

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

**IN THE MATTER OF** [REDACTED]  
[REDACTED]  
(ACCT. NO.: [REDACTED])

**INDIVIDUAL INCOME TAX  
ASSESSMENTS**

**DOCKET NOS.: 21-057 (2012)  
21-058 (2013)  
21-059 (2014)  
21-060 (2015)  
21-061 (2016)  
21-062 (2017)  
21-063 (2018)**

[REDACTED]

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**TODD EVANS, ADMINISTRATIVE LAW JUDGE  
APPEARANCES**

This case is before the Office of Hearings and Appeals upon a written protest dated November 21, 2019, sent by [REDACTED] Attorney at Law (“Taxpayers’ Representative”) on behalf of [REDACTED], the Taxpayers. The Taxpayers protested assessments issued by the Department of Finance and Administration (“Department”).

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<sup>1</sup> This amount represents [REDACTED] (tax) and [REDACTED] (interest) after application of a payment in the amount of [REDACTED]. The Department’s Representative conceded that this assessment would be waived as it is not timely issued.

<sup>2</sup> This amount represents [REDACTED] (tax) and [REDACTED] (interest) after application of a payment in the amount of [REDACTED]. The Department’s Representative conceded that this assessment would be waived as it is not timely issued.

<sup>3</sup> This amount represents [REDACTED] (tax) and [REDACTED] (interest) after application of a payment in the amount of [REDACTED]. The Department’s Representative conceded that this assessment would be waived as it is not timely issued.

<sup>4</sup> This amount represents [REDACTED] (tax), [REDACTED] (penalty), and [REDACTED] (interest) after application of a payment in the amount of [REDACTED]. The Department’s Representative conceded that this assessment would be waived as it is not timely issued.

<sup>5</sup> This amount represents [REDACTED] (tax) and [REDACTED] (interest) after application of a payment in the amount of [REDACTED].

<sup>6</sup> This amount represents [REDACTED] (tax) and [REDACTED] (interest) after application of a payment in the amount of [REDACTED].

<sup>7</sup> This amount represents [REDACTED] (tax) and [REDACTED] (interest) after application of a payment in the amount of [REDACTED].

A hearing was originally scheduled for July 2, 2020, at 9:00 a.m., in Little Rock, Arkansas.<sup>8</sup> The Department was represented by Susan Fowler, Attorney at Law, Office of Revenue Legal Counsel (“Department’s Representative”). A briefing schedule was established for the parties by letter dated November 18, 2020. The Taxpayers’ Representative filed his Opening Brief on December 17, 2020. The Department’s Representative filed her Response Brief on January 14, 2021. The Taxpayer’s Representative filed his Reply Brief on February 3, 2021. The Department’s Representative filed a second Response Brief on February 3, 2021.<sup>9</sup> The record was closed and the matter was submitted for a decision on February 5, 2021.

## **ISSUE**

Whether the assessments issued against the Taxpayers should be sustained after adjustments agreed to by the Department? Yes, in part.

## **FACTUAL AND LEGAL CONTENTIONS OF THE PARTIES**

### **Prehearing Filings**

#### **A. Department’s Filing**

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<sup>8</sup> During the prehearing teleconference the parties decided that this matter should be considered based on written documents instead.

<sup>9</sup> The Taxpayers’ Representative objected to the consideration of this document as this filing was not listed within briefing schedule. This additional filing was not authorized within the briefing schedule and the Department did not request leave to provide this additional filing. This document is not considered for purposes of this decision.

The Department's Representative provided her rendition of the alleged facts and contentions within her Answers to Information Request writing as follows<sup>10</sup>:

Taxpayers, [REDACTED], timely filed an Arkansas full year resident individual income tax return (**AR1000F**) for the tax years ending December 31, 2016 through December 31, 2018 using the filing status "Married Filing Separately on the Same Return." **Exhibit 1.**<sup>11</sup> Taxpayers are residents of the State of Arkansas, with their address located at [REDACTED]. Taxpayers were residents of Arkansas at all times relevant to this action.

Kevin Melson, Tax Auditor with the Department, reviewed Taxpayers' individual income tax returns and noted that Taxpayers included partnership income for two companies, [REDACTED] and [REDACTED] in arriving at their federal adjusted gross income on their federal individual income tax returns for the years 2012 through 2018. The Taxpayers also reported their [REDACTED] partnership income in arriving at their Arkansas adjusted gross income but failed to reconcile income from [REDACTED] for Arkansas allowable deductions, namely the special depreciation deduction known as the bonus deduction which is set out in 26 U.S.C. § 168(k). Arkansas has not adopted the federal bonus deduction found at 26 U.S.C. § 168(k).

Kevin Melson, Tax Auditor, sent a series of inquiries to Taxpayers regarding periods 2016 through 2018. See Individual Income Tax Inquiries, periods 2016 through 2018 collectively attached as **Exhibit 2**. The Inquiries requested that Taxpayers provide copies of the K-1s and partnership returns for [REDACTED]. See **Exhibit 2**. In response, Taxpayers submitted additional information to the auditor including copies of the federal partnership returns of [REDACTED] for 2012 through 2018. **Exhibit 3**. The partnership returns demonstrate that Taxpayers are the sole members of [REDACTED] treated as a partnership by the IRS.

The principal business of [REDACTED] as listed on its federal partnership return is [REDACTED]. No other information was provided by the Taxpayers concerning the exact nature of the [REDACTED] or property offered by [REDACTED]. Taxpayers have also confirmed that the situs of [REDACTED] is the [REDACTED] and all of its business is conducted within the boundaries of the [REDACTED].

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<sup>10</sup> All exhibits support the statements for which they are cited.

<sup>11</sup> The Department's Representative explained that the parties agreed to remove the assessments for tax years 2012-2015 and agreed to additional adjustments to the assessment for tax years 2016-2018.

State of [REDACTED]. See Taxpayer's Protest Letter attached hereto as **Exhibit 7**. [REDACTED] was organized in the [REDACTED] and continuously operated in the [REDACTED] during the periods of 2016 through 2018. Based upon the information currently available to the Department, [REDACTED] is not required to file an Arkansas partnership return.

After reviewing the information made available by Taxpayers, the auditor adjusted Taxpayers' Arkansas income tax returns for the periods of 2012 through 2018. Taxpayers failed to reconcile their depreciation differences from [REDACTED]. Accordingly, the auditor adjusted their Arkansas individual income tax returns to disallow the special depreciation deduction. An adjusted Arkansas individual income tax return for the years 2012 through 2018 was completed by the Department to reflect the taxes owed Arkansas without the deduction for bonus depreciation.

**Exhibit 4.**

The auditor also determined that Taxpayers underreported their individual income tax liability by greater than 25% for the tax years 2012, 2013, 2014 and 2015. This determination was made by calculating the net tax due as filed by Taxpayers and comparing it with the proposed adjustment of additional tax due. The auditor issued Explanations of Tax Adjustment for the periods 2012 through 2018. Copies of the Explanations of Tax Adjustment are collectively attached as **Exhibit 5**. A Notice of Proposed Assessment was issued as to each period, assessing additional individual income tax in the amounts of [REDACTED] for 2012; [REDACTED] for 2013; [REDACTED] for 2014; [REDACTED] for 2015; [REDACTED] for 2016; [REDACTED] for 2017; and [REDACTED] for 2018. Copies of the Notices of Proposed Assessments are collectively attached as **Exhibit 6**.

Taxpayers recently provided additional information and recalculations of their net tax without use of the bonus depreciation deduction. The Department subsequently reviewed the proposed assessments along with the additional information and found the recalculations of net tax performed by Taxpayers to be correct. The Department concedes that Taxpayers' current tax liability should not, however, include the additional tax assessed for the years 2012, 2013, 2014 and 2015 because they are no longer 25% underreported and outside the applicable statute of limitations. The tax liability for the years 2016 through 2018, should be adjusted as set out in Paragraph 3 above.

The Department received Taxpayer's protest on December 10, 2019. **Exhibit 7**. In it, the Taxpayers claim that the Department is requiring the Taxpayers to recalculate [REDACTED] taxable income. For the reasons outlined below, the Department's assessment of additional individual income tax was correct.

Within her Answers to Information Request, the Department's Representative explained that partnerships are taxed as pass-throughs whose income is directly taxable to the partners in their proportionate share within the State of Arkansas under Ark. Code Ann. § 26-51-405(a) (Repl. 2020). She further instructed that Arkansas residents must calculate their Arkansas tax liability under the Arkansas tax laws, including only those deductions allowed under Arkansas law, citing Ark. Ann. § 26-51-101 *et seq.* (Repl. 2020). While the IRS allows special bonus depreciation during 26 U.S.C. § 168(k) for federal income tax purposes, that deduction was not adopted for Arkansas income tax purposes and must be added back in the calculation for Arkansas income tax purposes as required by Ark. Code Ann. § 26-51-436 (Repl. 2020).

The Department's Representative stated that the Taxpayers filed Arkansas income tax returns reporting income from all sources, including the income from [REDACTED] but improperly continued to claim bonus depreciation, not allowed under Arkansas tax laws. She asserted that the Taxpayers bore the burden of proving entitlement to that deduction. While Arkansas has no authority to assess [REDACTED] (an out of state company without Arkansas income), she declared the Department is asserting its taxing authority over the Taxpayers and their income. Rejecting Taxpayers' citation to Ark. Code Ann. § 26-51-703, she instructed that statute is applicable to apportionment of income earned across multiple states and not the matter at hand, citing *Collins v. Skelton*, 256 Ark. 955, 512 S.W.2d 542 (1974). Addressing Taxpayers' citation to 15 U.S.C. § 381, she observed that residents are excluded from application under 15 U.S.C. § 381(b) and that section is limited to interstate income. Dismissing Taxpayers' citation to Ark. Code Ann.

§ 26-51-404(b)(7), she stated that section is limited to domestic corporations. She concluded noting that the taxation of all of a resident's income has generally been upheld as constitutional, citing *Morgan v. Cook*, 211 Ark. 755, 202 S.W.2d 255 (1947), *People of the State of New York ex re. Cohn v. Graves*, 300 U.S. 308, 57 S.Ct. 466 (1937), and *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. 542, 135 S. Ct. 1787 (2015). She also asserted that the assessment of interest was appropriate under Ark. Code Ann. § 26-18-508 (Repl. 2020).

### **B. Taxpayer's Filing**

The Taxpayers' Representative provided his rendition of the alleged facts and contentions within his Answers to Information Request writing as follows<sup>12</sup>:

The Taxpayers are the sole owners of [REDACTED] [REDACTED] is formed [REDACTED] and conducts all of its business operations outside the State of Arkansas. [REDACTED] pays franchise taxes in [REDACTED] those taxes are based on the amount of revenue collected by [REDACTED] All of [REDACTED] assets are outside the State of Arkansas.

In the course of business, [REDACTED] timely prepared and filed federal income tax returns [REDACTED] partnership and claimed depreciation deductions as provide under federal tax law. [REDACTED] income tax returns were prepared in accordance [REDACTED] and in accordance with the applicable Operating Agreement. The calculations shown on [REDACTED] federal income tax returns control how much money is distributable on the Taxpayers pursuant to the Operating Agreement and those figures were reported to the Taxpayers pursuant to the Operating Agreement and those figures were reported to the Taxpayers on Schedules K-1, allocated to them based on their ownership percentages in [REDACTED] The Taxpayers filed their Arkansas income tax returns using the same figures reported on Schedule K-1.

The Department has proposed assessments against the Taxpayers based on recalculations of [REDACTED] taxable income as it would have been calculated under Arkansas tax law had that law applied to its income tax returns.

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<sup>12</sup> All exhibits support the statements for which they are cited.

It is believed that none of the above-cited facts are in dispute. The only dispute is whether the Department can legally make the proposed assessments.

The Taxpayers cited *N.C. Dept. of Revenue v. Kimberly Rice Kaestner 1992 Family Trust*, 139 S.Ct. 2213, 204 L.Ed. 621 (2019) in support of an apparent assertion that the current assessment violates due process guarantees under the U.S. Constitution.<sup>13</sup>

## Written Briefs

### A. Opening Brief

The Taxpayer's Representative provided the following statement of the stipulated facts within his Opening Brief:

Taxpayers, [REDACTED] timely filed an Arkansas full year resident individual income tax return (**AR1000F**) for the tax years ending December 31, 2016 through December 31, 2018 using the filing status "Married Filing Separately on the Same Return." **Exhibit 1.**<sup>14</sup> Taxpayers are residents of the State of Arkansas, with their address located at [REDACTED] [REDACTED] Taxpayers were residents of Arkansas at all times relevant to this action.

The Department reviewed Taxpayers' individual income tax returns and noted that Taxpayers included partnership income from [REDACTED] [REDACTED] in arriving at their federal adjusted gross income on their federal individual income tax returns for the years 2012 through 2018. The Taxpayers also reported their [REDACTED] partnership income in arriving at their Arkansas adjusted gross income but failed to reconcile income from [REDACTED] for Arkansas allowable deductions, namely the special depreciation deduction known as the bonus deduction which is set out in 26 U.S.C. § 168(k). Arkansas has not adopted the federal bonus deduction found at 26 U.S.C. § 168(k).

The Department sent a series of inquiries to Taxpayers regarding periods 2016 through 2018. See Individual Income Tax Inquiries, periods 2016 through 2018 collectively attached as **Exhibit 2**. The Inquiries requested that Taxpayers provide copies of the K-1s and partnership returns for [REDACTED] See **Exhibit 2**. In response, Taxpayers submitted

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<sup>13</sup> In an additional prehearing reply, the Department's Representative characterized that case as barring states from assessing a grantor trust based on the location of beneficiaries and distinguished that case as involving a separately taxable entity and not a pass-through entity reported on residents' returns like the matter at hand.

<sup>14</sup> The Taxpayer's Representative asserted that all citations to exhibits refers to the exhibits attached to the Department's Answers to Information Request.

additional information to the auditor including copies of the federal partnership returns of [REDACTED] for 2016 through 2018. **Exhibit 3.** The partnership returns demonstrate that Taxpayers are the sole members of [REDACTED] treated as a partnership by the IRS.

The principal business of [REDACTED] as listed on its federal partnership return is [REDACTED]. No other information was provided by the Taxpayers concerning the exact nature of the [REDACTED] offered by [REDACTED]. Taxpayers have also confirmed that the situs of [REDACTED] is the [REDACTED] and all its business is conducted within the boundaries of the [REDACTED]. See Taxpayer's Protest Letter attached hereto as **Exhibit 7.** ORI II was organized in the [REDACTED] and continuously operated in the [REDACTED] during the periods of 2016 through 2018. [REDACTED] is not required to file an Arkansas partnership return. [REDACTED] Operating Agreement is set forth as a part of **Exhibit 7.**

The Department adjusted Taxpayers' Arkansas income tax returns for the periods of 2016 through 2018. The Department adjusted their Arkansas individual income tax returns to disallow the special depreciation deduction claimed by [REDACTED]. An adjusted Arkansas individual income tax return for the years 2016 through 2018 was completed by the Department to reflect the taxes owed Arkansas without the deduction for bonus depreciation. **Exhibit 4.**

The Department issued Explanations of Tax Adjustment for the periods 2016 through 2018. Copies of the Explanations of Tax Adjustment are collectively attached as **Exhibit 5.** Taxpayers recently provided additional information and pro forma recalculations of their net tax without use of the bonus depreciation deduction. The Department subsequently reviewed the proposed assessments along with the additional information and found the pro forma recalculations of net tax performed by Taxpayers to be correct. The Department concedes that Taxpayers' current tax liability should not, however, include the additional tax assessed for the years 2012, 2013, 2014 and 2015 because they are no longer 25% underreported and are outside the applicable statute of limitations. The Department asserts the tax liability for the years 2016 through 2018, should be adjusted as set out below.

The Department received Taxpayer's protest on December 10, 2019. **Exhibit 7.**

The parties agree, that should the Department prevail, the original assessments of additional individual income tax liability for the tax years of 2016, 2017 and 2018 should be adjusted as follows:

	Net Tax	Current Interest	Payments	Balance
2016	████████	████████	████████	████████
2017	████████	████████	████████	████████
2018	████████	████████	████████	████████

Taxpayers recently paid the following amounts that were credited only to the tax balance (not the total balance) owed as requested by the Taxpayers. The current account balance for each year is set forth below:

	Payment	Current Balance
2016	████████	████████
2017	████████	████████
2018	████████	████████

Within his Opening Brief, the Taxpayer’s Representative characterized this matter as an assessment of additional tax (placing the burden upon the Department) and not the denial of a bonus depreciation deduction. He further asserted that the Department lacks jurisdiction over ██████ citing Ark. Code Ann. §§ 26-51-701-723, U.S. Const. Admend. 14, 15 U.S.C. § 381 *et seq.*, and *N.C. Dept. of Rev. v. Kimberly Rice Kaestner 1992 Family Trust*, 139 S.Ct. 2213, 204 L.Ed.2d 621 (2019). He stated that the partnership income, deductions, and credits are determined at the partnership level and the partnership was properly calculated under ██████████. He asserted that an Arkansas partner may only be taxed on income distributable or received by them under Ark. Code Ann. § 26-51-405. He acknowledged that bonus depreciation is not allowed within Arkansas but averred that the Department lacks the authority to force ██████ to recalculate its return under Arkansas law. He concluded his analysis by arguing that the

Department's approach is unworkable by requiring taxpayers to obtain records of out of state partnerships and recalculate their associated income tax returns.

### **B. Response Brief**

Within this filing, the Department's Representative initially incorporated all prior filings and agreed with the stipulated facts provided within the Taxpayer's Opening Brief. She further stated that the Taxpayers are the sole members/partners of [REDACTED] and were required to report the distributable income or loss under Ark. Code § 26-51-405 (Repl. 2020). She noted that Arkansas has not adopted bonus depreciation deduction authorized under 26 U.S.C. § 168(k), which she stated must be added back under Arkansas law. She asserted that the nature of pass-through treatment is to treat the income as if it was personally earned by the Taxpayers. The Taxpayers are then to be taxed upon that income by any relevant taxing authority with sufficient jurisdiction over the Taxpayers. She characterized the partnership return as simply a methodology for calculating the net income/loss prior to inclusion upon the Taxpayers' individual income tax return. She reasserted that Taxpayer's tax liability must be calculated under Arkansas law, citing Ark. Code Ann. §§ 26-51-201 (Repl. 2020) and 26-51-504 (Repl. 2020). She acknowledged that the Department lacks jurisdiction over [REDACTED] but averred that the Taxpayers are still required to prove entitlement to any claimed deductions and to properly calculate their Arkansas income tax returns. She dismissed the Taxpayer's characterization of the use of the Uniform Division of Income for Tax Purposes Act (UDITPA) stating those provisions only apply to partnership returns containing income deriving from activities conducted within multiple

states. Finally, she declared the assessment of interest to be appropriate under Ark. Code Ann. § 26-18-508 (Repl. 2020).

### **C. Reply Brief**

Within this filing, the Taxpayer's Representative initially noted that the Department concurred that it lacks jurisdiction of [REDACTED]. He asserted that any assertion of the principles of taxation of a partnership are irrelevant without statutory adoption. He asserted that Ark. Code Ann. § 26-51-405 (Repl. 2020)) limits the amount of income includable from a partnership within an income tax return to only those amounts received or distributable to them, which he argued was determined at the partnership level through the calculation of income and deductions under Ark. Code Ann. § 26-51-802 (Repl. 2020). He noted that [REDACTED] and the LLC's operating agreement. He declared the requirement that Taxpayers reconstruct a foreign partnership's income tax return in order to accommodate Arkansas income tax statutes and rule that he deemed inapplicable to be unworkable. He acknowledged that Arkansas did not allow bonus depreciation by stated that the Department was attempting to make that adjustment to the return calculated by the foreign partnership.

After a general discussion of the burdens of proof in tax proceedings, a legal analysis with associated conclusions shall follow.

## **FINDINGS OF FACT AND 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).

## **Tax Assessment**

Initially, the Taxpayers bear the burden of establishing entitlement to a tax deduction.<sup>15</sup> Tax deductions and credits, like tax exemptions, exist as a matter of legislative grace. *Cook, Commissioner of Revenue v. Walters Dry Good Company*, 212 Ark. 485, 206 S.W.2d 742 (1947); and *Kansas City Southern Ry. Co. v. Pledger*, 301 Ark. 564, 785 S.W.2d 462 (1990). A taxpayer claiming a deduction or credit bears the burden of proving that he or she is entitled to the deduction or credit by bringing himself or herself clearly within the terms and conditions imposed by the statute that contains the deduction or credit. *Weiss v. American Honda Finance Corp.*, 360 Ark. 208, 200 S.W.3d 381 (2004). Further, as stated above, tax deductions must be narrowly construed. Ark. Code Ann. § 26-18-313(a), (b), and (e) (Repl. 2020). Additionally, any doubts regarding the application of a deduction must be resolved against the application of the deduction. Ark. Code Ann. § 26-18-313(f)(2) (Repl. 2020). Further, the constitutionality of the taxation of both the in state and out of state income of state residents is well established. *Cf Oklahoma Tax Com'n v. Chicksaw Nation*, 515 U.S. 450, 462-463, 115 S.Ct. 2214, 2222-2223 (1995).

Ark. Code Ann. § 26-51-201 (Supp. 2020) imposes the Arkansas individual income tax upon, and with respect to, the entire income of every resident, individual, trust, or estate regardless of whether that income is earned inside or outside the state. The tax is levied, collected, and paid annually upon the entire net income of the individual. Ark. Code Ann. § 26-51-102(16) (Repl. 2020) defines the term “taxpayer” to include any individual, fiduciary, or corporation

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<sup>15</sup> While the Taxpayers’ Representative argued that the Department bore the burden of proof in this matter, that argument is not persuasive as the Taxpayers are attempting to claim a deduction and the burden of proving entitlement to the full amount of a tax deduction is upon a taxpayer under Ark. Code Ann. § 26-18-313(b) (Repl. 2020).

subject to the Arkansas income tax. Ark. Code Ann. § 26-51-102(8) (Repl. 2020) defines the term “individual” as a natural person. For the purpose of tax imposition, the term “Resident” is defined at Ark. Code Ann. § 26-51-102 (Repl. 2020) as follows:

(13) “Resident” means natural persons and includes, for the purpose of determining liability for the tax imposed by the Income Tax Act of 1929, § 26-51-101 et seq., upon or with reference to the income of any taxable year, any person domiciled in the State of Arkansas and any other person who maintains a permanent place of abode within this state and spends in the aggregate more than six (6) months of the taxable year within this state;

The Taxpayers’ income tax returns indicate that the Taxpayers are Arkansas residents and the Taxpayers have not contested this fact.

Discussing the treatment of partnership income, Ark. Code Ann. § 26-51-405 (Repl. 2020) provides the following guidance:

- (a) An individual carrying on business as a partner in a partnership shall be liable for income tax only in his or her individual capacity and shall include in his or her gross income the distributive share of the net income or net loss of the partnership received by him or her or distributable to him or her during the income year.
- (b) The partner shall report all deductions or credits distributable to him or her personally as a partner in the partnership.
- (c) A partner's distributive share of partnership loss shall be allowed only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the partnership year in which the loss occurred.
- (d) Any excess of the loss over the basis shall be allowed as a deduction at the end of the partnership year in which the excess is repaid to the partnership.

While Ark. Code Ann. § 26-51-405(a) (Repl. 2020) mentions a distributive share from a partnership, it does not discuss the calculation of that amount. Ark. Code Ann. § 26-51-403(b)(1) (Repl. 2020) allows a deduction in the calculation of adjusted gross income under Ark. Code Ann. § 26-51-403(b)(1) (Repl. 2020) stating: **“Trade and business deductions otherwise allowable as**

**deductions under this chapter** that are attributable to a trade or business carried on by the taxpayer if the trade or business does not consist of the performance of services by the taxpayer as an employee; . . .” Emphasis supplied.

Further, Ark. Code Ann. § 26-51-504(a)(1) (Repl. 2020) discusses the calculation of an Arkansas income tax liability by a resident upon out of state income, stating:

For the purpose of ascertaining the income tax due by an individual resident of Arkansas whose gross income includes income derived from property located outside the State of Arkansas, or from business transacted outside the State of Arkansas, **the tax shall first be computed as if all of the income of the resident were derived from sources within the State of Arkansas**, but a credit shall then be given on the tax as so computed, for the amount of income tax actually owed by the resident for the year to any other state or territory on account of income from property owned or business transacted in the other state or territory. However, credit shall not exceed what the tax would be on the outside income, if added to the Arkansas income, and calculated at Arkansas income tax rates. [Emphasis supplied.]

The application of Ark. Code Ann. § 26-51-802 (Repl. 2020) is limited to partnerships filing Arkansas partnership income tax returns. Additionally, Ark. Code Ann. § 26-51-703 (Repl. 2020) addresses the apportionment of interstate income and is not applicable to the matter at hand. *See Collins v. Skelton*, 256 Ark. 955, 957, 512 S.W.2d 542,543 (1974).

Based on the applicable statutes, Taxpayers may only calculate their tax liability based on deductions allowed under the Arkansas Income Tax Act (see Ark. Code Ann. § 26-51-403(b)(1) (Repl. 2020)) and must calculate the tax upon their out of state income “as if all of the income of the resident were derived from sources within the State of Arkansas” (see Ark. Code Ann. § 26-51-504(a)(1) (Repl. 2020)). Application of both of these statutes explicitly bars the allowance

of deductions not authorized under Arkansas law. Further, the Taxpayers elected to treat their LLC as a disregarded, pass-through entity and are bound by the tax consequences of that election. While the Taxpayers included language within their Operating Agreement to calculate profits and losses at the LLC prior to distribution, the Department is not bound by that language.

The Department has demonstrated that the Taxpayers earned taxable income within the State of Arkansas during the relevant tax years. That income is generally taxable unless the Taxpayers can demonstrate that a tax credit, deduction, or exemption is applicable by a preponderance of the evidence. The record does not preponderate in favor of a finding that the claimed deduction should be allowed under Arkansas law. Consequently, the assessment is sustained.

### **Interest**

Subject to the limitation in Ark. Code Ann. § 26-18-405(d)(1)(C) (Repl. 2020) and the adjustments agreed to by the Department, 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 remaining tax balance is sustained after the adjustment required under Ark. Code Ann. § 26-18-405(d)(1)(C) (Repl. 2020).

### **DECISION AND ORDER**

Subject to the adjustment required under Ark. Code Ann. § 26-18-405(d)(1)(C) (Repl. 2020) and the adjustments agreed to by the Department, the assessment 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 Taxpayers request 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](mailto: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 Taxpayers have 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.<sup>16</sup>

OFFICE OF HEARINGS & APPEALS

  
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TODD EVANS  
ADMINISTRATIVE LAW JUDGE

DATED: March 11, 2021

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<sup>16</sup> See *Board of Trustees of Univ. of Arkansas v. Andrews*, 2018 Ark. 12.