JURISDICTION: **OKLAHOMA TAX COMMISSION DECISION**
CITE: **2004-06-01-03 / NOT PRECEDENTIAL**
ID: **P-95-071**
DATE: **JUNE 1, 2004**
DISPOSITION: **DENIED**
TAX TYPE: **INCOME TAX**
APPEAL: **AFFIRMED**
CITE: **2006 OK CIV APP 54, 135 P.3D 828**

The above taxpayer protests the demand by the Commission's Taxpayer Assistance Division that taxpayer, a resident of Texas, file an Oklahoma income tax return in regard to royalty income received from oil and gas property located in this State. The demand also notified taxpayer that all production payments could be ordered withheld upon a determination that the recipient has failed to file a State income tax return or has failed to pay income tax on production payment income. After a lengthy procedural contest and several hearings and attempted hearings, the Administrative Law Judge entered findings of fact and conclusions of law herein, with a recommendation that taxpayer's protest be denied. This matter now comes on for entry of a final order of disposition by the Commission.

Having reviewed the files and records herein and being fully advised, the Commission hereby adopts the Findings of Fact, Conclusions of Law and Recommendation made and entered herein by the Administrative Law Judge on the 2nd day of April, 2004, and the same, appended hereto, together herewith shall constitute the Order of the Commission.

FINDINGS OF FACT AND PROCEDURAL HISTORY

1. On February 3, 1995, the Division mailed a letter to PROTESTANT advising the Oklahoma Tax Commission ("Commission") obtained information indicating PROTESTANT received sufficient income in 1991 to require the filing of an Oklahoma income tax return for tax year 1991. The letter further provided it was necessary for PROTESTANT to file an Oklahoma income tax return in order to avoid action by the Commission.

2. In a letter dated February 25, 1995, PROTESTANT requested a hearing pursuant to §207 of Title 68 of the Oklahoma Statutes regarding whether the Commission was entitled to collect Oklahoma income taxes from him. The letter indicated PROTESTANT was challenging certain income tax statutes of Oklahoma based on several grounds including taxation of nonresidents, taxation without representation in violation of constitutional rights, selective enforcement, and arbitrary nature of the relevant statute, lack of personal jurisdiction, full payment of all taxes on an in rem basis and interference with interstate commerce.

3. On March 22, 1995, the Division forwarded the matter to the Office of the Administrative Law Judge ("ALJ"). A pre-hearing conference was held on June 12, 1995, during which it was agreed the parties would provide status reports to the ALJ and request a procedural schedule if necessary. A scheduling teleconference was requested by the parties and held on December 12, 1995. The parties later requested a status conference which was held on May 14, 1996, at which time PROTESTANT requested the matter be continued until a decision

was rendered in *Walters v. Oklahoma Tax Commission*, 1996 OK CIV APP 154, 935 P.2d 398, a case then pending before the Oklahoma appellate courts.

4. On March 11, 1997, the Division notified the Office of the ALJ that the Oklahoma Supreme Court had denied certiorari in the *Walters* case. Based on the prior agreement of the parties to continue the hearing pending the outcome in the *Walters* case, the matter was scheduled for hearing on September 23, 1997. On September 16, 1997, the Division filed its Brief and Documents in Support of the Division's Position. On September 18, 1997, PROTESTANT filed his Position Letter in support of his position. On September 23, 1997, PROTESTANT filed a supplemental statement expanding his Position Letter.

5. A hearing was held on September 23, 1997, at which time PROTESTANT offered testimony and argument on issues including in personam jurisdiction and state income tax filing requirements. The Division offered argument on the issue of whether PROTESTANT is required to file Oklahoma income tax returns. At the request of the Division, the record was held open for the filing of optional post-hearing briefs. On October 9, 1997, the Division filed its Supplemental Brief, and on October 21, 1997, PROTESTANT filed a Reply to the Brief of the Division. Based on the matters presented at the hearing, it appears there were no factual disputes between the parties.

6. On November 27, 2000, PROTESTANT filed a letter challenging the jurisdiction of the Office of the ALJ. On April 18, 2001, the Division filed a Motion to Dismiss Protest challenging the jurisdiction of the ALJ based upon there being no assessment of tax to which a protest could have been filed. On April 30, 2001, PROTESTANT filed a letter asserting the Motion to Dismiss should not be considered, as it should have been filed as a pre-trial motion, and further asserting the State of Oklahoma has no jurisdiction over him.

7. On July 1, 2002, the undersigned issued Findings, Conclusions and Recommendations Regarding Dismissal ("Findings"). The undersigned found dismissal was appropriate for reasons other than those suggested by the Division. The Division asserted the matter should be dismissed as there had been no assessment of taxes. The undersigned found the Commission had taken no action of legal consequence against PROTESTANT, and therefore, there was no definite and concrete controversy upon which a decision could be rendered.

8. Following the issuance of Findings, on July 10, 2002, the Division, while in agreement with the ultimate decision, filed a Motion for Partial Rehearing requesting certain findings be amended. On July 16, 2002, PROTESTANT filed a Motion to Vacate Findings asserting the decision violated OTC Rules in that a hearing was not held and also asserting the findings were clearly erroneous. On July 29, 2002, PROTESTANT filed his Response Against Taxpayer Assistance Division's Motion for Partial Rehearing challenging the propriety of the Division's Motion. On August 5, 2002, PROTESTANT filed a Motion for Opportunity to Be Heard on Taxpayer Assistance Division's Motion to Dismiss in which he asserted the original letter of the Division contained an imminent threat to withhold production payments. On November 8, 2002, the undersigned entered an order vacating the Findings issued on July 1, 2002 and setting a hearing on the Motion to Dismiss for December 13, 2002. The Findings were

vacated for the reason that such Findings could not be issued without first holding a hearing to consider the Motion as was asserted by PROTESTANT in his Motion to Vacate Findings.

9. On December 2, 2002, PROTESTANT filed a Motion to Quash Taxpayer Assistance Division's Motion to Dismiss Protest, And Vacate A.L.J.'s Order as Moot; Or Alternatively, Motion for Corrective Modification of the Order, And to Quash Exhibits Attached to the Motion to Dismiss, and for a Pre-hearing Conference. Based on the request of PROTESTANT for a pre-hearing conference, on December 6, 2002, the undersigned issued an order striking the December 13, 2002 hearing, and instead setting a scheduling teleconference for December 13, 2002.

10. On December 13, 2002, the scheduling teleconference was held. Following the teleconference, on January 13, 2003, the undersigned issued an order setting the hearing on the Motion to Dismiss and the related Motions for February 14, 2003. The hearing was continued to February 28, 2003, and on that date, the hearing on all outstanding Motions was held.

12. On March 5, 2004, the undersigned issued an order denying the Motion to Quash filed by PROTESTANT and also denying the Motion to Dismiss filed by the Division. On March 25, 2004, PROTESTANT filed a Rebuttal of Procedural History and Objections to Order Denying Motion to Quash and Motion to Dismiss for the Post-hearing Record, in which he raised certain objections to the order of March 5, 2004, and the recitation of the procedural history contained in that order. The undersigned finds nothing in the Rebuttal that would require modification of the order. Additionally, the undersigned disagrees with many of the statements and assertions contained in the Rebuttal, but will not specifically address those matters as PROTESTANT clearly stated in his Rebuttal he does not want the pleading to be construed as a motion for rehearing or reconsideration. Therefore, the case is ripe for a decision on the merits.

CONCLUSIONS OF LAW

1. Section 2355(A) provides for the imposition of income tax upon the taxable income of every resident or nonresident individual.[1]

2. Sections 2368(A)(4) and (I) provide "every nonresident individual having Oklahoma gross income for the taxable year of One Thousand Dollars ($1,000.00) or over" is required to file an Oklahoma income tax return on forms prescribed by the Tax Commission.

3. Section 2358 provides the method by which Oklahoma adjusted gross income is calculated. Section 2358(A)(4) provides, in pertinent part, as follows:

> Items of the following nature shall be allocated as indicated...
>
> * * *
>
> a. Income from real and tangible personal property, such as rents, oil and mining production or royalties, and gains or losses from sales of such property, shall be allocated in accor
> dance with the situs of such property;

4. Section 2362, in dealing with the taxable income of nonresident individuals, provides, in relevant part, as follows:

> The Oklahoma taxable income of a nonresident individual … shall be the same as if he were a resident individual … with the following modifications:
>
> 1. Taxable income or adjusted gross income, as reported or reportable to the federal government … shall be excludable unless such income, gain, loss or deduction is attributable to:
>
> a. the ownership of any interest in real or tangible personal property in this state;

5. PROTESTANT contends he is not subject to Oklahoma income tax because he owns no interest in real or tangible personal property within Oklahoma. He asserts his interest is in the nature of intangible property having a taxable situs at the domicile of the owner. PROTESTANT further asserts the attempted taxation of his interest violates the Due Process Clause and the Commerce Clause of the United States Constitution.[2]

6. The Division contends the interest held by PROTESTANT is an interest in real estate, subjecting PROTESTANT to Oklahoma income tax on any income derived from his ownership of such property. The Division further contends the Oklahoma legislature intended royalty income be classified as income derived from real property for purposes of income taxation.

7. The constitutionality of the taxation of royalty income of nonresident individuals was examined by the United States Supreme Court in *Schaffer v. Carter*, 252 U.S. 37, 40 S.Ct. 221, 64 L.Ed. 445 (1920). In *Schaffer*, the Supreme Court upheld the imposition of Oklahoma income taxes against an Illinois resident that owned oil and gas leases in Oklahoma and oil-producing land in Oklahoma.

8. The Supreme Court of Oklahoma has classified accrued royalties as personal property and unaccrued royalties as real property. *McCully v. McCully*, 1939 OK 43, 86 P.2d 786. The Oklahoma Court has classified a royalty arising out of an ordinary oil and gas lease as a profit issuing out of the land. *Id.* The Court has classified mineral interests held separate from the possession of the land itself as incorporeal hereditaments. *Rich v. Doneghy*, 1918 OK 689, 177 P. 86. The granting of a mineral interest to one and his heirs and assigns forever has been classified as the granting of an interest in fee and the granting of such interest for a term of years is the granting of a chattel real. *Id.* The granting of an oil and gas lease has been classified as the granting of a vested present interest in land. *Id.*

9. The classification by the Supreme Court of Oklahoma of accrued royalties as personal property, unaccrued royalties as real property, and royalties arising out of an ordinary oil and gas lease as a profit issuing from the land supports the taxation system adopted by the Oklahoma legislature. However, even if such classifications did not support the Oklahoma taxation approach, the classifications regarding the nature of royalties made by the Oklahoma Court in non-tax cases is not determinative of the nature of royalties for state income tax purposes where the Oklahoma legislature has specifically classified such interests for tax purposes.

10. Under the Oklahoma taxation approach, oil and mining production or royalties are clearly classified as income from real or tangible personal property and are allocated in accordance with the situs of the property. Nonresident individuals are taxed in the same manner as resident individuals with respect to income attributable to the ownership of any interest in real or tangible personal property. Therefore, royalties received by nonresidents as a result of their ownership of a mineral interest in land within Oklahoma are properly subject to Oklahoma income tax.

11. It is undisputed that PROTESTANT received royalty income of $8,927.62 in 1991 from properties located within Oklahoma. Pursuant to §2368, PROTESTANT is required to file an Oklahoma income tax return for 1991 as his Oklahoma gross income exceeded $1,000.00 in that tax year.

DISPOSITION

Based on the above and foregoing findings of fact and conclusions of law, the denial of the protest of PROTESTANT IS ORDERED. Further, a waiver of a substantial portion of the interest and all penalty which may otherwise be collected as a result of the late payment of the income tax for tax year 1991 IS ORDERED.

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[1] All references to sections of the law refer to sections contained within the 1990 Supplement to Title 68 unless otherwise stated.

[2] The undersigned has not addressed PROTESTANT'S arguments regarding the constitutionality of the statutes in question for the reason that the Commission, as an administrative agency, does not have the power to decide the constitutional validity of a statute. *Dow Jones & Co. v. Oklahoma Tax Commission*, 1990 OK 6, 787 P.2d 843.

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.