**JURISDICTION:** **OKLAHOMA TAX COMMISSION - DECISION**
**CITE:** **2001-12-20-005 / NOT PRECEDENTIAL**
**ID:** **P9400113**
**DATE:** **12-20-01**
**DISPOSITION:** **SUSTAINED IN PART / DENIED IN PART**
**TAX TYPE:** **INCOME**
**APPEAL:** **OK SUP CT 97,295 / AFFIRMED**

## FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. The parties stipulate to the following:

*PROCEDURAL FACTS*

1. The Division, on January 24, 1994, proposed the assessment of additional Oklahoma income taxes, together with interest thereon, against Protestant for the taxable years ending December 31, 1990, 1991, and 1992, all as set forth in a letter of the Division by THE Auditor, Corporate Income Tax Section of the Audit Division, in the following amounts:

| TAX YEAR | 1990 | 1991 | 1992 |
|---|---|---|---|
| Tax Due | $57,891.00 | $46,562.00 | $35,259.00 |
| Interest | $25,742.00 | $13,701.00 | $ 5,086.00 |
| TOTAL | $83,633.00 | $60,263.00 | $40,345.00 |
| TOTAL DUE FOR ALL YEARS | | $184,241.00 | |

2. Protestant timely filed a formal protest objecting to the proposed assessment dated January 24, 1994, of all additional income tax and interest on April 6, 1994, all as set forth in a letter by Protestant.

3. The 1994 protest of Protestant is properly before the Commission.

*FACTS REGARDING THE DEDUCTION OF DEPRECIATION ON INTERCOMPANY PROFIT AND INVESTMENT TAX CREDIT*

4. Protestant filed its 1990 Oklahoma Corporate Income Tax Return on October 14, 1991.

5. Protestant filed its 1991 Oklahoma Corporate Income Tax Return on October 5, 1992.

6. Protestant filed its 1992 Oklahoma Corporate Income Tax Return on October 4, 1993.

7. Taxpayer is a subsidiary of XYZ Corporation and is included in the parent's consolidated federal income tax return.

8. Taxpayer for Oklahoma state income tax reporting purposes does not file on a consolidated basis with the parent company or with any affiliated companies.

9. The depreciation expense disallowed per the assessment includes (A) the addback of depreciation on assets purchased from the other XYZ affiliated companies, (B) the addback of depreciation on the investment tax credit, and (C) the depreciation methodology adjustment for assets placed in service after January 1, 1981, and on or before December 31, 1982. Each of these adjustments is described below:

**A. Assets purchased from other XYZ affiliated companies**

10. Effective with the year 1966, the U.S. Treasury Department issued new consolidated return regulations which leave with the selling company in an affiliated group the liability for tax on its intercompany transaction rather than having the liability shifted to the purchasing company in the group.

11. Notwithstanding the basic provision of the new regulations, an opportunity was afforded regulated public utilities under a permissive feature of these regulations whereby a "closing agreement" may be requested which would permit passing from the selling company to the purchasing company the current reduction in the consolidated tax liability. This was accomplished, in part, via an asset basis adjustment made on the books of the purchasing corporation.

12. On September 12, 1967, XYZ Corporation on behalf of itself and all of its subsidiaries entered into such a closing agreement with the Internal Revenue Service (IRS).

13. The agreement required that for purposes of filing its Federal consolidated tax return, the taxpayer or any XYZ company that purchased assets from another XYZ affiliate would, in effect, record or adjust the basis of the asset acquired to an amount not equal to the purchase price but equal to the basis of the asset in the hand of the XYZ affiliate selling the asset. The basis of the asset would, in effect, "carry-over" from the selling affiliate to the purchasing affiliate. Rather than make the adjustment as a consolidation elimination entry, as required under the pre-1966 Federal Consolidated return regulations, the agreement requires that the adjustment be made directly on the books of the purchasing affiliate; here, the taxpayer.

14. The selling company does report gain or loss for federal tax purposes under the terms of the agreement.

**B. Addback of depreciation on investment tax credit**

15. On its Federal tax return, taxpayer claimed the federal investment tax credit.

16. As a result, for federal purposes, taxpayer was required to adjust downward its basis in the property by 50 percent of the amount of the investment tax credit.

17. Consequently, the depreciation deduction which would ordinarily be claimed on its federal return was correspondingly reduced.

18. Oklahoma did not allow such an investment tax credit.

19. As a result, taxpayer increased its depreciation deduction so as to have the effect of reversing the downward cost basis adjustment required in taking the federal investment tax credit.

**C. The depreciation methodology adjustment for assets placed in service after January 1, 1981, and on or before December 31, 1982**

20. The federal ACRS deduction as defined in the Economic Recovery Tax Act of 1981 was not allowed for Oklahoma income tax purposes for tax years 1981 and 1982.

## ISSUES AND CONTENTIONS

The following three issues are presented for decision.

### ISSUE I

*Intercompany Profit Depreciation Deduction*

This issue concerns the basis to be assigned to depreciable property purchased from affiliated companies. In accordance with the closing agreement with the Internal Revenue Service, Protestant was required for purposes of the federal consolidated returns to reduce the depreciable basis of the property by the amount of the intercompany profit realized by the affiliated companies, but unrecognized for federal income tax purposes. On the Oklahoma income tax returns, Protestant increased the depreciable basis of the property by the amount of the intercompany profit. The issue is whether the Division erred by disallowing the deduction of depreciation on the intercompany profit.

## ISSUE II

*Investment Tax Credit Depreciation Deduction*

This issue concerns the basis to be assigned to the depreciable property Protestant elected for federal income tax purposes to take an investment tax credit on rather than a depreciation deduction. As a result of the election, Protestant was required to reduce the basis in the property by fifty percent (50%) of the amount of the investment tax credit. On the Oklahoma income tax returns, Protestant increased the depreciable basis of the property by the adjustment required in taking the federal investment tax credit. The issue is whether the Division erred in disallowing the deduction of depreciation on this adjustment.

## ISSUE III

*Asset Depreciation Deduction*

This issue concerns the basis of and the adjustment to the method for depreciation of assets placed in service after December 31, 1981, and before January 1, 1983. On the Oklahoma income tax returns, Protestant depreciated these assets utilizing the accelerated cost recovery system ("ACRS") allowed under the Internal Revenue Code. Because Oklahoma did not allow the ACRS for the period of January 1, 1982 through December 31, 1982, Protestant's federal and state depreciation deduction on these assets was different. The issue is whether the Division erred by disallowing the additional deduction of depreciation on the assets placed in service after December 31, 1981, and before January 1, 1983.

## CONCLUSIONS OF LAW

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

2. The Internal Revenue Code provisions applicable to consolidated corporate income tax returns are not applicable in this cause. 68 O.S. 1991, Section 2367.

3. The starting point for determining Oklahoma taxable income is the taxpayer's federal taxable income. 68 O.S. 1991, Section 2353(12). See, ***Getty Oil Company v. Oklahoma Tax Commission***, 563 P.2d 627, 630 (Okl. 1977). A taxpayer's federal taxable income is subject to the adjustments provided in Section 2358 of the Oklahoma Income Tax Act, 68 O.S. 1991, Section 2351 et seq., to arrive at Oklahoma taxable income. 68 O.S. 1991, Section 2358(A). See, ***Getty***, *supra*.

4. Deductions depend entirely upon legislative grace. ***Flint Resources Company v. Oklahoma Tax Commission***, 780 P.2d 665, 673 (Okl. 1989). See, ***Getty***, *supra* at 631.

5. The tax status and all elections of all taxpayers shall be the same for purposes of the Oklahoma Income Tax Act as they are for federal income tax purposes. 68 O.S. 1991, Section 2352(3). See, ***Flint**, supra*.

6. Here, Protestant's federal taxable income did not include deductions for depreciation on the amount of the intercompany profits nor the amount of the adjustment for the investment tax credit. The provisions of Section 2358 do not provide for the deduction of depreciation on these amounts to arrive at Oklahoma taxable income. Further, Protestant elected to forego the inclusion of these amounts in the depreciable basis of the property for federal income tax purposes. Accordingly, the Division did not err in disallowing the deduction of depreciation on either the intercompany profit or the adjustment required in taking the federal investment tax credit.

7. In 1982, Section 2358 of the Oklahoma Income Tax Act was amended to deny the federal method of depreciation, accelerated cost recovery system, for assets placed into service after December 31, 1981. 68 O.S. Supp. 1982, Section 2358(B)(1)[1].

8. In 1983, Section 2358(B) was amended to embrace the accelerated cost recovery system method of depreciation. 68 O.S. Supp. 1983, Section 2358(B)[2]. The amendment also allowed the accelerated cost recovery system method of depreciation on assets placed in service and held by a corporation to which the method was previously disallowed and permitted an adjustment to taxable income in the first taxable year beginning after December 31, 1982, to reconcile the basis of said assets to the basis allowed in the Internal Revenue Code. *Id.* The purpose of the adjustment, as stated in the amendment, was "to equalize the basis and allowance for depreciation accounts between that reported to the Internal Revenue Service and that reported to Oklahoma." *Id.*

9. Here, Protestant utilized the accelerated cost recovery system method of depreciation on the assets placed in service after December 31, 1981, and before January 1, 1983, and held by Protestant. The Division's disallowance of the depreciation method is directly contrary to the provisions of 68 O.S. Supp. 1983, Section 2358(B). Accordingly, the Division erred in disallowing the additional depreciation on the assets placed in service after December 31, 1981, and before January 1, 1983.

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[1] Laws 1982, c. 293, ∋ 2, emerg. eff. May 24, 1982.

[2] Laws 1983, c. 275, ∋ 10, emerg. eff. June 24, 1983.

10. Protestant's protest to the assessment of additional income tax and interest should be sustained in part and denied in part.

## DISPOSITION

Based on the above and foregoing, it is DETERMINED that the protest of Protestant be sustained in part and denied in part. It is further DETERMINED that the assessment be adjusted in accordance herewith and that the resultant amount, inclusive of any additional accrued and accruing interest, be fixed as the deficiency due and owing.

**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.