

JURISDICTION: OKLAHOMA TAX COMMISSION DECISION
CITE: 87-10-30-19 / PRECEDENTIAL
ID: P-85-085
DATE: OCTOBER 30, 1987
DISPOSITION: DENIED
TAX TYPE: INCOME
APPEAL: REVERSED / S.CT. 69,971
1989 OK CIV APP 101, 792 P.2d 87
OVERRULED BY *In re O'Carroll*, 1998 OK 6, 952 P.2d 45

FINDINGS OF FACT AND CONCLUSIONS OF LAW

STATEMENT OF FACTS

By agreement prior to the hearing, the parties adopted a Stipulation of Facts, approved and executed by the General Counsel's Office and PROTESTANT, concerning the procedure leading up to the hearing and the domiciliary situs of Protestant. The Stipulations, admitted as Exhibit No. 3, is hereby incorporated into these Findings of Fact, Conclusions of Law and Recommendations, and is, by reference, made a part hereof. However, for the convenience of the reader, a brief summary of the salient facts is made.

The PROTESTANT is a corporation organized and existing under the laws of the State of Wisconsin, having its domiciliary situs for purposes of this protest at CITY, Wisconsin. Protestant is duly qualified to do business in the State of Oklahoma. Protestant's principal business activity is the manufacturing of paper and paper products. Protestant timely filed its 1977 Oklahoma Corporate Income Tax Return prior to April 15, 1978. Taxpayer's final net income as originally reported to the Federal government was changed by order of the United States Tax Court on October 20, 1983, and taxpayer advised the Oklahoma Tax Commission of this change by letter dated April 18, 1984, which letter was received on April 23, 1984. The Oklahoma Tax Commission then issued an assessment of additional income tax due the State of Oklahoma, for the tax year 1977, on April 5, 1985. As is stated in the Stipulation of Facts filed by the parties, the taxpayer and the Division did not consent, in writing, to an extension of the assessment period statutorily addressed in Section 223 of the Uniform Tax Procedure Code. Title 68 O.S. 1981, § 223. The limitation of time in which an assessment may be made is set at three (3) years under the latter section, unless, inter alia, the taxpayer and the Oklahoma Tax Commission have consented to an assessment after such time.

CONTENTIONS OF PROTESTANT

Protestant alleges in its first assignment of error that it did not enter into a written agreement to extend the assessment period and therefore the assessment at issue is barred under the limitation period set forth in Section 223 of the Uniform Tax Procedure Code. Title 68 O.S. 1981, § 223.

Protestant alleges in its second assignment of error that the Oklahoma Tax Commission erred in disallowing a deduction by taxpayer of interest expense in the amount of Six Hundred

Ninety-Four Thousand Two Hundred Thirty Dollars and Ninety-Eight Cents (\$694,230.98). Protestant further contends that the only authority the Income Tax Division has for the disallowance is based on Division policy and not authorized under 68 O.S. 1971, § 2358(A)(4).

Protestant alleges in its third assignment of error that interest income from Certificates of Deposit is “investment” income and should be directly allocated to the domiciliary situs of the Protestant under 68 O.S. 1971, § 2358(A)(4), rather than apportioned in part to Oklahoma as “business interest” under 68 O.S. 1971, § 2358(A)(5).

Protestant alleges in its fourth assignment of error that rental income derived from houses and buildings in the Protestant’s domicile should be treated as investment income under 68 O.S. 1971, § 2358 (A)(4)(a), and therefore allocated to Protestant’s domicile rather than treated as business income, and therefore includable in unitary income and apportionable in part to Oklahoma under 68 O.S. 1971, § 2358(A)(5).

Protestant alleges in its fifth assignment of error that the Oklahoma Tax Commission has adjusted Protestant’s sales apportionment factor by deducting sales returns and allowance as well as freight charges from total sales within and without Oklahoma without statutory authority for this procedure. Protestant further alleges that this is inconsistent application of the statute because it reduces only the total sales of Protestant (affecting the denominator in the apportionment equation) while not reducing the sales of Protestant in Oklahoma (affecting the numerator in the apportionment equation). Protestant asserts that Protestant has applied the sales apportionment formula consistently by including sales returns and allowances as well as freight charges in both the numerator and denominator.

CONTENTIONS OF THE DIVISION

In response to the Protestant’s allegations of error, the Division states the following:

First, the Division timely made its assessment within one (1) year from the date it was given notice of changes made by the Internal Revenue Service in Protestant’s 1977 Federal return. The Division contends that its assessment thereafter is consistent with statutory authority under Section 2375(G) of Title 68 of the Oklahoma Statutes.

Second, the Division has disallowed a portion of interest expense related to income that is not subject to Oklahoma income tax using a widely accepted formula applied by a majority of states. The Division contends that this disallowance is consistent with statutory authority under Section 2358(A)(4) of Title 68 of the Oklahoma Statutes.

Third, the Division states that interest income attributable to Certificates of Deposit is properly considered “business interest” and is therefore unitary in nature and in part apportionable to Oklahoma under Section 2358(A)(5) of Title 68 of the Oklahoma Statutes.

Fourth, the Division contends that Protestant treated rental income as allocable solely to Protestant’s domicile as investment property rather than apportionable in part to Oklahoma as business income, while at the same time, Protestant treated the subject property as unitary in

nature and included such property in the formulation of the Property Factor. The Division contends that this is inconsistent treatment by Protestant of income attributable to certain assets and the Division has therefore disallowed the allocation of income therefrom to its domicile since the property was treated as unitary in nature by the Protestant.

Fifth, the Division has reduced total sales within and without Oklahoma by eliminating sales returns and allowances as well as freight charges from Protestant's gross sales. This Division states that the foregoing, which reduces the denominator of the sales factor formula, was adjusted to reflect gross sales reported on Protestant's 1977 Federal return. The Division states that the sales factor should include only sales under Section 2358(A)(5)(c) of Title 68 of the Oklahoma Statutes.

ISSUES

I. Whether, if the Oklahoma Tax Commission and the taxpayer have not consented in writing to a tax assessment before the limitation of time prescribed under Section 223 of Title 68, the Tax Commission may impose an assessment under Section 2375(G), where the net income from taxpayer's original return is subsequently changed or corrected by the Internal Revenue Service.

II. Whether interest expense attributable to income fully allocable to taxpayer's domicile is likewise fully allocable to taxpayer's domicile, and therefore, fully deductible from Oklahoma taxable income under Section 2358(A)(4) of Title 68 of the Oklahoma Statutes.

III. Whether interest income derived from short-term Certificates of Deposit are unitary in nature, and thus should be apportioned in part to Oklahoma under Section 2358(A)(5) of Title 68 of the Oklahoma Statutes.

IV. Whether gross rental income derived from real property is fully allocable to taxpayer's domicile without deduction for allowable expenses under Section 2358(A)(4)(a) of Title 68 of the Oklahoma Statutes.

V. Whether the numerator and denominator on Protestant's federal and state income tax returns were properly adjusted to arrive at Protestant's Oklahoma taxable income.

APPLICABLE LAW

This action arises under Sections 2358 and 2375 of the Oklahoma Income Tax Code (68 O.S. 1971, §§ 2358, 2375), and the Oklahoma Tax Commission has jurisdiction to hear this protest under the Uniform Tax Procedure Code (68 O.S. § 203).

The first issue presented is whether the Tax Commission may impose an additional assessment under Section 2375(G) of the Oklahoma Income Tax Code where the limitation of time to make an assessment has expired under Section 223 of the Uniform Tax Procedure Code. As pertinent to this issue, Section 223(a) provides that, "No assessment of any tax levied under the provisions of any state tax law . . . shall be made after the expiration three (3) years from the

date the return was required to be filed, or the date the return was filed, whichever period expires the later ...”

Section 223(b) provides:

(b) Where before the expiration of the time prescribed in the preceding paragraph for the assessment of the tax, both the Tax Commission and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon, and the period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon. In those instances where the time to file a claim for a refund has not expired at the date the extension agreement is entered into, the entering into such an agreement shall automatically extend the period in which a refund may be allowed or a claim for a refund may be filed to the final date of such agreement.

Based on the statutory prescription requiring the mutual consent, in writing, of the taxpayer and the Tax Commission before an assessment could be extended beyond the three (3) year limitation provided in subsection (a) above, Protestant asserts that the Division is necessarily prohibited from changing or correcting its original assessment since the three (3) year period of time had expired. In the alternative, Protestant argues that Section 2375 likewise requires a written agreement between taxpayer and the Tax Commission before any other assessment may be made.

Section 2375(G) provides:

G. Where, before the expiration of the time prescribed in Section 223 of the Uniform Tax Procedure Code for the assessment of the tax, the taxpayer and the Internal Revenue Service have consented in writing to an extension of time in which the federal income tax may be assessed, the tax imposed under this law may be assessed, or refunded, at any time prior to the expiration of time agreed upon, with such additional time added as specified hereinbelow.

If the amount of the net income for any year of the taxpayer under this law, and as returned to the United States Treasury Department, is changed or corrected by the Internal Revenue Service, such taxpayer, within one (1) year after final determination of the corrected net income, shall file an amended return reporting the corrected net income, or notify the Tax Commission by letter that the information is available, and the Tax Commission shall make assessment or refund based thereon within one (1) year from the date the return or notice required by this section is filed and not thereafter, unless a waiver is agreed to and signed by the Tax Commission and the taxpayer.

In the event of failure by a taxpayer to comply with the provisions of this section, the statute of limitations shall be tolled for a period of time equal to

the time between the date the return or notice under this section is required until such return or notice is actually furnished.

The underlying rationale of the second paragraph of Section 2375(G) is apparent when applied to the facts of this case. Where the Internal Revenue Service has changed or corrected a taxpayer's federal return, that change must be reported to the Oklahoma Tax Commission within one year either by the filing of an amended return reporting the corrected net income or by notifying the Tax Commission by letter that the correct information is available. Where, therefore, the taxpayer's federal return is corrected by the Internal Revenue Service, the state return cannot be corrected until the required notice is received. The language of Section 2375(G) would be rendered useless if the Tax Commission could require notice of the amended return but, in effect, be unable to assess an additional tax or grant a refund based upon the correct information. The additional time necessary to complete this process is granted in Section 2375(G), first paragraph. The second paragraph of Section 2375(G) contemplates a situation in which an agreement has not been reached between the Internal Revenue Service and the taxpayer in writing and in which the Tax Commission assessment or refund provisions are dependant upon the Internal Revenue Service determination.

This statute must grant the Tax Commission additional time since the source of the corrected information is not within the control of the Tax Commission. This is consistent with the purpose of limitation of actions in taxation and consistent with a reasonable construction of § 2375(G) since the Tax Commission is given, under the 1971 statute, only one (1) year to make an additional assessment or refund.

The second issue presented is whether, under Section 2358(A)(4), interest expense is fully allocable to taxpayer's domicile along with the income related to that expense. If the interest expense is fully allocable, then it should be fully deductible from Oklahoma taxable income, says taxpayer, since there is no statutory authority for allocating only a portion thereof. The Division argues that Section 2358(A)(4) specifically provides for allocation of only part of the expense related to interest income.

Section 2358(A)(4) provides:

§ 2358. Adjustments to arrive at Oklahoma taxable income and Oklahoma adjusted gross income.

A. Taxable income where use of adjusted gross income is necessary, i.e. required by this act, adjusted gross income shall be adjusted as follows to arrive at Oklahoma taxable income and Oklahoma adjusted gross income:

...

4. Items of the following nature shall be allocated as indicated. Allowable deductions attributable to items separately allocable in subparagraphs a, b and c of this paragraph, whether or not such Items of income were actually received, shall be allocated on the same basis as those items:

...
b. Income from intangible personal property, such as interest, dividends, patent or copyright royalties, and gains or losses from sales of such property, shall be allocated in accordance with the domiciliary situs of the taxpayer, ...

The point of departure between the Division and taxpayer is the question as to whether deductions of a portion of those allowable deductions in the second sentence of subsection (4) should be determined by the Division, by use of its own formula, without having the benefit of a verifiable figure supplied by the taxpayer, or whether, as taxpayer contends, there is no expense involved in earning the allocated income, and, thus no deduction should be allocated to taxpayer’s domicile; no deduction for costs incurred in earning that income should be made on taxpayer’s Oklahoma return.

The statute plainly proscribes state taxation of long term allocated interest income. However, implicit in the statutory scheme is the principle that, if taxpayer is going to allocate income to its domicile, it is constrained from deducting from Oklahoma taxable income the expense associated with earning that income, since that expense is associated with carrying assets which produce income not taxable by the State of Oklahoma. The question then becomes, upon what basis does the Division determine, by formula, an allowable deduction of expense associated with interest earned and which must be reported on taxpayer’s Oklahoma return?

The underlying assumption should be that expenses incurred should reasonably relate to the income earned. That is, absent any separate and verifiable accounting by taxpayer as to actual expense incurred, the Division must determine what percentage of total expense reasonably relates to taxpayer’s total income.

The Division achieved this by first determining the ratio of taxpayer’s interest income to total income. This ratio was then applied to arrive at the amount of interest expense allowable as a deduction from Oklahoma taxable income. This portion of interest expense then was not allowed as a deduction because it did not relate to Oklahoma taxable income. Expressed as a formula, the following illustrates how it applied to this taxpayer:

1. Average investments in intangible personal property for this taxpayer in tax year 1977 were Fifty-Five Million Three Hundred Seventy-Nine Thousand Three Hundred Three Dollars (\$55,379,303.).
2. Taxpayer’s average assets for tax year 1977 were Two Hundred Sixty-Five Million Nine Hundred Twenty-Five Thousand One Hundred Thirty-Seven Dollars (\$265,925,137.00).
3. Ratio of average investments in intangible personal property to total average assets:

\$ 55,379,303.00		20.83%
-----	=	or roughly
\$265,925,137.00		21%

The above formula illustrates that roughly Twenty-One Percent (21%) of taxpayer's assets were derived from investments in intangible personal property. These assets are not taxable by the State of Oklahoma because they are allocable to taxpayer's domicile under § 2358(A)(4)(b) of Title 68 of the Oklahoma Statutes. Taxpayer reported on its Oklahoma return that Three Million Three Hundred Thirty-Three Thousand Six Hundred Twenty-Six Dollars (\$3,333,626.00) in expense was incurred in earning its total assets a portion of which expense should likewise be allocated under § 2358(A)(4) (First). The Division correctly determined, then, that a deduction for expense incurred in earning intangible assets should be in the same proportion as intangible assets are to total assets, the presumption being that the cost of carrying intangible assets is likewise proportional to the cost of carrying all assets.

Protestant states that it is its policy to protest all taxes for which the only basis is Division policy (Brief of Protestant, p. 5). The policy of the Division in this case is well within the purview of Section 203 of the Uniform Tax Procedure Code, which section authorizes the Division to promulgate all necessary rules "as may be necessary to ascertain and compute the tax payable by any taxpayer subject to taxation under State tax law; . . . "Title 68 O.S. § 203. Taxpayer has the burden of showing the unreasonableness of the Division's determination. Rule 26 of the Rules of Practice and Procedure Before the Oklahoma Tax Commission. Absent an accounting by taxpayer as to actual expense incurred, it was necessary for the Division to reasonably calculate an allowable deduction, and the Division's formulation reasonably relates cost of carrying the assets for which a deduction was claimed.

The third issue presented is whether interest income derived from short-term Certificates of Deposit is to be construed as allocated interest income under § 2358(A)(4)(b) or, whether such income is considered as property used by the Protestant of a unitary nature and thus in part apportionable to Oklahoma. In broad terms, the introductory paragraph to the Oklahoma statute relevant to this issue provides that certain income of a unitary nature shall be apportioned in part to Oklahoma based on the arithmetical average of three factors consisting of property, payroll and sales or gross revenue. The short-term certificates here were held and used in the regular course of taxpayer's business to meet current obligations should they arise, and were not invested in the business of taxpayer which is the manufacture of paper products, and were thus unitary in nature. The burden of proof again rests on the taxpayer to show that the income in question was non-business income, and should therefore have been allocated to Protestant's domicile. The Division's reasoning is correct in that the funds invested in short-term Certificates of Deposit are in actuality working capital used to meet business expenses.

Protestant, having conceded that the Thirty-Seven Thousand Sixty-Nine Dollars and Ninety Cents (\$37,069.90) of rental income is properly includable in unitary income, Issue IV is moot. Finally, Protestant, having conceded that the Division properly adjusted Protestant's total sales as reported on its federal return to reflect that same figure on its state return, Issue V is moot.

CONCLUSIONS OF LAW

In view of the above and foregoing findings of fact and law applicable thereto, the undersigned Administrative Law Judge concludes as follows:

(1) That the Oklahoma Tax Commission has jurisdiction in this matter.

(2) That the Oklahoma Tax Commission may impose an additional assessment under Section 2375(G) of Title 68 of the Oklahoma Statutes where the net income from taxpayer's original return is subsequently changed or corrected by the Internal Revenue Service.

(3) Interest expense attributable to income which is allocable to taxpayer's domicile is likewise allocable to taxpayer's domicile. Title 68 O.S. 1971, § 2358(A)(4).

(4) Interest income from short-term Certificates of Deposit are unitary in nature since they are held and used in the regular course of taxpayer's business as working capital and are not of an allocable nature to the taxpayer's domicile as an investment in furtherance of the manufacture of paper products.

(5) Issues IV and V, having been conceded by Protestant at hearing, are therefore rendered moot as to this proceeding.

(6) The Income Tax Protest of PROTESTANT should be denied.

DISPOSITION

It is the ORDER of the TAX COMMISSION based upon the specific facts and circumstances of this case, that the Income Tax Protest of PROTESTANT be denied.

OKLAHOMA TAX COMMISSION