JURISDICTION: OKLAHOMA TAX COMMISSION
CITE: 2005-04-19-13
ID: P-02-043-K
DATE: APRIL 19, 2005
DISPOSITION: SUSTAINED
TAX TYPE: INCOME
APPEAL: NONE TAKEN

FINDINGS OF FACT AND CONCLUSIONS OF LAW

By certified letter dated January 4, 2002, the Division issued a proposed income tax assessment against Protestant pursuant to adjustments made by way of an office audit of Protestant's Oklahoma amended corporate income tax returns filed for the tax years 1996 and 1997. Protestant timely protested the proposed adjustments and assessment by letter dated February 1, 2002, and requested an oral hearing.

On April 1, 2002, the Division forwarded its file, consisting of the proposed assessment letter, notice of adjustments and letter of protest with attachments, to the Office of the Administrative Law Judges ("ALJ's Office") for further proceedings consistent with the *Uniform Tax Procedure Code*[1] and the *Rules of Practice and Procedure Before the Oklahoma Tax Commission*[2]. The Case was docketed as Case No. P-02-043 and was assigned to ALJ, Administrative Law Judge.[3]

A pre-hearing conference was scheduled for May 23, 2002, by *Notice of Prehearing Conference* issued May 8, 2002.[4] The pre-hearing conference was held by telephone at the appointed date and time with the parties' representatives in attendance. Pursuant to the pre-hearing conference, a *Prehearing Conference Order*[5] was issued setting forth dates for the filing of a stipulation of facts, simultaneous briefs and reply briefs[6]. Due to changes of counsel for the Division and upon request of the parties' representatives, the *Prehearing Conference Order* was amended on two (2) separate occasions to allow additional time for compliance with submission of the case on briefs.

In accordance with the *Amended Scheduling Order* issued October 18, 2002, a *Stipulation of Facts* was filed on November 20, 2002. The parties filed their respective briefs on January 17, 2003.

---

[1] 68 O.S. 2001, § 201 et seq.

[2] Rules 710:1-5-20 through 710:1-5-47 of the Oklahoma Administrative Code ("*OAC*").

[3] *OAC*, 710:1-5-22(b).

[4] *OAC*, 710:1-5-28.

[5] *OAC*, 710:1-5-28(b).

[6] *OAC*, 710:1-5-38.

On February 11, 2003, the parties jointly filed a *Motion to Bifurcate Proceedings and Stay the Adjustment Disallowing Part of the Interest Expense Deduction*. The motion was granted by *Order Granting Motion to Bifurcate Proceedings and Stay the Adjustment Disallowing Part of the Interest Expense Deduction* issued February 28, 2003.

A status conference was scheduled in this cause for January 6, 2004, by *Notice of Reassignment of Case and Notice of Status Conference* issued December 10, 2003.[7] The case was reassigned to ALJ2, Administrative Law Judge, pursuant to *OAC*, 710:1-5-31, subsequent to ALJ'S acceptance of a position with the Tax Policy Division of the Tax Commission.

The status conference was held by telephone at the appointed date and time with the parties' representatives in attendance. Pursuant to the status conference, a *Scheduling Order* was issued setting forth dates for the Division to file a brief in chief and Protestant to file a response brief.

A *Motion to Strike Scheduling Order and Set New Scheduling Order Allowing for New Discovery* was filed by the Division on February 12, 2004. The motion was granted by *Order* issued February 13, 2004. The *Order* scheduled dates for the exchange and completion discovery, the filing of a stipulation of facts and statement of the issues and the submission of briefs.

A *Motion to Set New Scheduling Order for Extension of Time to Respond to Discovery Requests* was filed by Protestant on April 19, 2004. The motion was granted by *Order* issued April 26, 2004. The *Order* rescheduled the procedural dates as requested by the parties.

A *Statement of the Issue* was filed by the Division on June 29, 2004. The Division also filed an *Additional Brief of the Audit Division* on July 26, 2004.

A *Motion to Set New Scheduling Order for Extension of Time to Respond to Additional [sic] Brief of the Audit Division* was filed by Protestant on August 18, 2004. The Division filed *Audit Division's Response to Protestant's Motion to Set New Scheduling Order for Extension of Time to Respond to Additional Brief of the Audit Division* on August 20, 2004. By letter dated August 23, 2004, the ALJ's Office issued a procedural schedule for the filing of briefs by the parties.

A *Response by Petitioner to Additional Brief of the Audit Division Filed on July 26, 2004*, was filed by Protestant on September 24, 2004. A *Reply Brief of the Audit Division* was filed October 19, 2004, upon the Division's *Motion to File Brief Out of Time* filed October 19, 2004 and *Order* granting the motion issued October 19, 2004. Although given the opportunity, Protestant did not file a response brief. As set forth in the procedural schedule of August 23, 2004, the record in this cause was thereafter closed and the matter was submitted for decision.

[7] *See, OAC*, 710:1-5-38, wherein it provides "[t]he Administrative Law Judge may schedule a conference between the parties if it is deemed necessary to clarify the positions of the parties."

FINDINGS OF FACT

Upon review of the file and records, including the *Stipulation of Facts* filed November 20, 2002, Exhibits A through I attached thereto, the *Statement of the Issue* filed June 29, 2004, and the brief of the parties, the undersigned finds:

A. STIPULATED FACTS:

1. The [Protestant] is a foreign corporation doing business both within and without the State of Oklahoma.

2. On or about the 14th day of October 1997, [Protestant] filed its 1996 Form 512 with the Commission. Exhibit A attached to the Stipulation of Facts.

3. On or about the 14th day of September 1998, [Protestant] filed its 1997 Form 512 with the Commission. Exhibit B attached to the Stipulation of Facts.

4. On or about the 23rd day of March 2001, the taxpayer and the Internal Revenue Service consented and agreed to extend the time to assess Federal Income Taxes for periods ended December 29, 1996 and December 31, 1997, until December 31, 2001. Exhibit C attached to the Stipulation of Facts.[8]

5. The Internal Revenue Service completed audits of [Protestant's] 1996 and 1997 taxable years on August 7, 2001. Exhibit D attached to the Stipulation of Facts.[9]

6. On or about the 26th day of November 2001, [Protestant] filed 1996 Form 512X and 1997 Form 512X with the Commission reporting the adjustments from the IRS audit. Exhibits E and F attached to the Stipulation of Facts.

7. On or about the 4th day of January, 2002, the [Division] issued a proposed assessment based on the RAR and the Amended Corporation Income tax returns for tax years 1996 and 1997, assessing additional corporate tax, plus interest thereon, in the following amounts:

	1997	1996
Additional Tax Due	$21,175.00	$12,648.00
Interest	12,340.00	9,268.00
Penalty	0	0
Total Due	$33,515.00	$21,916.00

Total Tax & Interest Due $55,431.00
Exhibit G attached to the Stipulation of Facts.

[8] Exhibit C is identified as a true and correct copy of IRS Form 872, Consent to Extend the Time to Assess Tax.

[9] Exhibit D is identified as a true and correct copy of the RAR, Revenue Agents Report.

8. On or about the 5th day of February 2002, [Protestant] filed its written protest to the proposed assessment. Exhibit H to the Stipulation of Facts.

9. Federal Forms 1120, "U.S. Corporation Income Tax Return", as originally filed by [Protestant] for 1996 and 1997, reflect deductions for interest expense in the amount of $38,319,736 and $41,911,296, respectively.

10. There were no adjustments made by the IRS to reduce the federal interest expense deductions per the Federal RAR.

11. The Division proposed two adjustments in its proposed assessment. Exhibit I attached to the Stipulation of Facts.

12. First, the Division disallowed a portion of the [Protestant's] interest expense as originally reported on the Federal tax returns, by multiplying total Federal interest expense by a ratio as follows:

YEAR	Average Other Investments Per 1120	Average Assets Per 1120	Ratio	Interest Expense Per 1120	Disallowed Oklahoma Interest Expense
1996	2,108,322,347	3,204,339,197	.658	38,319,736	25,212,815
1997	2,216,869,215	3,536,439,572	.627	41,911,296	26,272,725

13. The second audit adjustment disallowed the Oklahoma deduction for non-Oklahoma state and local tax refund(s) claimed on both the amended and original Oklahoma returns for 1996 and 1997. The Federal audit resulted in no adjustments regarding the state tax refund deduction claimed on the Oklahoma returns.

B. ADDITIONAL FINDINGS:

1. Taking into account the RAR adjustments, Protestant reported a tax due of $1,150.00 on its 1996 Oklahoma amended corporation income tax return, Form 512X, filed November 26, 2001. Exhibit E attached to the Stipulation of Facts.

2. Taking into account the RAR adjustments, Protestant claimed a refund of $4,008.00 on its 1997 Oklahoma amended corporation income tax return, Form 512X, filed November 26, 2001. Exhibit F attached to the Stipulation of Facts.

3. The net Oklahoma income tax refund claimed by Protestant for the 1996 and 1997 tax years is $2,858.00. Exhibits E and F attached to the Stipulation of Facts.

4. The only issue addressed by these *Findings, Conclusion and Recommendations* is whether the State of Oklahoma can subject to income tax the non-Oklahoma state and local income tax refunds received by Protestant in 1996 and 1997, and recognized by Protestant for federal income

tax purposes in 1996 and 1997 under the tax benefit rule of Section 111 of the Internal Revenue Code.

5. Taxes based on or measured by income are not deductible in computing the net apportionable income or loss of a unitary business enterprise. 68 O.S. Supp. 1996, § 2358(A)(5).

6. Protestant on its original and amended Oklahoma corporation income tax returns for tax years 1996 and 1997 added back to its federal taxable income all taxes based on income paid to other states of $7,551,064.00 and $12,632,172.00, respectively. Exhibits A, B, E and F to the Stipulation of Facts.

7. Protestant on its original and amended Oklahoma corporation income tax returns for tax years 1996 and 1997 excluded from Oklahoma apportionable/taxable income, by separate allocation, state income tax refunds received from states other than the State of Oklahoma of $2,334,374.00 and $1,542,966.00, respectively. Exhibits A, B, E and F to the Stipulation of Facts.

8. Protestant included the state tax refunds in its federal taxable income for tax years 1996 and 1997 pursuant to I.R.C. § 111, since the taxes which were refunded in 1996 and 1997 were deducted from Protestant's federal taxable income in previous years pursuant to I.R.C. § 164. Exhibits A and B to the Stipulation of Facts.

9. The Division disallowed the exclusion of the state tax refunds from Oklahoma apportionable/taxable income for tax years 1996 and 1997, asserting "[t]here is no provision in the Oklahoma Statutes for the deduction of State Tax Refunds on the Oklahoma corporate income tax return to arrive at Oklahoma Apportionable/Taxable Income." Exhibit I to the Stipulation of Facts.

10. A portion of the additional income taxes assessed against Protestant for tax years 1996 and 1997 is attributable to the disallowance of the exclusion of the state tax refunds from Oklahoma apportionable/taxable income.

11. Protestant initially argued that the items of adjustment were not matters of allocation and/or apportionment between Oklahoma and some other state and therefore, the adjustments were barred by the statute of limitations for assessment of taxes. Exhibit H to the Stipulation of Facts.

12. In addition to its initial argument, Protestant also argued that common logic and fairness dictates that a deduction of state and local tax refunds is warranted since Oklahoma statutes and regulations are silent with respect to the proper tax treatment of the refunds and that the refunds are subject to unconstitutional double taxation since the refunds are included in Oklahoma taxable income notwithstanding that income taxes were paid to Oklahoma on the amount of the refunds in prior years inasmuch as Oklahoma does not permit a deduction of income taxes paid to other states. Brief of Petitioner filed January 17, 2003.

13. The Division initially only addressed Protestant's statute of limitations argument. Brief of the Audit Division filed January 17, 2003.

14. The status conference of January 6, 2004 was scheduled to discuss a procedural schedule whereby Protestant's remaining arguments concerning the taxation of the state and local income tax refunds would be addressed.

15. Protestant concedes and does not dispute the fact that the allocation or exclusion of state tax refunds from Oklahoma taxable income relates to allocation and/or apportionment of income between Oklahoma and other states, thus abandoning its argument that the statute of limitation for assessment of taxes bars the assessment in this case. Response by Petitioner to Additional Brief of the Audit Division filed on July 26, 2004, filed September 24, 2004.

ISSUE AND CONTENTIONS

The issue presented for decision is whether the State of Oklahoma can subject to income tax the non-Oklahoma state and local income tax refunds received by Protestant in 1996 and 1997, and recognized by Protestant for federal income tax purposes in 1996 and 1997 under the tax benefit rule of I.R.C. § 111.

Protestant contends that the Division erred in denying the deduction of the state and local income tax refunds in determining Oklahoma taxable income. In support of this contention, Protestant argues that Oklahoma does not allow a deduction for state and local income taxes paid to other states and therefore should allow a deduction for state and local income tax refunds. In support of this argument, Protestant asserts that there is no justification in the environment of the Oklahoma income tax for the operation of a tax benefit rule which serves, at the federal level, to recapture state tax refunds where a deduction has been taken in a prior year for amounts paid as state income tax since Oklahoma does not permit the deduction of income taxes paid to other states. Protestant further asserts that it is subject to unconstitutional double taxation since the amounts received as income tax refunds from other states are included in Oklahoma taxable income even though income taxes have already been paid to Oklahoma on that income in prior years.

The Division contends that it properly disallowed the deduction for state and local income tax refunds from other states and prays that the adjustment be upheld. In support of this contention, the Division argues that the Oklahoma Income Tax Act and regulations do not have a provision allowing the deduction of state and local income tax refunds and therefore, the deduction must be denied, citing ***Flint Resources Company v. Oklahoma Tax Commission***, 1989 OK 9, 780 P.2d 665; ***Home State Royalty Corporation v. Weems***, 1935 OK 1043, 175 Okla. 340, 52 P.2d 806; and, ***New Colonial Ice Co. v. Helvering***, 292 U.S. 435, 54 S.Ct. 788, 78 L.Ed. 1348 (1934). The Division further cites ***Herzog Contracting Corporation v. Director of Revenue State of Missouri***, 1987 WL 51180 (Mo.Admin.Hrg.Com.), and argues that Protestant makes exactly the same argument in the instant case as the Petitioner made in ***Herzog***, the Petitioner in ***Herzog*** lost and ***Herzog*** has persuasive precedential value and is relevant to this case. The Division further argues that Protestant's double taxation argument is without merit since Protestant did not file Oklahoma income tax returns prior to 1996, thus Protestant did not pay any prior Oklahoma income taxes on the amount of the state income tax refunds.

In response to the Division's argument regarding double taxation, Protestant asserts that the Division's argument in essence recognizes and acknowledges the relevance of Protestant's

arguments, but seems to advocate a penalty for foreign corporations in their first few years of doing business in the state. Protestant also argues that the state taxes paid to other states prior to 1996 were not taxable in Oklahoma because Protestant was not doing business in the state at that time, therefore the state tax refunds should be viewed as an overpayment of the state taxes incurred in those previous years when they would not have been income for Oklahoma tax purposes.

These *Findings, Conclusions and Recommendations* do not address Protestant's argument that the taxation of the state and local income tax refunds is unconstitutional due to double taxation because of the determination that the refunds should be excluded from Oklahoma taxable income. Furthermore, every statute is deemed constitutionally valid until a court of competent jurisdiction declares otherwise, ***State ex rel. York v. Turpen***, 1984 OK 26, 681 P.2d 763, 767; and the Tax Commission as an administrative agency is not empowered to decide the constitutional validity of a taxing statute, ***Dow Jones & Company, Inc. v. Oklahoma Tax Commission***, 1990 OK 6, 787 P.2d 843, 845.

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, § 221(D).

2. Oklahoma imposes an income tax upon the Oklahoma taxable income of every corporation doing business within Oklahoma or deriving income from sources within Oklahoma. 68 O.S. Supp. 1992, § 2355(C). *See, OAC*, 710:50-17-1.

3. "Oklahoma taxable income" is defined to mean "`taxable income' as reported (or as would have been reported by the taxpayer had a return been filed) to the federal government, and in the event of adjustments thereto by the federal government as finally ascertained under the Internal Revenue Code, adjusted further as" provided in Section 2358 of the Oklahoma Income Tax Act[10]. 68 O.S. Supp. 1994, § 2353(12). *See*, 68 O.S. Supp. 1996, § 2358(A).[11] Thus, the starting point for computing Oklahoma taxable income of a corporate taxpayer is the taxpayer's federal taxable income prior to any net operating loss and special deductions. *See*, ***Getty Oil Company v. Oklahoma Tax Commission***, 1997 OK 19, 563 P.2d 627, 630 and *OAC*, 710:50-17-50.

4. Taxes based on or measured by income are not deductible in computing the net apportionable income or loss of a unitary business enterprise. 68 O.S. Supp. 1996, § 2358(A)(5). *See, OAC*, 710:50-17-51(1)(A). The type of taxes that are based on or measured by income are: (1) state and local income taxes; (2) foreign income taxes; (3) some franchise taxes that are based on or measured by income; and (4) federal income taxes. *OAC*, 710:50-17-51(1)(B)(i), (ii) and (iii) and 710:50-17-51(2). These taxes must be added back to federal taxable income in computing Oklahoma taxable income. *See*, 68 O.S. Supp. 1996, § 2358(A)(5) and I.R.C. § 164(a).

[10] 68 O.S. 1991, § 2351 et seq.

[11] Amended by Laws 1996, c. 3, § 15, emerg. eff. March 6, 1996 and Laws 1996, c. 216, § 1, eff. Nov. 1, 1996, effective until January 1, 1997 and by Laws 1996, c. 217, § 1 and Laws 1996, c. 296, § 1, effective January 1, 1997.

5. I.R.C. § 164 provides as a general rule that "[s]tate and local, and foreign, income, war profits, and excess profits taxes" shall be allowed as a deduction for the taxable year within which paid or accrued. I.R.C. § 164(a)(3).

6. The federal "tax benefit rule" generally provides that "[t]he recovery of an amount deducted or credited in an earlier tax year is included in a taxpayer's income in the current (recovery) year, except to the extent the deduction or credit *didn't* reduce federal income tax * * * imposed in the earlier year." 1996 *RIA Federal Tax Handbook*, Chapter 2, § 1206. (Emphasis original). See, I.R.C. § 111(a). "The tax benefit rule applies to state income taxes deducted in an earlier year where there's a refund or credit of taxes paid or the cancellation of taxes accrued." *Id.* I.R.C. § 111(a) in general provides "[g]ross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter." (Emphasis added).

7. The Division argues that the Oklahoma Income Tax Act and regulations do not have a provision allowing the deduction of state and local income tax refunds and therefore, the deduction must be denied, citing ***Flint Resources Company v. Oklahoma Tax Commission***, 1989 OK 9, 780 P.2d 665; ***Home State Royalty Corporation v. Weems***, 1935 OK 1043, 175 Okla. 340, 52 P.2d 806; and, ***New Colonial Ice Co. v. Helvering***, 292 U.S. 435, 54 S.Ct. 788, 78 L.Ed. 1348 (1934).

These cases stand for the propositions that deductions and exemptions from income tax are not matters of right, but matters of legislative grace, and a taxpayer claiming a deduction or exemption must bring himself squarely within the terms of the statute expressly authorizing it.

The undersigned, however, finds that the state and local income tax refunds relate to the amount of Protestant's total income subject to Oklahoma income tax, that the amount of Protestant's total income subject to Oklahoma income tax must be determined before consideration can be given to deductions and that Protestant's true total income subject to Oklahoma income tax in tax years 1996 and 1997 cannot be determined without consideration of the state and local income tax refunds.

The word "income" in a tax statute must be taken in its ordinary sense of gain or profit. *See*, ***Southern Weaving Co. v. Query***, 206 S.C. 307, 34 S.E.2d 51 (1945), citing 61 C.J., page 1577. In ***Southern Weaving***, *supra*, a large portion of taxpayer's income for the tax year ended November 30, 1942, was derived from contracts for the sale of its products to the War, Navy and other Departments of the United States Government. Taxpayer's contracts were subject to renegotiation under an act of Congress for the purpose of determining whether the prices and the amount received the thereunder were excessive. A contractor was required to refund to the United States Government any amount found to be excessive. At the time taxpayer's state income tax return was due for filing the only figures available for purposes of making the return were the original prices under the contracts. Shortly thereafter the prices under the contracts were found to be excessive and taxpayer was required to repay the excess amount to the Government, less a credit for the amount of federal income and excess profit taxes paid on the excess profit. In other words, taxpayer was not required to file an amended federal income tax return to seek a refund of the taxes paid on the excess profits. No credit was allowed for the state income taxes paid on the excess profit. Taxpayer thereafter filed an amended state income tax return reporting a net taxable income based on the

renegotiated prices which was the amount previously reported less the amount repaid to the Government. The South Carolina Tax Commission disallowed taxpayer's amended return and assessed additional tax representing the difference between the income tax liability reported on the original return and the amount paid according to the amended return.

In determining whether the repayment of the excess profits to the government was a "deduction", the Court held:

> It seems to be well established that `deductions from gross income are not a matter of right. They are a matter of legislative grace, and a taxpayer claiming a deduction must bring himself squarely within the terms of a statute expressly authorizing it.' Hales-Mullaly, Inc. v. Commissioner of Internal Revenue, 10 Cir., 131 F.2d 509, 511. There are numerous other cases to the same effect. But we think it clearly appears that the usual rules applicable to `deductions' in income tax returns have no application here. This item is not a `deduction' from gross income, but it relates to the amount of gross income. The amount of gross income must be first determined before consideration can be given to deductions and the true gross income of [taxpayer] cannot be determined without consideration of this refund. [Taxpayer] only sought by its amended return to reflect its true income and did not seek to claim a deduction from such income. *Id*. at 54.

In this case, had Protestant been subject to Oklahoma income tax in tax years prior to 1996, Protestant would have been required to add the amount of the state and local income tax refunds back to federal taxable income in computing Oklahoma taxable income and would have paid Oklahoma income tax with respect to the refunds. The state and local tax refunds for Oklahoma income tax purposes would not represent a gain or profit in the year of receipt, but would represent a return of income previously realized and taxed for Oklahoma income tax purposes. But for the tax benefit rule, Protestant would not have recognized the refunds as income in tax years 1996 and 1997. I.R.C. § 111 concepts, however, as applied to the Oklahoma income tax law, plainly would not have created any income because Protestant would not have received a tax benefit for the state and local taxes paid. Realization of income rather than recognition of income is the touchstone in determining whether the income is subject to state taxation. *See*, ***Clearwater Federal Savings & Loan Association v. Department of Revenue State of Florida***, 350 So.2d 1134 (1977).[12]

The fact that Protestant was not subject to Oklahoma income tax prior to 1996 does not require a different result. *See*, ***Clearwater***, *supra*. The income represented by the state and local tax refunds was realized by Protestant prior to 1996. With respect to Protestant's recovery in tax years 1996 and 1997 of the erroneously paid state and local income taxes for tax years prior to 1996, it is apparent that the prerequisite to the recognition of income under § 111 is absent. Protestant would have been required to realize the income represented by the state and local income taxes paid for purposes of computing Oklahoma taxable income in the tax years prior to 1996. Again, the tax benefit rule as applied to Oklahoma income tax law would plainly not create any income since the

[12] In this case, the Court discusses the difference between the realization of income doctrine and the doctrine of recognition of income for income tax purposes.

erroneous overpayment of the state and local income taxes would not have resulted in a prior tax benefit for Oklahoma income tax purposes.

Protestant in allocating or excluding the state and local income tax refunds from its Oklahoma taxable income only sought to reflect its true Oklahoma taxable income for tax years 1996 and 1997 which could not be determined without excluding the refunds. Protestant was not seeking to claim a deduction of those refunds from Oklahoma taxable income. Accordingly, the common law concepts that deductions are a matter of legislative grace and a taxpayer claiming a deduction must bring himself squarely within the terms of a statute expressly authorizing the deduction are not applicable in this case.

8. The Division also cites ***Herzog Contracting Corporation v. Director of Revenue State of Missouri***, 1987 WL 51180 (Mo.Admin.Hrg.Com.), and argues that ***Herzog*** has persuasive precedential value and is relevant to this case. In ***Herzog***, *supra*, the Missouri Department of Revenue disallowed the deduction of refunds of state income tax paid to states other than Missouri which had been included in the taxpayer's federal taxable income for tax years 1981 and 1982. As a finding of fact, the Missouri Administrative Hearing Commission found:

> The state income tax refunds referred to above were included in the Petitioner's federal taxable income on its federal tax returns for tax years 1981 and 1982, because in previous years the taxes which were refunded were deducted on the Petitioner's federal income tax return pursuant to § 164 of the Internal Revenue Code. During the years that the particular taxes in question were deducted on the Petitioner's federal income tax return, these state income taxes were not also claimed as deductions on the Missouri income tax returns but were, instead, added to the Petitioner's federal taxable income on Petitioner's Missouri corporate income tax return pursuant to Section 143.431 and 143.141, RSMo, in order to arrive at Missouri taxable income. Thus, these state income taxes never caused, directly or indirectly, a Missouri income tax benefit on any Missouri income tax return previously filed.

With respect to the issues raised, the Missouri Administrative Hearing Commission held as a conclusion of law:

> Petitioner's point is well-taken as to the inequity of the income tax statute in this circumstance, but there is no relief available on these facts. First, we note that double taxation is not per se unconstitutional. (Citation omitted). Secondly, this Commission has no authority to declare a statute unconstitutional. (Citations omitted).
>
> It is an established principle that exemptions from tax are the exception, not the rule, and are strictly construed against the one claiming them. (Citation omitted). Exemptions will not be read into the law which do not clearly appear therein. (Citation omitted). By the unambiguous terms of the statute, Petitioner is not accorded any deduction or modification which will relieve it of the burden of which it complains.

> Finally, we note that the enactment by the legislature in 1977 of S.B. 46, which permits the subtraction from federal taxable income of any amount received as a Missouri income tax refund, implies the legislature's intent to deny relief of the sort which Petitioner seeks. (Citations omitted).

The undersigned finds that the decision in ***Herzog***, *supra*, should not be relied on by the Oklahoma Tax Commission in deciding the present controversy because the Missouri Commission did not consider the doctrines of "realization of income" versus "recognition of income" for federal tax purposes and did not consider the application of the "tax benefit rule" to its own state tax statutes. Further, it should be noted as recognized by both the Division and Protestant that the Oklahoma Income Tax Act and the income tax regulations do not address the treatment of non-Oklahoma state and local income tax refunds which are included in a taxpayer's federal taxable income by reason of I.R.C. § 111. *See*, ***Magnolia Petroleum Co. v. Oklahoma Tax Commission***, 1941 OK 407, 190 Okl. 172, 121 P.2d 1008; and, ***Phillips v. Oklahoma Tax Commission***, 1935 OK 1056, 174 Okl. 401, 49 P.2d 805.[13]

The tax benefit rule is applicable in Oklahoma under proper circumstances. ***Chapman v. Oklahoma Tax Commission***, 1969 OK 177, 462 P.2d 654. *See*, ***National Bank of Tulsa v. Oklahoma Tax Commission***, 1944 OK 68, 193 Okl. 529, 145 P.2d 768; and 68 O.S. Supp. 1994, § 2353(3). In ***Chapman***, *supra*, taxpayers, for tax years 1958 through 1960, deducted from adjusted gross income, for purposes of determining income subject to the Oklahoma income tax, approximately $680,000.00 representing federal income taxes paid during those years and allocable to Oklahoma. Thereafter, due to heavy losses incurred in out-of-state operations, taxpayers took advantage of the "loss carry-back" provisions of the Internal Revenue Code and received during 1962 and 1963, federal income tax refunds exceeding $700,000.00 for the tax years 1958 through 1960. Taxpayer appealed from a decision of the Oklahoma Tax Commission which held, in effect, that the portion of the refunds allocable to Oklahoma was subject to the Oklahoma income tax law, and assessed additional taxes accordingly for tax years 1962 and 1963.

The Court, in ***Chapman***, held that in determining the applicability of the tax benefit rule in this state, the question of source [of the item recovered] must be considered since Oklahoma income tax laws and those of most other jurisdictions are distinct, in that; the place where the income is earned is a factor in Oklahoma but not elsewhere. *Id.*, at 656. The Court in affirming the Order of the Tax Commission found that the item recovered was the federal income taxes paid in 1958, 1959 and 1960, which were deducted, insofar as they were allocable to Oklahoma, in computing the Oklahoma income tax for those years and the ultimate source of the recovery was the income earned by taxpayers in the State of Oklahoma. *Id.*

In ***National Bank of Tulsa***, *supra*, the Court also looked to the source of the item subsequently recovered for purposes of determining whether the deduction had resulted in a tax benefit to the taxpayer, and held that the item previously deducted had originally been a part of capital and not income, that the deduction had not resulted in a tax savings to the taxpayer and that

[13] The Oklahoma Supreme Court in ***Magnolia*** held that income tax statutes, where at all uncertain as to the elements comprising the taxpayer's duty, will be construed in the taxpayer's favor, and in ***Phillips*** held that income tax laws must be given a logical and reasonable construction.

the subsequent recovery of the item deducted was not taxable under the tax benefit rule. *Id*. at 771-772.

9. In ***Chapman***, *supra* at 655, the Court noted that under the income tax code in effect at the time the only business income subject to taxation in Oklahoma was that arising from all property owned and/or business transacted within the state, citing 68 O.S. 1965 Supp., § 2304(a). The income tax code of 1965 did not incorporate the provisions of the Internal Revenue Code. See, 68 O.S. Supp. 1965, § 2301 et seq. Since 1971, the Oklahoma Income Tax Act has incorporated the provisions of the Internal Revenue Code. *See*, generally, 68 O.S. 1971 § 2351 et seq., and in particular § 2353(3).

10. For all the above reasons, the undersigned finds that the tax benefit rule should be found to be applicable to the circumstances of this case. Although, it is not a material aspect to the decision herein since this proceeding concerns Protestant's apportionable income, the source of the item recovered is the non-Oklahoma state and local income tax refunds and the ultimate source of the recovery is the income earned by Protestant in the states from which it received the refunds. Accordingly, since Protestant would not have received a tax benefit under the Oklahoma Income Tax Act for the state and local income taxes paid to states other than the State of Oklahoma in tax years prior to 1996, the amount of the state and local income tax refunds is not required to be included in the computation of Protestant's 1996 and 1997 Oklahoma taxable income.

11. Protestant's protest to the disallowance of the exclusion or allocation of the non-Oklahoma state and local income tax refunds received in 1996 and 1997, and recognized for federal income tax purposes in 1996 and 1997 under the tax benefit rule of I.R.C. § 111 should be sustained.

DISPOSITION

Based on the above and foregoing findings of fact and conclusions of law, it is ORDERED that the protest of PROTESTANT, be sustained as to the bifurcated issue of whether the State of Oklahoma can subject to income tax the non-Oklahoma state and local income tax refunds received in 1996 and 1977, and recognized for federal income tax purposes in 1996 and 1997 under the tax benefit rule of I.R.C. § 111.

OKLAHOMA TAX COMMISSION