

**JURISDICTION:** OKLAHOMA TAX COMMISSION DECISION  
**CITE:** 2004-03-04-03 / PRECEDENTIAL  
**ID:** P-02-014A / P-02-014B / P-02-014C  
**DATE:** MARCH 4, 2004  
**DISPOSITION:** DENIED  
**TAX TYPE:** INCOME  
**APPEAL:** AFFIRMED / OK S.CT. 100,453 / CERT. DENIED  
DECISION NOT PUBLISHED

### FINDINGS OF FACT AND CONCLUSIONS OF LAW

The above styled and numbered cause comes on for decision pursuant to Rule 710:1-5-38 of the *Oklahoma Administrative Code* and Oral Argument held on September 9, 2003. Protestants, COMPANY, and SHAREHOLDER 1, SHAREHOLDER 2, and SHAREHOLDER 3 (hereinafter referred to as "Taxpayers"), are represented by ATTORNEY 1, ATTORNEY 2, and ATTORNEY 3, Attorneys at Law, LAW FIRM. The Audit Division of the Tax Commission (hereinafter "Division") is represented by OTC ATTORNEY 1 and OTC ATTORNEY 2, Assistant General Counsels, General Counsel's Office of the Tax Commission.

Upon review of the file and records, including the *Stipulation of Facts*, the exhibits attached thereto and the arguments of the parties, oral and written, the undersigned finds:

### FINDINGS OF FACT

The parties stipulate to the following:

### PROCEDURAL FACTS

1. The Division on January 18, 2002, denied COMPANY'S claim for refund in the amount of \$1,248,505.00, for the taxable year ending April 30, 1998, all as set forth in a letter of the Division by AUDITOR, Auditor, Corporate Income Tax Section of the Division.

2. SHAREHOLDER 1, as the real party in interest to the denial of the claim for refund of income tax filed on his behalf by COMPANY, timely filed a formal protest to said denial of the claim for refund on February 19, 2002.

3. SHAREHOLDER 2, as the real party in interest to the denial of the claim for refund of income tax filed on his behalf by COMPANY, timely filed a formal protest to said denial of the claim for refund on February 19, 2002.

4. SHAREHOLDER 3, as the real party in interest to the denial of the claim for refund of income tax filed on his behalf by COMPANY, timely filed a formal protest to said denial of the claim for refund on February 19, 2002.

5. The 2002 income tax protests of SHAREHOLDER 1, SHAREHOLDER 2 and SHAREHOLDER 3 as the real parties in interest on behalf of COMPANY are properly before the Commission.

**FACTS RELATING TO THE DENIAL OF THE CLAIM FOR REFUND**

6. COMPANY, an Oklahoma Subchapter S corporation, had three (3) shareholders during the period at issue, SHAREHOLDER 1, SHAREHOLDER 2 and SHAREHOLDER 3 (collectively referred to as the "Shareholders").

7. If called to testify at a hearing on this matter before the Commission, the Shareholders would testify that during the tax period relevant to the refund claim, the Shareholders were not residents of Oklahoma as SHAREHOLDER 1 and SHAREHOLDER 2 were residents of Texas and SHAREHOLDER 3 was a resident of Florida.

8. On or about December 17, 1998, DELAWARE COMPANY filed COMPANY'S original Oklahoma corporate income tax return for the taxable period at issue.

9. Pursuant to the original return, COMPANY paid Oklahoma tax in the amount of One Million Two Hundred Eighty-three Thousand Four Hundred Seventeen Dollars (\$1,283,417.00).

10. On or about November 29, 2001, COMPANY filed an amended Oklahoma corporate income tax return, which claimed a refund in the amount of One Million Two Hundred Fourteen Thousand Three Hundred Forty-five Dollars (\$1,214,345.00).

11. In a letter dated January 18, 2002, the Division denied COMPANY'S claim for refund.

*Additional Findings:*

1. On May 4, 1998, Taxpayers entered into an agreement entitled "Stock Purchase Agreement" with DELAWARE COMPANY, a Delaware corporation, whereby the Taxpayers, owners of all of the outstanding capital stock of COMPANY, sold the stock to DELAWARE COMPANY.

2. Pursuant to the Stock Purchase Agreement, Taxpayers, COMPANY and DELAWARE COMPANY agreed to treat the sale of all of the outstanding capital stock of COMPANY as a sale of all of the assets of COMPANY to DELAWARE COMPANY, wherein the agreement provides at Article 6.1:

(a) Each of the Stockholders [Taxpayers] and the Company [COMPANY] shall join with Buyer in an election to have the provisions of Code Section 338(h)(10) and similar provisions of federal, state, local or foreign law (where permissible) ('Section 338(h)(10) Election') apply to Buyer's acquisition of the Company such that (i) the Company, while still an S corporation, will be treated as having sold all of its assets to the Buyer as of the Closing Date, (ii) the Company will be treated as having distributed the proceeds of such sale to the Stockholders in complete liquidation and (iii) the Stockholders will

personally report their allocable share of gain from the deemed sale of assets by the Company. After the date of this Agreement, the Stockholders shall take no action which may (i) disqualify the Company as an S corporation as of the Closing Date or (ii) prevent the making of the Section 338(h)(10) Election.

(b) Buyer shall be responsible for, and control, the preparation and filing of any Section 338(h)(10) Election. The allocation of purchase price among the assets of the Company shall be made in accordance with Exhibit 2.5 to be attached hereto. The Stockholders shall execute and return to Buyer such documents or forms (including Section 338 Forms (as defined below)) as Buyer shall reasonably request or as are required by applicable Legal Requirements for an effective Section 338(h)(10) Election. The Stockholders shall execute complete Powers of Attorney authorizing Buyer to take any and all necessary actions to effectuate the Section 338(h)(10) Election for the Company. As used in this Agreement, 'Section 338 Forms' shall mean all returns, documents, statements and other forms that are required to be submitted to any federal, state, county or other local taxing authority in connection with a Section 338(h)(10) Election, including any 'statement of Section 338 Election' and IRS Form 8023-A (together with any schedules or attachments thereto) that are required pursuant to Treasury Regulations.

3. On or about November 30, 1998, DELAWARE COMPANY filed COMPANY'S U.S. Income Tax Return for an S Corporation, Form 1120S, for the taxable period at issue – January 1, 1998 through April 30, 1998, with the Internal Revenue Service.

4. The federal return reports a total property distribution other than dividends of \$26,763,441.00 on Schedule K to the return, of which \$21,755,970.00 is reported as net long-term capital gain attributable to "Goodwill", as reported on Schedule D to the return.

5. Attached to the federal return was Form 8023, *Elections Under Section 338 for Corporations Making Qualified Stock Purchases*, executed by the Taxpayers as the persons authorized to make the Section 338(h)(10) Election.

6. Also attached to the federal return were Schedule K-1s, *Shareholder's Share of Income, Credits, Deductions, etc.*, for each of the Taxpayers, reporting "property distributions (including cash) other than dividend distributions". The majority of each of the property distributions was net long-term capital gain attributable to Goodwill.

7. On the Oklahoma Small Business Corporation Income Tax Return, Form 512-S, filed on or about December 17, 1998, by DELAWARE COMPANY on behalf of COMPANY for the taxable period at issue, Protestants reported "Non-resident Share of Income" of \$22,583,495.00 and paid income tax on said income to the State of Oklahoma in the amount of \$1,355,010.00.

8. The amount reported on the Oklahoma return as "Non-resident Share of Income" represents the gain realized by the Taxpayers from the sale of COMPANY.

9. The Oklahoma return shows that COMPANY was domesticated in Oklahoma on January 1, 1990 and that One Hundred percent (100%) of its income was received from sources within Oklahoma.

10. By letters dated April 28, 1998 and August 14, 2001, Protestants requested a letter ruling from the Tax Commission with respect to whether income realized by non-resident shareholders from the sale of stock of an Oklahoma corporation is subject to Oklahoma income tax when an IRS Section 338(h)(10) Election is made in regard to the sale.

11. In response to the first request, the Office of the General Counsel of the Tax Commission by letter dated May 1, 1998, opined that "[b]ased upon the factors you have submitted, it appears that the sale of stock would not be taxable to the State of Oklahoma", except to the extent of items of recapture, if any. The letter also advised the reader that the opinion was not binding on the Tax Commission pursuant to Rule 710:1-3-73 of the Oklahoma Administrative Code ("OAC").

12. In response to the second request, the Office of the General Counsel of the Tax Commission by letter dated October 5, 2001, opined:

Just as there is no recognition of gain or loss on the sale of stock for federal purposes pursuant to a Section 338(h)(10) election, neither is there a recognized gain or loss on the stock sold for Oklahoma income tax purposes because there is no change to federal adjusted gross income. The sale of stock under the election will be treated for purposes of Oklahoma income tax as a sale of the assets of COMPANY. Any gain on the sale of assets recognized for federal purposes would be recognized for Oklahoma purposes.

To the extent that treating the sale of stock as a sale of assets results in a recapture of depreciation on such assets, COMPANY may be required to file a return with the State of Oklahoma reporting such recapture. Such recapture may result in additional taxable income to the shareholders. [Footnotes omitted].

13. The letter also advised the reader that "this Letter Ruling is an informal written statement of policy or a treatment of a specific fact situation under Oklahoma tax law" and that "[i]t generally may be relied upon only by the taxpayer to whom it is addressed, provided that all the facts have been accurately and completely stated and there has been no change in applicable law."

14. On the Amended Oklahoma Small Business Corporation Income Tax Return, Form 512-SX, filed on or about November 29, 2001, for the taxable period at issue, Protestants reported "Non-resident Share of Income" of \$1,758,420.00 and "Tax" on said income of \$105,505.00.

15. On the amended return, Protestants excluded from Oklahoma taxable income, the gain from the sale of COMPANY and sought a refund of income tax in the amount of \$1,214,345.00.

16. The Division denied the claim for refund.

17. Protestants timely protested the Division's denial.

18. The amount in controversy is \$1,214,345.00.

### ISSUES AND CONTENTIONS

The issue presented for decision is whether a nonresident individual is subject to Oklahoma income tax upon the sale of such nonresident's stock in an Oklahoma subchapter S corporation in the event a Section 338(h)(10) election is made under the Internal Revenue Code of 1986, as amended.

Protestants offer three (3) propositions in support of their contention that the Division erred by disallowing the exclusion of the income attributable to the sale of COMPANY from Oklahoma income taxation. First, Protestants argue that subjecting the income attributable to the sale of their COMPANY stock to Oklahoma income tax violates the Due Process and Commerce Clauses of the United States Constitution. In support of this argument, Protestants assert that the income is attributable to the sale of intangible personal property (the stock of COMPANY), consequently the income may only be subjected to income taxation by the domiciliary situs of the Taxpayers.

Second, Protestants argue that the "piggyback" provision of the Oklahoma Income Tax Act must be construed in a manner so as to reconcile it with the other provisions of the Act and so as to observe federal constitutional limitations on a state's power to tax. In support of this argument, Protestants first assert that they are not taxpayers covered by the Act and therefore, the "piggyback" provision is not applicable. Second, Protestants assert that if they are regarded as taxpayers covered by the Act, the Act "specifically provides otherwise" wherein it requires the deduction of amounts included in income which "the state is prohibited from taxing because of the provisions of the Federal Constitution" or wherein it requires the allocation of the gain from sales of intangible personal property "in accordance with the domiciliary situs of the taxpayer".

Third, Protestants argue that, constitutional considerations aside, a Section 338(h)(10) election to treat a stock sale as if it were an asset sale for federal income tax purposes does not govern the state tax treatment of the transaction. In support of this argument, Protestants cite authority from the states of Indiana, Oregon and Massachusetts.

The Division contends that the disallowance of the exclusion of the income attributable to Protestants' sale of their stock in COMPANY is proper. In support of this contention, the Division argues that Protestants irrevocably elected under the Internal Revenue Code to treat the sale of the stock in COMPANY, a subchapter S corporation operating solely within the State of Oklahoma, as a sale of the assets of COMPANY and therefore, the state is not prohibited from taxing the income attributable to the gain from the "deemed" asset sale. The Division further argues that Protestants may not re-characterize or reclassify the income for state tax purposes since the income recognized at the federal level was attributable to the sale of the assets of COMPANY, not the sale of the stock in COMPANY.

### CONCLUSIONS OF LAW

1. Jurisdiction over the parties and the subject matter of this cause is vested in the Tax Commission. 68 O.S. 2001, §§ 2373 and 207.

2. Section 338 of the Internal Revenue Code creates a legal fiction whereby a "purchasing corporation"<sup>1</sup> in the case of a "qualified stock purchase"<sup>2</sup> transaction may treat the acquisition of the stock of a "target corporation"<sup>3</sup>, if elected, as an acquisition of all of the assets of the target corporation at the fair market value of the assets. If elected, "the target corporation recognizes gain or loss with respect to the transaction as if it sold all of its assets in a single transaction" \* \* \* "and (to the extent provided in regulations) no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group." IRC, § 338(h)(10)(A). The provisions of § 338(h)(10) apply to subchapter S corporations and their shareholders. Temp. Reg. § 1.338(h)(10)-IT(c).

3. "[T]he tax status and all elections of all taxpayers covered by [the Oklahoma Income Tax Act]<sup>4</sup> ("Act") shall be the same for all purposes material hereto as they are for federal income tax purposes except when [the Act] specifically provides otherwise." 68 O.S. 1991, § 2353(3). "The language of § 2353(3) and (12)<sup>5</sup>, indicates that the Legislature intended that federal elections be controlling in determining Oklahoma taxable income." *In the Matter of the Income Tax Protest of Flint Resources v. Oklahoma Tax Commission*, 780 P.2d 665, 673, 1989 OK 9 (Okla. 1989).<sup>6</sup> Here, Taxpayers, COMPANY (the "target corporation") and DELAWARE COMPANY (the "purchasing corporation") joined in the election for federal tax purposes to treat the sale of Taxpayers' stock in COMPANY as if COMPANY had sold all of its assets to DELAWARE COMPANY. Such election was irrevocable<sup>7</sup> and resulted in the Taxpayers recognizing income for federal tax purposes attributable to the gain realized from the sale of COMPANY'S assets rather than any gain which Taxpayers would have realized from the sale of their stock.

4. The state is not barred from levying an income tax upon income within its boundaries. *Getty Oil Co. v. Oklahoma Tax Commission*, 563 P.2d 627 (Okla. 1977); *McCutchan v. Oklahoma Tax Commission*, 191 Okl. 578, 132 P.2d 337 (1943). A state has power to tax the income of a nonresident corporation or individual derived from sources within the state. *Chestnut Securities Co. v. Oklahoma Tax Commission*, 125 F.2d 571 (C.C.A.Okla. 1942). The state may levy an income tax on income accruing from personalty having situs within state without violating

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<sup>1</sup> Defined at IRC, § 338(d)(1).

<sup>2</sup> Defined at IRC, § 338(d)(3). See, IRC, § 1504(a)(2) wherein an Eighty percent (80%) voting and value test is provided, i.e., ownership of at least 80% of the total voting power of the stock and at least 80% of the total value of the stock.

<sup>3</sup> Defined at IRC, § 338(d)(2).

<sup>4</sup> 68 O.S. 1991, § 2351 et seq.

<sup>5</sup> Section 2353(12) defines "Oklahoma taxable income" as "taxable income" as reported to the federal government, adjusted pursuant to the Internal Revenue Code. See, *Flint*, supra. at 673.

<sup>6</sup> In *Flint*, the Supreme Court held that "corporations electing to treat payment of foreign income taxes as a tax credit for federal tax purposes may not claim those payments as a deduction from Oklahoma taxable income.

<sup>7</sup> IRC, § 338(g)(3).

any provision of the federal Constitution. *Oklahoma Tax Commission v. American Refrigerator Transit Co.*, 349 P.2d 746 (Okla. 1960).

Here, due to the Section 338(h)(10) Election, the source of the income in dispute was the gain from the sale of COMPANY'S assets. COMPANY was domesticated in and derived 100% of its income from sources within Oklahoma. In the transaction at issue, COMPANY was "deemed" to have sold its land, buildings and equipment located in Oklahoma to DELAWARE COMPANY. The land, buildings and equipment constitute items of real and tangible personal property, the income from the sale of which is allocated in accordance with the situs of such property pursuant to 68 O.S. 1991, § 2358(A)(4)(a). Accordingly, the state is not prohibited by any provision of the federal Constitution from levying an income tax on the income derived from the gain realized on the "deemed" sale of the land, buildings and equipment of COMPANY.

COMPANY was also "deemed" to have sold "goodwill" to DELAWARE COMPANY in the transaction at issue. Goodwill is an intangible asset. Generally, income from the sale of intangible personal property is allocated in accordance with the domiciliary situs of the taxpayer, 68 O.S. 1991, § 2358(A)(4)(b); except where such property has acquired a nonunitary business or commercial situs apart from the domicile of the taxpayer. 68 O.S. 1991, § 2358(A)(4)(b)(1). In such cases, the income from the intangible personal property is allocated in accordance with the business or commercial situs of the property. The goodwill of COMPANY was an asset of COMPANY<sup>8</sup>, a subchapter S Corporation separate and apart from the Taxpayers herein, the income from the sale of which is allocated to the domiciliary situs of COMPANY, the State of Oklahoma. Accordingly, the state is not prohibited by any provision of the federal Constitution from levying an income tax on the income derived from the gain realized on the "deemed" sale of the goodwill of COMPANY.

5. Protestants are "taxpayers" covered by the provisions of the Act. 68 O.S. 1991, § 2365<sup>9</sup>. "Taxpayer" is defined to mean "any person<sup>10</sup> subject to a tax imposed by [the Act], or whose

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<sup>8</sup> See, 18 O.S. 1991, § 1092(A).

<sup>9</sup> Section 2365 provides:

The provisions, applicable to the taxation of income of corporations and stockholders, electing treatment as provided in subchapter S of the Internal Revenue Code, shall apply equally to taxpayers under this act; a corporation having an election in effect under subchapter S of the Internal Revenue Code shall not be subject to the Oklahoma income tax on corporations, and the shareholders of said corporation shall include in their taxable incomes their proportionate part of such corporations' federal income, subject to the modifications as set forth in Sections [2358] and [2362] hereof, in the same manner and to the same extent as provided by the Internal Revenue Code; provided, however, that if any of the shareholders of such corporation are nonresidents during any part of the corporation's taxable year, such corporation shall be taxable for such year on that part of the corporation's income, as determined under Sections [2358] and [2362] hereof, allocable to the shares of stock owned by such nonresident unless the corporation files with its return for such year an agreement executed by each nonresident stockholder stating that such nonresident will file an Oklahoma income tax return which will include in his Oklahoma nonresident adjusted gross income that portion of the corporation's Oklahoma taxable income allocable to said nonresident's interest in such corporation. [Citations omitted].

<sup>10</sup> "[P]erson means an individual, trust, estate, fiduciary, partnership, limited liability company, or a corporation \* \* \*." 68 O.S. 1991, § 202(e).

income is, in whole or in part, subject to a tax imposed by any provision of [the Act]. 68 O.S. 1991, § 2353(15). See, *C.H. Leavell & Co. v. Oklahoma Tax Commission*, 450 P.2d 211 (Okla. 1968). Here, Protestants did not make the election under § 2365 and Taxpayers' "non-resident share of income" was reported on the returns, original 512-S and amended 512-SX, filed on behalf of COMPANY by DELAWARE COMPANY. Accordingly, the "piggyback" provisions of § 2353(3) are applicable to Protestants.

6. Protestants further argue that the "piggyback" provisions of § 2353(3) do not apply because the Act "specifically provides otherwise." Nothing in the Act provides that a federal election to treat the sale of stock in a corporation as a "deemed" sale of the assets of the corporation is not effective for Oklahoma tax purposes. Further, as discussed above, because the source of the "deemed" income at issue is attributable to the gain realized from the sale of the assets having a situs in Oklahoma, the income is allocable to Oklahoma, 68 O.S. 1991, § 2358(A)(4)(a) and (b); and the state is not prohibited from taxing the income because of the provisions of the federal Constitution, 68 O.S. 1991, § 2358(A)(2). See, *Getty, supra.*; *McCutchan, supra.*; *Chestnut Securities, supra.*; *American Refrigerator, supra.*

7. Protestants admit that the revenue laws of the states of Indiana, Oregon and Massachusetts do not have a provision similar to the "piggyback" provisions of § 2353(3) of the Oklahoma Act. Because the states of Indiana, Oregon and Massachusetts do not a revenue provision similar to § 2353(3), the undersigned finds the authorities cited by Protestants inapposite. Further, as the Supreme Court determined in *Flint, supra.*, "the Legislature intended that federal elections be controlling in determining Oklahoma taxable income." *Id.* at 673. Accordingly, Protestants argument that a Section 338(h)(10) election to treat a stock sale as if it were an asset sale for federal tax purposes does not govern the state tax treatment of the transaction is without merit.

8. Protestants protest to the denial of the income tax claim for refund should be denied.

### DISPOSITION

Based on the above and foregoing findings of fact and conclusions of law, it is ORDERED that the protest of Protestants, COMPANY, SHAREHOLDER 1, SHAREHOLDER 2, and SHAREHOLDER3, be denied.

### OKLAHOMA TAX COMMISSION

CAVEAT: This decision was NOT deemed precedential by the Commission. This means that the legal conclusions are 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.