JURISDICTION: **OKLAHOMA TAX COMMISSION - DECISION**
CITE: **99-02-08-007 / NOT PRECEDENTIAL**
ID: **P9500330**
DATE: **02-08-99**
DISPOSITION: **SUSTAINED**
TAX TYPE: **INCOME**
APPEAL: **NO APPEAL TAKEN**

BY ORDER NUMBER 99-01-05-004, THE COMMISSION WITHDREW ITS PRIOR ORDER, NO. **98-12-03-004**, AND GRANTED A MOTION FOR RECONSIDERATION FILED BY THE OFFICE OF THE GENERAL COUNSEL.

UPON RECONSIDERATION, THE COMMISSION ADOPTED THE FINDINGS, OF FACT, CONCLUSIONS OF LAW AND RECONSIDERATION MADE AND ENTERED BY THE ADMINISTRATIVE LAW JUDGE ON THE 16TH DAY OF OCTOBER, 1998.

WE SEE NO IMPEDIMENT IN ADOPTING SAID FINDINGS AS TO THE RULE IN QUESTION, ESPECIALLY SINCE OUR RULING IN THIS REGARD IN NO WAY OPERATES TO THE PREJUDICE OF THE TAXPAYER.

FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. The parties stipulate to the following:

I. PROCEDURAL FACTS

1. By letter dated August 24, 1995, by AN ANONYMOUS AUDITOR, Corporate Auditor's Section, Income Tax Division of the Commission, the Commission proposed to assess additional income tax against the PROTESTANT Group for the fiscal periods ending June 30, 1990, June 30, 1991 and June 30, 1993, under the Commission's audit numbers. No additional income tax was proposed for assessment for the fiscal period ending June 30, 1992 under audit file no. 555555.

2. An extension of time pursuant to Subsection 221(c) of Title 68 to December 22, 1995, in which to reply to the proposed assessment was granted in the letter of the Commission by AN ANONYMOUS AUDITOR dated October 6, 1995, pursuant to the request of the undersigned counsel for the PROTESTANT Group, by letter dated September 18, 1995.

3. The PROTESTANT Group timely filed a formal Protest objecting to the proposed assessment on December 21, 1995.

4. On February 9, 1996, the Commission by letter of AN ANONYMOUS AUDITOR issued a revised proposed assessment which corrected certain errors in the original proposed assessment. The Commission no longer proposes to assess any amounts for the fiscal periods ending June 30, 1990 and June 30, 1991. Additional tax and interest is now proposed for assessment only for the fiscal period ending June 30, 1993.

5. The PROTESTANT Group timely filed its First Supplement to Protest (the "First Supplement") objecting to the Revised Proposed Assessment on February 29, 1996.

6. The amounts at issue with respect to the Revised Proposed Assessment are as follows:

	1992 (07/01/92 - 06/30/93)
Income Tax	$21,553.00
Interest (Through 03/01/96)	7,954.00
TOTAL	$29,507.00

In addition, in the event that the Protest is upheld, the overpayment of tax by the PROTESTANT Group on line L of page 1 of the Revised Proposed Assessment, for each of the fiscal years ending June 30, 1990 through June 30, 1993, will increase due to the availability of investment/new jobs credits allowed per lines G through K of the Revised Proposed Assessment.

7. A prehearing conference was held on March 18, 1996. The Administrative Law Judge issued a Prehearing Conference Order and Notice of Hearing on April 23, 1996.

8. The PROTESTANT Group filed its Second Supplement to Protest herein on May 17, 1996 ("Second Supplement") adding certain additional alleged errors in the Revised Proposed Assessment.

II. THE UNITARY NATURE OF THE PROTESTANT GROUP

9. PROTESTANT was a ANONYMOUS corporation having its principal place of business and commercial domicile in AN ANONYMOUS STATE.

10. PROTESTANT was the ultimate parent corporation and owner, directly or indirectly through one or more wholly-owned subsidiaries, of all the outstanding voting stock of the Subsidiaries, with the exception that COMPANY X, Inc. (one of the Subsidiaries) was the owner of 99.996% of the stock of COMPANY Y and the owner of 89% of the stock of COMPANY Z.

11. The members of the PROTESTANT Group were engaged in business in all fifty States and overseas and had their principal places of business and commercial domicile in fourteen States.

12. The PROTESTANT Group were all engaged in the same line of business, which was the design, manufacture and marketing of an extensive line of valves for the water plumbing and heating, water quality, water flow control, steam, industrial, and oil and gas markets. A detailed description of the business of the PROTESTANT Group is set forth in the Form 10-K filed with the United States Securities and Exchange Commission for the fiscal year ended June 30, 1993.

13. PROTESTANT and the Subsidiaries had common officers and Directors.

III. THE PROTESTANT GROUP CONSOLIDATED FEDERAL AND STATE INCOME TAX RETURNS

14. The PROTESTANT Group constituted an "affiliated group" pursuant to Section 1504 of the Internal Revenue Code of 1986, as amended.

15. The PROTESTANT Group filed its Federal income tax returns on a consolidated basis.

16. PROTESTANT itself and four (4) of the Subsidiaries, SUBSIDIARY ONE, Inc., SUBSIDIARY TWO, Inc., SUBSIDIARY THREE, Inc. and SUBSIDIARY FOUR, were qualified to do business in Oklahoma and were directly engaged in business in Oklahoma. SUBSIDIARY THREE, Inc. was merged into SUBSIDIARY ONE, Inc. during the fiscal year ended June 30, 1993.

17. PROTESTANT and four (4) other members of the PROTESTANT Group had property, payroll or sales from within and without the State of Oklahoma. All other members of the PROTESTANT Group had property, payroll or sales outside the State of Oklahoma.

18. The PROTESTANT Group timely elected to file its Oklahoma income tax returns on a consolidated basis and the Commission has not challenged the form of the election or the PROTESTANT Group's right to file such election.

19. In its consolidated Oklahoma income tax return, the PROTESTANT Group reported its Federal consolidated group taxable income and then apportioned that income to Oklahoma based on the consolidated Oklahoma apportionment factors of the

PROTESTANT Group.

20. In the proposed assessment, the Commission computed the separate Oklahoma taxable income for each member of the PROTESTANT Group on its own respective Oklahoma apportionment factors and then combined the resulting amounts for one total income upon which the tax was computed. This resulted in the separate income (or loss) of PROTESTANT itself and three (3) of the PROTESTANT Subsidiaries, namely SUBSIDIARY ONE, Inc., SUBSIDIARY TWO, Inc. and SUBSIDIARY FOUR, Inc., being added together to determine the Oklahoma consolidated income of the PROTESTANT Group, since the separate Oklahoma factors of the other Subsidiaries were zero.

21. The proposed assessment was proposed in accordance with the Oklahoma Tax Commission Permanent Rules (the "Rules").

22. The Oklahoma consolidated taxable income of the PROTESTANT Group, as adjusted in the proposed assessment, does not reflect the Federal intercompany adjustments used in determining the PROTESTANT Group's Federal consolidated taxable income. Such Federal intercompany adjustments include adjustments for dividends received from affiliated companies, intercompany interest income and expense, investments in Subsidiaries, intercompany payables and receivables, and netting of capital gains and losses of the affiliated companies.

23. The following consolidated adjustments were made on the PROTESTANT Group Federal income tax returns for the fiscal period ending June 30, 1993:

- A consolidated adjustment was made for the elimination of intercompany sales between PROTESTANT and the Subsidiaries in the amount of $6,898,664.

- A consolidated adjustment was made for the elimination of intercompany investment between PROTESTANT and the Subsidiaries in the amount of $3,630,695.

- A consolidated adjustment was made to eliminate intercompany debt between PROTESTANT and the Subsidiaries in the amount of $16,900,000.

- A consolidated adjustment was made for the elimination of intercompany accrued royalty expense between PROTESTANT and the Subsidiaries in the amount of $3,694,124.

- A consolidated adjustment was made for the elimination of intercompany accrued interest expense between PROTESTANT and the Subsidiaries in the amount of $397,500.

IV. THE STATUTORY AMENDMENT

24. Section 2367 of Title 68 was amended effective September 1, 1993. The amendment is contained in Chapter 273, Section 5, and was effective under Chapter 273, Section 17 of the 1993 Session Laws.

V. THE ANONYMOUS GROUP CASE

25. The ANONYMOUS Group has executed a Limited Waiver of Confidentiality as to the disclosure of material facts of the ANONYMOUS Case for the purposes of this Protest, except for financial and tax data regarding the ANONYMOUS Group therein.

26. The ANONYMOUS Case presented the same method of consolidated filing issue under the same statute as in effect in this Protest.

27. The Administrative Law Judge issued Findings, Conclusions and Recommendations denying the Protest in the ANONYMOUS Case, filed therein on March 7, 1994 (the "Findings").

28. The Division withdrew the proposed assessment in the ANONYMOUS Case by letter dated March 21, 1994.

29. The Division and the ANONYMOUS Group filed that certain Joint Motion of Protestant and Income Tax Division Withdrawing Proposed Assessment and Protest in the ANONYMOUS Case, filed therein on March 21, 1994.

30. In the ANONYMOUS Case, (1) the Findings interpreted subsection (2) of Section 2367 to preclude a consolidated return by a Federal consolidated group having any members who do not derive a portion of their income from sources inside the State of Oklahoma, and (2) the Findings interpreted the term, the "group's consolidated income," within the meaning of subsection (3) of Section 2367 then in effect, to mean the Federal consolidated income of the Federal consolidated group.

B. Additional Findings of Fact

1. PROTESTANT provided significant administrative, personnel and supervisory services for the Subsidiaries.

2. The PROTESTANT Group had shared technology, shared performance and safety standards, common production standards, a common acquisition strategy focused on the valve industry, and common regulatory standards and code enforcement.

3. PROTESTANT negotiated and reviewed major contracts and purchases for the Subsidiaries and provided input and review of the budgets of the Subsidiaries.

4. PROTESTANT determined the identity of senior management of each Subsidiary.

5. PROTESTANT employed a centralized cash management system for the benefit of the Subsidiaries and obtained all third party financing for members of the PROTESTANT Group.

6. PROTESTANT provided group insurance policies for the PROTESTANT Group.

7. PROTESTANT approved all capital expenditures by a Subsidiary in excess of $20,000.00.

8. PROTESTANT maintained a centralized Tax Department for the preparation of consolidated Federal Income Tax Returns and of the various state income and franchise tax returns of the PROTESTANT Group.

9. PROTESTANT maintained a corporate Legal Department to assist the PROTESTANT Group on all pending legal matters.

10. PROTESTANT maintained approval authority over significant personnel issues of the PROTESTANT Group including employee benefit changes, headcount additions, pay increases for salaried employees, and intercompany employee transfers from one Subsidiary to another.

11. Bonus payments to Subsidiary executive management were based not only upon the performance of the Subsidiary employer, but also partly on the performance of the PROTESTANT Group as a whole.

12. The withdrawal of the proposed assessment against the ANONYMOUS Group by letter dated March 21, 1994 was by its own terms an action of the Tax Commission by AN ANONYMOUS EMPLOYEE, then Director of the Income Tax Division.

13. The Tax Commission by the Income Tax Division withdrew the proposed assessment against the ANONYMOUS Group even though the protest of the ANONYMOUS Group therein had been denied by the Administrative Law Judge in the proposed ANONYMOUS Findings.

14. The Tax Commission by the Income Tax Division withdrew the proposed assessment against the ANONYMOUS Group because it understood that the proposed legal conclusions in the proposed ANONYMOUS Group Findings were adverse to the position of the Income Tax Division in the ANONYMOUS Group Case.

15. In withdrawing the proposed assessment against the ANONYMOUS Group, the Division permitted a Federal affiliated group with corporate members who do not have separate Oklahoma income to file on a consolidated basis under the statute at issue.

16. The Division has maintained in this proceeding that the proposed assessment against the PROTESTANT Group is valid even though the Division is aware that it withdrew the proposed assessment against the ANONYMOUS Group.

17. The facts and law applicable to the consolidated return method of filing issue presented in this Protest are substantially similar to those presented in the ANONYMOUS Case, but the Division has declined to withdraw the Revised Proposed Assessment.

ISSUES AND CONTENTIONS

The primary issue presented for decision is whether the starting point for determining the Oklahoma taxable income of an affiliated group of corporations which file an Oklahoma consolidated return pursuant to 68 O.S. 1991, § 2367, is the consolidated taxable income of the group, as reported on the group's Federal consolidated income tax return, or the separate taxable income for each member of the consolidated group. The statute at issue, Section 2367, was amended effective September 1, 1993, which does not include the tax period at issue in this Protest.

The PROTESTANT Group contends that the consolidated income of an affiliated group of corporations for Oklahoma income tax purposes begins with the group's consolidated income for Federal income tax purposes. In support of this contention, the PROTESTANT Group raises several arguments.

First, the PROTESTANT Group argues that the provisions of Section 2367 are plain and unambiguous and expressly provide that it is "the group's consolidated income" which is subject to allocation and apportionment under Sections 2358 and 2362, not the separate income of each member of the group.

Second, the PROTESTANT Group argues that the Division's interpretation of the statute not only effectively denies the right to elect to file on a consolidated basis, but makes the statute a nullity.

Third, the PROTESTANT Group argues that the Division's method is inconsistent with the Legislature's intent that there be symmetry between Federal and State income tax concepts; in particular, that the consolidated group be treated as a single taxpaying entity.

Fourth, the PROTESTANT Group argues that the Division's method fails to recognize the intercompany adjustments required under the Internal Revenue Code of 1986, as amended, to compute Federal consolidated income, as required by the preamble to Section 2367.

Fifth, the PROTESTANT Group cites ***Getty Oil Co. v. Oklahoma Tax Commission***[1] and ***Postal Finance Co. v. Oklahoma Tax Commission***[2] and argues that the Division's Method is inconsistent with the Supreme Court's interpretation of consolidated returns under these cases.

Sixth, the PROTESTANT Group argues that Subsection 2 of Section 2367 requires only that one member of the group have separate nexus with Oklahoma, and alternatively, the PROTESTANT Group as a "group" had nexus with Oklahoma, and that any nexus objection which a company may interpose is effectively waived by the PROTESTANT Group's election voluntarily to file a consolidated return.

The PROTESTANT Group argues that the Rules issued by the Commission in interpreting Section 2367 are inconsistent with the statute and are invalid because an Oklahoma consolidated return is not a combined return. Finally, the PROTESTANT Group argues that the changes made to the consolidated return statute, Section 2367, effective after September 1, 1993, demonstrate that the Division's interpretation of the statute in effect for the tax period at issue is erroneous.

The PROTESTANT Group also argues that the Division's proposed assessment is inconsistent with the Tax Commission's withdrawal in 1993 of the 1991 proposed assessment against the ANONYMOUS Group, a similarly-situated multistate, Federal affiliated taxpayer group that filed a consolidated Oklahoma income tax return under the same statute and under the same method as the PROTESTANT Group. The PROTESTANT Group argues that such inconsistency violates the Uniformity and Due Process Clauses of the Oklahoma Constitution and the Equal Protection and Due Process Clauses of the Federal Constitution. The PROTESTANT Group argues that such inconsistency is intentional and shows "bad faith" on the part of the Division.

The Division contends that the Oklahoma consolidated income of an affiliated group is determined by computing the separate Oklahoma taxable income for each member of the group on its own respective Oklahoma factors and then combining the resulting separate Oklahoma taxable incomes for one total income upon which the tax is computed. In support of this contention, the Division argues that the PROTESTANT Group's interpretation of Section 2367 is against the intent of the Legislature and not supported under the Rules of the Tax Commission. The Division argues that under the PROTESTANT Group's interpretation, the Tax Commission could possibly tax the income of a corporation which does not have any nexus with the State of Oklahoma. The Division argues that its method of computing the consolidated income of an affiliated group of corporations more nearly represents the Federal consolidated method than the approach advocated by the PROTESTANT Group.

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[1] 563 P.2d 627 (Okl. 1977)

[2] 594 P.2d 1205 (Okl. 1977)

Finally, the Division asserts that the ANONYMOUS Group Case is not relevant to this Protest and, accordingly, has objected to the relevancy of any stipulations and also to the deposition testimony of MS. A with respect to the ANONYMOUS Group Case. The Division also argues that the withdrawal of the ANONYMOUS Group Case was not the act of the Tax Commission but that of an employee of the Tax Commission and that the ANONYMOUS Group Findings are not precedential since the same were withdrawn.

The PROTESTANT Group seeks costs and reasonable attorneys' fees. In addition, the PROTESTANT Group seeks a waiver of interest in the event any taxes are found to be due and owing under the proposed assessment. The Division asserts that the Protest should be denied and the proposed assessment upheld.

CONCLUSIONS OF LAW

1. Jurisdiction over the parties and subject matter of this proceeding is vested in the Commission. 68 O.S. 1991, § 207.

2. The provision of the Oklahoma Tax Act[3] which is relevant to the issue presented herein is 68 O.S. 1991, § 2367. Section 2367 provides:

> The provisions of the Internal Revenue Code, applicable to consolidated corporate income tax returns, shall not apply to taxpayers under this act, except that:
>
> 1. If two or more corporations file federal income tax returns on a consolidated basis, and if all of such corporations derive all of their income from sources within Oklahoma, then such corporations shall be required to file consolidated returns for purposes of determining their Oklahoma income tax liability.
>
> 2. If two or more corporations file federal income tax returns on a consolidated basis, and if one or more of such corporations derive a portion of their income from sources outside the State of Oklahoma, then such corporations shall not be required to file consolidated returns for purposes of determining their Oklahoma income tax liability except as hereinafter provided in subsection 3 of this section.
>
> 3. The Oklahoma Tax Commission shall permit an affiliated group of corporations described in subsection 2 of this section to elect to file a consolidated return for Oklahoma income tax purposes provided such group files an appropriate election in accordance with regulations to be promulgated by the Tax Commission. If an affiliated group of corporations elects to file a consolidated Oklahoma income tax return under the provisions of this subsection, the group's consolidated income, loss or deductions shall be determined in accordance with the provisions of Sections [2358 and 2362] of this act.

[3] 68 O.S. 1991, § 2351, ***et seq.***

This statute was amended effective for the period after September 1, 1993, and the changes made are, as shown in the Session Law, by underscoring for additions and cross-through for deletions, as follows:

> Section 2367. The provisions of the Internal Revenue Code, 26 U.S.C., Section 1 ***et seq.***, applicable to consolidated corporate income tax returns, shall not apply to taxpayers under this act, except that:
>
> 1. If two or more corporations file federal income tax returns on a consolidated basis, and if all of such corporations derive all of their income from sources within Oklahoma, then such corporation shall be required to file consolidated returns for purposes of determining their Oklahoma income tax liability.
>
> 2. If two or more corporations file federal income tax returns on a consolidated basis, and if one or more of such corporations derive a portion of their income from sources outside the State of Oklahoma, then such corporations shall not be required to file consolidated returns for purposes of determining their Oklahoma income tax liability except as hereinafter provided in subsection 3 of this section.
>
> 3. The Oklahoma Tax Commission shall permit an affiliated group of corporations described in subsection 2 of this section to elect to file a consolidated return for Oklahoma income tax purposes provided such group files an appropriate election in accordance with regulations to be promulgated by the Tax Commission. If an affiliated group of corporations elects to file a consolidated Oklahoma income tax return under the provisions of this section, such election shall be binding and the affiliated group of corporations shall be required to file a consolidated Oklahoma income tax return for future tax years unless the Oklahoma Tax Commission released the affiliated group of corporations from such election. If an affiliated group of corporations elects to file a consolidated Oklahoma income tax return under the provisions of this subsection, the group's consolidated income, loss or deductions shall be determined on a component member by component member basis in accordance with the provisions of Sections 2358 and 2362 of this title.

3. The statute at issue clearly provides that the starting point for determining the Oklahoma taxable income of an affiliated group of corporations is the "group's consolidated [federal] income." It should be noted that the Division has not challenged the form of the PROTESTANT Group's consolidated filing election or its right to file an election. The Division has permitted the filing of an Oklahoma consolidated return by a federal consolidated group consisting of non-nexus Oklahoma members. Accordingly, any issue regarding the applicability of the relevant statute to this protest is not presented for decision. The PROTESTANT Group is entitled to the benefit of a consolidated Oklahoma return which starts with the "group's [federal] consolidated income" since one or more members of the group derive a portion of their income from both inside and outside of Oklahoma.

The statute also clearly provides that the federal consolidated return procedures shall be followed in determining the Oklahoma consolidated income of an affiliated group which is permitted or required to file consolidated returns. Under the Internal Revenue Code, "consolidated returns are based upon the principle of levying the tax according to *the true net income of* invested capital of *a single enterprise*, even though the business is operated through more than one corporation." Fed. Reg. 62, Art. 631 (1923) (Emphasis added.) As stated in a 1928 report of the Senate Finance Committee, which adopted consolidated returns at the Federal level, the legislative purpose of consolidated returns was described as follows:

> *The permission to file consolidated returns by affiliated corporations merely recognizes the business entity as distinguished from the legal corporate entity of the business enterprise*. Unless the affiliated group as a whole in the conduct of its business enterprise shows net profits, the individuals conducting the business have no gain. The failure to recognize the entire business enterprise means drawing technical legal distinctions, as contrasted with the recognition of actual facts. The mere fact that by legal fiction several corporations owned by the same stockholders are separate entities should not obscure the fact that they are in reality one and the same business owned by the same individuals and operated as a unit.
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> Report - Senate Finance Committee; 70th Cong., 1st Sess. S. Rept. No. 960, p. 14 (1928) (Emphasis added.)

The Commission's combination method is inconsistent with Federal consolidated rules and inconsistent with the plain meaning of the phrase "the group's consolidated income" in Subsection 2367(3). The purpose behind allowing corporations to file on a consolidated basis is to treat them as a single taxpaying entity. This purpose can only be achieved by starting with Federal consolidated income prior to apportionment.

4. The Division's interpretation of a "combined" method under Section 2367 on a separate company basis is erroneous. First, the Division's interpretation would effectively deny the right of an affiliated group of corporations that come within the provisions of the statute to file on a consolidated basis and would make the statute a nullity as to such group. The statute expressly permits an affiliated group of corporations that come within its provisions to file a consolidated Oklahoma income tax return starting with "the group's consolidated income, loss or deductions." Second, the statute provides for symmetry between Federal and State tax concepts; in particular, it recognizes that the affiliated group of corporations shall be treated as a single taxpaying entity, and it recognizes the elimination of intercompany adjustments as required under the Internal Revenue Code. See, 68 O.S. 1991, § 2353(3), (12), and (13). Third, the statute requires an Oklahoma nexus with only "one or more" members of the affiliated group of corporations under subsection (2), not "each" member of the group.

5. The Rules during the period at issue support the Division's combination method for filing a consolidated tax return. See, Rule 710:50-17-31 of the ***Oklahoma Administrative Code***. However, under the statute at issue, an Oklahoma consolidated return is not a combined return. Therefore, the Rules conflict with the statute at issue and are, for the period at issue, invalid.

6. The protest of the PROTESTANT Group to the proposed income tax assessment should be sustained.

7. The PROTESTANT Group seeks a waiver of interest in the event any taxes are found to be due and owing under the proposed assessment. The waiver request is moot since the undersigned has determined that the protest of the PROTESTANT Group should be sustained.

8. The PROTESTANT Group also seeks its costs and reasonable attorneys fees. In support of this request, the PROTESTANT Group argues that the proposed assessment is "without reasonable basis or is frivolous." See, 12 O.S. 1991, § 941(B). The PROTESTANT Group also argues that the Division is acting in "bad faith" by pursuing this assessment.

The undersigned finds that this request should be denied. The Division in proposing the assessment against the PROTESTANT Group was following the Rules regarding consolidated returns adopted by the Tax Commission. Although the rule was found to be invalid in this case, the Rule was promulgated in accordance with the ***Administrative Procedures Act***[4], and was valid and had the force of law. See, 75 O.S. 1991, § 308.2. This Rule represents the only statement by which the Division could conduct the audit.

DISPOSITION

Based on the above and foregoing, it is DETERMINED that the protest of PROTESTANT Industries, Inc., and Subsidiaries, be sustained. It is further DETERMINED that the request for costs and reasonable attorneys' fees be denied.

OKLAHOMA TAX COMMISSION

CAVEAT: This decision was **NOT** deemed precedential by the Commission. This means that the legal conclusions are not generally applicable or are limited in time and/or effect. Non-precedential decisions are not considered binding upon the Commission. Thus, similar issues may be determined on a case-by-case basis.

[4] 75 O.S. 199, § 301 ***et seq.***