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This Week in State Tax (TWIST)



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Arkansas: State high court says residents' computation of income from Texas LLC must comply with Arkansas' denial of bonus depreciation

The Arkansas Supreme Court recently held that a resident couple could not claim federal bonus depreciation attributable to income from a non-Arkansas partnership because Arkansas has not adopted Internal Revenue Code (IRC) section 168(k) (the federal provision permitting bonus depreciation of qualified property). The taxpayers, Arkansas residents, owned an interest in a Texas limited liability company that was treated as a partnership for federal income tax purposes. The partnership conducted all its business in Texas and did not file Arkansas returns. In calculating their Arkansas income for tax years 2016 through 2018, the taxpayers included their share of income or loss reported on the partnership's federal returns, which included deductions for federal bonus depreciation. The Arkansas Department of Finance and Administration disallowed the deductions on audit, and the taxpayers appealed. After the taxpayers exhausted administrative remedies, a circuit court ruled in their favor, concluding that they properly calculated their Arkansas liability using the partnership's federal returns, and that the Department lacked jurisdiction over the foreign partnership.

The Arkansas Supreme Court reversed the circuit court decision, explaining that Arkansas taxes residents on their entire income and that the use of federal tax forms does not mean Arkansas has adopted federal income tax law in its entirety. Arkansas law expressly adopts certain federal depreciation provisions but does not adopt IRC section 168(k). Therefore, the taxpayers could not take the deduction for bonus depreciation in calculating their Arkansas taxable income merely because the deduction was reflected on the partnership's federal return. The court also rejected the circuit court conclusion that the Department lacked jurisdiction over the foreign partnership, explaining that to do so conflates jurisdiction over the partnership with Arkansas's authority to tax its residents on all their income. Arkansas was not taxing the partnership; it was taxing the income of residents, and the relevant inquiry is where the taxpayer resides, not where the LLC operates. Accordingly, the partnership's status as a Texas entity and its lack of Arkansas business activity did not prevent Department from adjusting the taxpayers' income to remove a deduction not authorized under Arkansas law. Contact Asad Markatia with questions on *Department of Finance and Administration v. Risor*.

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