXXXXXXXXX business in Arkansas and in several other bordering states and did so for many years. Headquarters for the region, and specifically for XXXXXXXXXX, both before and after the transaction, was located in XXXXXXXXXX.

F. On July 31, 2000, in connection with a plan to sell certain XXXXXXXXXX wireline assets, both XXXXXXXXXX and XXXXXXXXXX sold their Arkansas wireline assets to XXXXXXXXXX.

G. XXXXXXXXXX sold its XXXXXXXXXX business in Arkansas (“XXXXXXXXXX”) for a total of $XXXXXXXXXX, which was attributable to Arkansas, as XXXXXXXXXX conducted business almost exclusively within the state. XXXXXXXXXX sold its XXXXXXXXXX business in Arkansas (“XXXXXXXXXX”), as well as XXXXXXXXXX assets located in several other states for a total of $XXXXXXXXXX. The proceeds from the assets assigned to Arkansas resulting from the XXXXXXXXXX Sale were $XXXXXXXXXX.

H. The proceeds from the XXXXXXXXXX Sale and the XXXXXXXXXX Sale (collectively “XXXXXXXXXX Sales”) were included in the numerator and denominator of XXXXXXXXXX and XXXXXXXXXX’s sales factors in XXXXXXXXXX’s return for the tax year ending December 31, 2000.

I. XXXXXXXXXX’s property factor was computed based upon the average of its property at the beginning of the tax period on July 1, 2000 and at the end of the period on December 31, 2000. Since the XXXXXXXXXX Sale occurred on July 31, 2000, XXXXXXXXXX owned substantial property in Arkansas for only one month out of the six months reflected in the return. As originally filed, XXXXXXXXXX’s property factor was 2.46% averaging the beginning and end of the year value of property.

J. On August 8, 2003, XXXXXXXXXX filed an amended Arkansas corporate income tax return and made the following modifications to its taxable income apportioned to Arkansas:

1. Exclusion of extraordinary receipts from the sale of company assets (i.e., XXXXXXXXXX Sales) by XXXXXXXXXX and XXXXXXXXXX from the sales factor; and

2. Employment of a monthly averaging convention for the property factor of XXXXXXXXXX and XXXXXXXXXX.

K. As a result of these modifications, XXXXXXXXXX claimed a refund in the amount of $XXXXXXXXXX, plus applicable interest, for corporate income taxes paid for tax year 2000.

L. The Department denied XXXXXXXXXX's refund claim.

M. Petitioner timely filed a Protest of that action on September 22, 2003.

2. An Administrative Hearing was initially scheduled for December 17, 2003, and thereafter continued at Taxpayer's request to February 11, 2004. Though Taxpayer styled their pre-hearing brief in the Matter of the Petition of XXXXXXXXXX, this matter is an Administrative Review, and not a Petition. The review of a denial of a tax refund is not a petition to alter the statutory method for filing.

3. In order to deviate from the three-factor apportionment method, a Taxpayer, prior to filing a corporate tax return, must petition the Director of the Department of Finance and Administration through the Corporate Income Tax Section. See Ark. Code Ann. § 26-51-718 (Repl. 1997).

4. XXXXXXXXXX had not petitioned the Arkansas Corporate Income Tax Section, for an alternative method from the three-factor formula, as provided at Ark. Code Ann. § 26-51-718.

5. The Corporate Income Tax Section analyzed the refund request made by the Taxpayer. The analysis by the Corporate Income Tax Section is reflected by the sworn testimony of Scott Fryer, DFA Tax Audit Supervisor. At the Administrative Hearing, Mr. Fryer reviewed the action of the Corporate Income Tax Section, with the aid of DFA Exhibits 1, 2, and 3.

6. Taxpayer's original Corporate Income Tax Return, as filed, was not the result of a clerical error. The matter was prepared and reviewed in house by Taxpayer's audit staff.

CONTENTIONS OF THE PARTIES

- Taxpayer counsel wrote in part on September 22, 2003: We respectfully protest the denial of XXXXXXXXXX's refund claim. …This refund claim is largely attributable to two items: (a) the exclusion of proceeds from the sale of fixed assets outside the ordinary course of business from the calculation of the sales factor; and (b) the application of a monthly averaging convention in calculation of the property factor for tangible personal property disposed of in the first month of a six month tax period. We respectfully assert that: (a) pursuant to the explicit wording of Arkansas' regulations, the proceeds from the occasional sale of a fixed asset should be excluded from the calculation of the sales factor (citing Arkansas Regulation 2.26-51-715(1)); and (b) the Director of the Department of Finance and

Administration should permit the use of a monthly averaging convention to properly reflect the value of XXXXXXXXXX's property during the tax year in question. At the hearing, Taxpayer contended the original return was the result of their clerical error.

- The agency counsel wrote in the *Answers to Information Request*, as follows: If you include the receipts in, then the distortion would be minimal, approximately 3%. If the Taxpayer is allowed to exclude the receipts, then the distortion would be much greater, approximately 320%. DFA also asserts the Taxpayer has failed to petition for a variance of the three-factor formula.

LAW

- Administrative Hearing was conducted 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. 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.

2. The Taxpayer did not follow the procedure at § 26-51-718. The importance of this section is made clear in Leathers v. Jacuzzi, Inc., 326 Ark. 857, 935 S.W.2d 252 (1996). The Arkansas Supreme Court found that Jacuzzi was not entitled to the relief granted by the chancellor because it did not apply to the Commissioner for permission to use a different method of accounting in accordance with section 26-51-718. This evidence was clearly before the chancellor. The cross-examination and re-direct testimony of Charles Bellott, assistant manager of the corporation income tax section of the Department, and a nineteen-year employee was quoted by the Court.

On cross-examination, he testified:

> I believe the Director can take into consideration various factors in related companies in order to arrive at a clear reflection of income. A clear reflection of income has a relationship to the activities within the state. Ark. Code Ann. § 26-51-718 states something to the effect that the inclusion of one or more additional factors will fairly represent the business activity in this State. It says the Director or the Department may consider those factors in the application of the taxpayer. It is the Department's goal to arrive at a clear reflection of income.

On redirect, he testified:

> Ark. Code Ann. § 26-51-718 deals with the allocation and apportionment provisions of the UDITPA section. A taxpayer who wishes to deviate from the standard formulary apportionment has to petition for a change. Jacuzzi has not petitioned for a change. The Director never authorized the deviation before the filing of the returns. Jacuzzi deviated without the Director's permission from the formulary apportionment by filing these

returns. That's an additional basis for rejecting the returns. A taxpayer cannot petition by filing a return. From my review of the returns, a petition to utilize combined unitary reporting is not contained in any of the returns.

3. Section 26-51-718 reads: 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; The inclusion of one (1) or more additional factors which will fairly represent the taxpayer's business activity in this state; or
   (c) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

4. The Taxpayer did not petition for the apportionment that it used. The Taxpayer erred to alter the three-factor formula without permission of the Department of Finance and Administration. Filing an Amended Corporate Income Tax Return is not a petition for relief (as required by § 26-51-718). Moreover, an appeal of the denial of a tax refund is not a petition for relief (as required by § 26-51-718).

5. Pursuant to the return filed for the period January 1, 2000 to December 31, 2000, XXXXXXXXXX's return calculated net taxable income of $209,105,494. XXXXXXXXXX's taxable income as reported was primarily attributable to XXXXXXXXXX and XXXXXXXXXX.

   Through testimony and exhibits, DFA compared the original return and the amended return to demonstrate that the percentages of the gross receipts varied greatly between the original return and the amended return. Taxpayer's gains do not dilute the sales factor in the original return as much as occurs in the amended return. DFA in its comparison demonstrated that it would be grossly unfair to not recognize the wireless assets as taxable Arkansas income.

   The amended return does not effectuate an equitable allocation and apportionment of the Taxpayer's income. Under Taxpayer's amended return, the method of reporting ignores the one time sale, and virtually eliminates the sales factor, and reduces the overall apportionment factor to .7 of 1%.

6. Corporate Income Tax Regulation 2.26-51-715(1) is a rule in Arkansas promulgated to administer section 26-51-715. The law of Arkansas is not the same as California law. The illustration at the end of Regulation 2.26-51-715(1) is an example only. A regulation cannot legislate.

7. The example given at the end of Regulation 2.26-51-715(1) is one example given in administering the law. The regulation example is not controlling in this matter.

8. The careful analysis given by the DFA Corporate Income Tax Section is helpful in understanding the distortion that results between the original and amended returns. In this matter, the DFA testimonial evidence showed that the sales factor would be distorted if the receipts are left out, or if they were left in the formula.

When weighing the evidence, particularly the testimonial evidence of the DFA Tax Supervisor, it is clear that a genuine material distortion results when the receipts from the wireless assets are excluded, as would occur in Taxpayer's amended return.

9. If Taxpayer were allowed to exclude receipts from the sale of company assets from the sales factor for XXXXXXXXXX and XXXXXXXXXX, then the result would be a greater distortion under Arkansas Regulation 2.26-51-715(1) than to include receipts from the sale of company assets.

10. Companies make a considered decision as to how to conduct business operations, including how to file Federal and state income tax returns. To refile a tax return due to an alleged clerical error in the prior filing is a misnomer or euphemism, but the original return was not an unintended clerical error, as reflected in the testimony of XXXXXXXXXX. XXXXXXXXXX tax return decision was Taxpayer's prerogative.

    After the original filing, the Taxpayer discovered its tax return decision was not as advantageous as would be obtained through the construct of the amended return. Now, the Taxpayer has sought somewhat belatedly to achieve a tax advantage that is not permissible.

    I imply no criticism of the sometimes need or duty to amend a tax return. However, I do not conclude that based on the facts and law that there is mandatory authority, only discretionary, requiring the DFA Corporate Income Tax Section to accept an amended return where the method of reporting business operations is inconsistent with existing laws and regulations.

    The Director, in whom the Arkansas General Assembly has vested discretion, has not exercised discretion to allow the Taxpayer to exclude income, or to deviate from the three-factor formula. The Taxpayer has failed to petition the Director for permission to deviate from the apportionment formula. See Ark. Code Ann. § 26-51-718 (Repl. 1997), and Leathers v. Jacuzzi, Inc., 326 Ark. 857, 935 S.W.2d 252 (1996).

11. In conclusion, XXXXXXXXXX has filed an Arkansas Corporate Income Tax Return, and an Amended Arkansas Corporate Income Tax Return. The initial Arkansas Corporate Income Tax Return has been accepted, while a refund in conjunction with the Amended Arkansas Corporate Income Tax Return has been denied. The Taxpayer is protesting the denial of the Amended Arkansas Corporate Income Tax Return. The action of the DFA Corporate Income Tax Section denying the tax refund and rejecting the Amended Arkansas Corporate Income Tax Return is upheld.

ORDER

The denial of a tax refund by DFA Corporate Income Tax Section is sustained. 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 to Assistant Commissioner John Theis, Department of Finance and Administration, Revenue Division, P. O. Box 1272, Room 2440, Little Rock, Arkansas 72203-1272.

If Taxpayer receives an unfavorable decision from the Commissioner, Taxpayer may appeal the final assessment to Circuit Court under Ark. Code Ann. § 26-18-406 (Supp. 2003).

OFFICE OF HEARINGS & APPEALS

Tom Clark
Administrative Law Judge
Mailed: March 1, 2004

Reply to Revision Request

June 14, 2004

XXXXXXXXXX
XXXXXXXXXX
XXXXXXXXXX
XXXXXXXXXX

RE: IN THE MATTER OF: XXXXXXXXXX
Docket 04-126

Dear XXXXXXXXXX:

This letter is in response to your request for a revision of the administrative decision entered in this matter on March 1, 2004. The administrative decision sustained the Corporation Income Tax Section's denial of the taxpayer's request for a corporate income tax refund in the amount of $XXXXXXXXXX.

Facts

A review of the facts indicates that the taxpayer, XXXXXXXXXX, was a XXXXXXXXXX "domestic business" corporation with its principal place of business at XXXXXXXXXX. On June 30, 2000, XXXXXXXXXX was acquired by XXXXXXXXXX. As a result, XXXXXXXXXX filed two short period Arkansas corporate income tax returns for calendar year 2000. XXXXXXXXXX filed a return for the period January 1, 2000 to June 30, 2000 to reflect the Arkansas activities of the XXXXXXXXXX companies. XXXXXXXXXX also filed a return for the period January 1, 2000 to December 31, 2000 to reflect the Arkansas activities of the XXXXXXXXXX companies for the period July 1, 2000 to December 31, 2000 and the Arkansas activities of XXXXXXXXXX for the period January 1, 2000 to December 31, 2000. Pursuant to the return filed for the period January 1, 2000 to December 31, 2000, XXXXXXXXXX's return calculated net taxable income of $XXXXXXXXXX. XXXXXXXXXX's taxable income as reported was primarily attributable to XXXXXXXXXX and XXXXXXXXXX.

Prior to XXXXXXXXXX's acquisition of XXXXXXXXXX, XXXXXXXXXX and XXXXXXXXXX operated XXXXXXXXXX's XXXXXXXXXX business in Arkansas and in several other bordering states and did so for many years. Headquarters for the region, and specifically for XXXXXXXXXX, both before and after the transaction, was located in XXXXXXXXXX. On July 31, 2000, in connection with a plan to sell certain XXXXXXXXXX wireline assets, both XXXXXXXXXX and XXXXXXXXXX sold their XXXXXXXXXX assets to XXXXXXXXXX. XXXXXXXXXX sold its XXXXXXXXXX business in Arkansas ("XXXXXXXXXX Sale") for a total of $XXXXXXXXXX, which was attributable to the state of Arkansas, as XXXXXXXXXX conducted business almost exclusively within the state. XXXXXXXXXX sold its XXXXXXXXXX business in Arkansas ("XXXXXXXXXX Sale"), as well as XXXXXXXXXX assets located in several other states, for a total of $XXXXXXXXXX. The proceeds from the assets assigned to Arkansas resulting from the XXXXXXXXXX were $XXXXXXXXXX.

The proceeds from the XXXXXXXXXX Sale and the XXXXXXXXXX Sale (collectively "XXXXXXXXXX Sales") were included in the numerator and denominator of XXXXXXXXXX and XXXXXXXXXX's sales factors in XXXXXXXXXX's return for the tax year ending December 31, 2000. XXXXXXXXXX's property factor was computed based upon the average of its property at the beginning of the tax period on July 1, 2000 and at the end of the period on December 31, 2000. Since the XXXXXXXXXX Sale occurred on July 31, 2000, XXXXXXXXXX owned substantial property in Arkansas for only one month out of the six months reflected in the return. As originally filed, XXXXXXXXXX's property factor was 2.46%, averaging the beginning and end of the year value of property.

On August 8, 2003, XXXXXXXXXX filed an amended Arkansas corporate income tax return that made two major modifications to its taxable income apportioned to Arkansas:

1. Exclusion of extraordinary receipts from the sale of company assets (i.e., XXXXXXXXXX Sales) by XXXXXXXXXX and XXXXXXXXXX from the sales factor; and
2. Employment of a monthly averaging convention for the property factor of XXXXXXXXXX and XXXXXXXXXX.

As a result of these modifications, XXXXXXXXXX claimed a refund in the amount of $XXXXXXXXXX, plus applicable interest, for corporate income taxes paid for tax year 2000. The Department denied XXXXXXXXXX's refund claim and XXXXXXXXXX proceeded to timely file a protest of that action on September 22, 2003.

<u>Issues</u>

Two issues were raised for consideration by the Office of Hearings & Appeals. The first issue (Issue 1) is whether or not XXXXXXXXXX and XXXXXXXXXX could properly exclude extraordinary receipts from the sale of company assets (the XXXXXXXXXX Sales) from their Arkansas sales factors. The second issue (Issue 2) is whether or not XXXXXXXXXX and XXXXXXXXXX could properly use a monthly averaging convention for calculating their Arkansas property factors.

<u>Issue</u> 1

XXXXXXXXXX set forth several arguments with regard to the first issue in its revision request of March 18, 2004. Those arguments are set forth below:

- The hearing officer improperly concluded that XXXXXXXXXX's entire refund claim was invalid since it did not petition the Department requesting the use of an alternative apportionment method prior to the filing of its return. XXXXXXXXXX believes that the portion of the refund claim relating to the exclusion of extraordinary receipts from the sales factor did not require XXXXXXXXXX to petition the Department for an alternative apportionment method. Such exclusion was mandated by the Department's own regulation and was not an "alternative apportionment method" subject to the Department's discretion. The hearing officer confused the two issues presented and lumped them both into discretionary authority.

  In excluding the extraordinary receipts, XXXXXXXXXX is following the Department's own regulation and is not requesting an alternative filing method, such as combined reporting (see <u>Leathers v. Jacuzzi</u>), or an alternative apportionment method, such as separate accounting. XXXXXXXXXX is amending its return and requesting a refund based upon the plain meaning of the Department's own regulation. XXXXXXXXXX is entitled to file an amended return requesting a refund for any period for which the statute of limitations has not expired. *Ark. Code Ann.* 26-18-507(a) states:

"(a) Any taxpayer who has paid any state tax to the State of Arkansas, in excess of the taxes lawfully due, subject to the requirements of this chapter, shall be refunded the overpayment of the tax determined by the Director of the Department of Finance and Administration to be erroneously paid upon the filing of an amended return or a verified claim for refund."

- Arkansas *Corporation Income Tax Regulation* 2.26-51-715(1) states that gross receipts from the sale of a factory or plant will be excluded from the sales factor. This regulation directly supports the taxpayer's position in this matter. The hearing officer dismissed this provision as "…one example given in administering the law. The regulation example is not controlling in this matter."

  If the hearing officer's interpretation of this example were correct, in drafting this portion of the regulation the Department would have stated that gross receipts from the sale of a factory or plant may be excluded from the sales factor. The hearing officer does not provide a reasonable explanation as to why the regulation example is not controlling in this matter. It is clearly on point.

- In his decision, the hearing officer stated that "… Regulation 2.26-51-715(1) is a rule in Arkansas promulgated to administer section 26-51-715. The law of Arkansas is not the same as California law. The illustration at the end of Regulation 26-51-715(1) is an example only. A regulation cannot legislate."

  The regulation in question was drafted and implemented by the Department to help it and taxpayers fairly interpret the statute. It is unclear why the hearing officer proposes to disregard the regulation's interpretation of the statute in favor of his own. XXXXXXXXXX agrees that a regulation cannot legislate, but neither can the hearing officer. XXXXXXXXXX submits that the Department is bound by its own regulation, and must not subjectively pick and choose when it wishes to apply its rules and when it does not.

- *Corporation Income Tax Regulation* 2.26-51-715(1) specifies that substantial amounts of extraordinary receipts are excluded from the sales factor if including such receipts materially distorts the sales factor. Therefore, Arkansas's baseline for identifying whether material distortion exists is the taxpayer's sales factor without the extraordinary receipts. The hearing officer incorrectly applied the material distortion element of 2.26-51-715(1) by considering whether distortion would exist if the extraordinary receipts were excluded in the sales factor. The hearing officer determined that "in this matter, the DFA testimonial evidence showed that the sales factor would be distorted if the receipts are left out, or if they were left in the formula."

  If the test set forth in the regulation is met, substantial, extraordinary receipts that distort the sales factor when included must be excluded from the sales factor. The test is objective and it has been met. The regulation requires that the extraordinary sales be excluded.

- The hearing officer failed to address the fact that XXXXXXXXXX's sales factor would increase from 0.014% to 11.93% if the extraordinary receipts were included in the receipts factor. The increase from 0.014% to 11.93% is materially distortive. Moreover, the hearing officer failed to acknowledge that the distortion is even more pronounced because XXXXXXXXXX's sales factor numerator only reflects XXXXXXXXXX's sales activities in Arkansas during one month of the tax period at issue. For the tax period at issue (July 1, 2000 to December 31, 2000), XXXXXXXXXX's Arkansas sales factor is 0.014%, excluding the extraordinary receipts from the sales factor. Since XXXXXXXXXX sold its

XXXXXXXXXX business in Arkansas on July 31, 2000, the numerator of the sales factor only reflects XXXXXXXXXX's sales activities in the state during July 2000. The denominator of the sales factor includes sales activities in other states before and after July 31, 2000, as XXXXXXXXXX continued to conduct business in other states.

- The hearing officer failed to address the fact that including XXXXXXXXXX's extraordinary receipts within the sales factor creates a material distortion by increasing XXXXXXXXXX's apportionment percentage from .072% to 7.06%, an approximate 900% increase. Moreover, the hearing officer failed to address the fact that including XXXXXXXXXX's extraordinary receipts within the sales factor generates a sales factor percentage that clearly deviates farther from the historical norm than the sales factor determined in accordance with Arkansas's prescribed apportionment method set forth in Regulation 2.26-51-715(1).

- The hearing officer found that XXXXXXXXXX's amended return is inconsistent with existing law and regulations. The hearing officer failed to support his conclusion that excluding XXXXXXXXXX and XXXXXXXXXX's extraordinary receipts from the sales factors is inconsistent with existing law and regulations. The hearing officer omitted references to existing statutes, regulations, case law or administrative rulings in support of his conclusion. This interpretation clearly contradicts the plain meaning of the regulation.

- The hearing officer failed to address XXXXXXXXXX's alternative position that XXXXXXXXXX and XXXXXXXXXX's sales factors improperly reflect the sale of intangible personal property in a manner inconsistent with Arkansas law and regulations. The proceeds at issue included proceeds from the sale of intangible personal property in addition to tangible personal property. Sales of intangible personal property are sourced to Arkansas if the income-producing activity is performed in Arkansas. Ark. Code Ann. § 26-51-715; Regulation 1.26-51-717. In this case, the income-producing activity related to the intangible property was readily identifiable and occurred in Texas. Accordingly, the proceeds from the sale of intangible property should be included in the denominator of XXXXXXXXXX and XXXXXXXXXX's sales factor but excluded from the numerator.

<u>Analysis – Issue 1</u>

XXXXXXXXXX cites *Corporation Income Tax Regulation* 2.26-51-715 in support of its argument regarding the "exclusion of extraordinary receipts" from its Arkansas sales factor. Regulation 2.26-51-715(1) states that receipts from an occasional sale of a fixed asset may be excluded from a taxpayer's sales factor if the receipts will "materially distort" the sales factor. However, contrary to XXXXXXXXXX's arguments, the facts and circumstances surrounding the Wireline Sales do not bring the provisions of Regulation 2.26-51-715(1) into play in this case.

With regard to XXXXXXXXXX (the primary source of the taxable income in question), its Arkansas assets accounted for approximately 17% of the total assets sold by that entity. The receipts from the sale accounted for over 70% of the total sales as originally reported by XXXXXXXXXX . The net gain on the sale of the assets amounted to more than 100% of the apportionable income of XXXXXXXXXX . If the receipts from the sale are excluded from XXXXXXXXXX's total sales, XXXXXXXXXX's apportionable income would balloon to about twice as much as its total sales. The Arkansas portion of the sales factor (the numerator) would therefore be significantly distorted because almost all of XXXXXXXXXX's Arkansas operations were sold early in 2000 and total sales receipts from XXXXXXXXXX's other Arkansas operations would be only $XXXXXXXXXX instead of the $XXXXXXXXXX originally reported by XXXXXXXXXX . In essence, XXXXXXXXXX wishes to apply the apportionment factors from normal ongoing operations to taxable income that consists entirely of income from the sale of the land-based (Wireline) XXXXXXXXXX systems. Historically, the property and sales factors for XXXXXXXXXX have been in the range of 4% to 5%. In this case, because XXXXXXXXXX's Arkansas assets amounted to 17% of the assets sold, XXXXXXXXXX's sales factor increased to 11.9% for the period ending December 31, 2000. However, under XXXXXXXXXX's position, the sales factor would be substantially reduced to a factor of only .014%. A reduction of this magnitude to XXXXXXXXXX's sales factor would result in an insufficient and therefore improper apportionment of that entity's business income to Arkansas.

Under § 26-51-718, alternative methods of apportionment are authorized if using the standard method under Arkansas' UDITPA provisions would not fairly represent a taxpayer's Arkansas business activities. However, this section's provisions are permissive in nature and the United States Supreme Court has recognized that states have "wide latitude" in the selection of apportionment formulas. Moorman Mfg. Co. v. Blair, 437 U.S. 267 (1978). Arkansas' primary objective in selecting an apportionment formula is to use a formula that results in a fair and reasonable apportionment of a taxpayer's income to this state. Courts in Utah and Oregon have recognized a reasonableness standard in the selection and application of apportionment formulas. See <u>Deseret Pharmaceutical Co. v. Utah State Tax Commission</u>, 579 P.2d 1322 (1978) and <u>Twentieth Century-Fox Film Corp. v. Oregon Department of Revenue</u>, 700 P.2d 1035 (1985). In this case it would be unreasonable to exclude the Wireline receipts from the sales factors because of the severe distortion that would result from the exclusion.

In a similar case involving the sale of fixed assets, a taxpayer (Kimberly-Clark Corporation) sold a paper mill and timberland for $600 million dollars. Kimberly-Clark treated the $600 million dollars of sale proceeds as apportionable business income but excluded the proceeds from its sales factors under Alabama's special "occasional sale" regulation (a regulation almost identical to 2.26-51-715(1)). <u>Kimberly-Clark, et al. v. Alabama Department of Revenue</u>, Alabama Dept. of Revenue, Administrative Law Division, Corp. 01-983 & Corp. 01-995. The administrative law judge denied Kimberly-Clark's sales factor exclusion, finding that the exclusion would result in apportionment formulas that would not "fairly reflect" Kimberly-Clark's business activities in Alabama. Likewise, the exclusion of the XXXXXXXXXX receipts from the sales factors for XXXXXXXXXX and XXXXXXXXXX would create a significant distortion that would not fairly reflect their business activities in Arkansas.

<u>Issue 2</u>

XXXXXXXXXX argues that the Department is specifically authorized to apply the monthly averaging convention if it is reasonably required to reflect the average value of a taxpayer's property. Ark. Code Ann. § 26-51-712. By averaging XXXXXXXXXX's values at the beginning and ending of the tax period, the results are clearly distortive and the Department is trying to shield its obligations behind a procedural defense. The true object of the return and the use of amended returns is to properly reflect income. According to XXXXXXXXXX, the Department should require XXXXXXXXXX's use of the monthly averaging convention to properly reflect income. XXXXXXXXXX believes that the Department cannot arbitrarily deny the use of its discretionary authority.

<u>Analysis – Issue 2</u>

XXXXXXXXXX relies upon Ark. Code Ann. § 26-51-712, which states that the Department may require the use of monthly averaging to properly reflect the average value of a taxpayer's property. However, § 26-51-712 does not authorize a taxpayer to "elect" the monthly averaging of property values. If a taxpayer desires to deviate from the standard property factor calculation method of using beginning and ending property values, § 26-51-718 requires taxpayers to "petition" the Department for permission to use an alternative method. The Supreme Court of Arkansas has addressed this issue, ruling that a petition must be submitted in writing prior to the filing of an original return and not in conjunction with the filing of an amended return (as was done by XXXXXXXXXXX in this case). Leathers v. Jacuzzi, 326 Ark. 857. 935 S.W.2d 252 (1996). Because XXXXXXXXXXX did not comply with the requirements set forth in § 26-51-718, XXXXXXXXXXX's request to use monthly averaging was properly denied.

Conclusion

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

Sincerely,

Tim Leathers
Commissioner of Revenue

TL/mjw