

JURISDICTION: OKLAHOMA TAX COMMISSION
CITE: 2007-06-07-03 (NON-PRECEDENTIAL)
ID: P-05-133-K
DATE: JUNE 7, 2007
DISPOSITION: DENIED
TAX TYPE: FRANCHISE
APPEAL: APPEAL PENDING S.CT. 104,827

FINDINGS OF FACT AND CONCLUSIONS OF LAW

Protestant, MUSIC COMPANY, is represented by ATTORNEY, Attorney at Law, LAW FIRM. The Audit Division of the Tax Commission (hereinafter "Division") is represented by OTC ATTORNEY, Assistant General Counsel, Office of the General Counsel, Oklahoma Tax Commission.

STATEMENT OF THE CASE

An office audit of Protestant's franchise tax, and state and federal income tax returns corresponding to the July 1, 2002 through June 30, 2005 audit period was performed by the Division. As a result of the audit, the Division by letter dated May 19, 2005, proposed the assessment of additional franchise tax, interest and penalty against Protestant in the aggregate amount of \$15,059.87. On June 22, 2005, Protestant submitted for filing amended franchise tax returns for the audit period and by accompanying letter protested the proposed assessment. An oral hearing was not requested in the letter of protest.

On September 15, 2005, the Division referred the protest to the Office of the Administrative Law Judges (ALJ's Office) for further proceedings consistent with the Uniform Tax Procedure Code¹ and the Rules of Practice and Procedure Before the Oklahoma Tax Commission². The case was docketed as Case No. P-05-133-K and assigned to ALJ, Administrative Law Judge.³

A pre-hearing conference was scheduled for November 14, 2005, by *Prehearing Conference Notice* issued October 18, 2005.⁴ A *Status Report In Lieu of Pre-Hearing Conference* was filed by the Division on November 10, 2005. By *Status Report* filed March 27, 2006, the parties jointly requested a scheduling order issue whereby the protest would be submitted for decision pursuant to OAC, 710:1-5-38. A *Scheduling Order* was issued March 28, 2006. The *Scheduling Order* was modified several times.

A *Stipulation of Facts and Statement of Issue* was filed October 17, 2006. Exhibits 1 through 12 and A-1 through A-10, B-1, C-1 and C-2, D-1, E-1, F and G were submitted therewith.

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 See, OAC, 710:1-5-22 and 710:1-5-30.

⁴ See, OAC, 710:1-5-28.

Protestant's *Brief in Chief* was filed January 3, 2007. The *Brief of the Audit Division* was filed January 30, 2007. Protestant's *Response Brief* was filed February 9, 2007, whereupon the record was closed and the protest was submitted for decision.

FINDINGS OF FACT

Upon review of the file and records, including the *Stipulation of Facts and Statement of Issue*, the exhibits and the briefs, the undersigned finds:

A. The parties stipulate to the following:

1. On or about August 26, 2002, Protestant filed its 2003 Oklahoma Franchise Tax Return⁵ for the period of July 1, 2002 through June 30, 2003 (with a balance sheet as of tax year ended 12/31/01). [Exhibit 1.]

2. On or about September 16, 2002, Protestant filed its 2001 Oklahoma 512-S corporate income tax return (with 2001 federal 1120-S corporate return attached, both) for the period of January 1, 2001 through December 31, 2001. [Exhibit 2.]

3. On its 2003 Franchise Tax Return, Protestant sought to claim Two Million, Five Hundred Thirty Thousand Seventy-six Dollars (\$2,530,076.00) of long-term debt as current liabilities. [Exhibit 1 (balance sheet, line 21 of 2003 franchise tax return) and 2 (Schedule L/balance sheet, line 17 and statement 12, 2001 federal 1120-S).]

4. On or about August 26, 2003, Protestant filed its 2004 Oklahoma franchise tax return⁶ for the period of July 1, 2003 through June 30, 2004 (with a balance sheet as of tax year ended 12/31/02). [Exhibit 3.]

⁵ Footnote 1 which is original to the Stipulation of Facts and Statement of Issue states:

On or about July 6, 2005, in response to the Division's assessment, Protestant filed an amended 2003 franchise tax return, reducing its "indebtedness payable three years or less after issuance" (See Line 21, balance sheet of 2003 franchise tax return) from \$2,530,076.00 as originally claimed to an amended amount of \$2,525,000.00. Because Protestant has provided no indication that it has filed a modified federal return for the 2001 federal tax year which would modify the 1120-S, Schedule L/balance sheet, line 17 "mortgages, notes, and bonds payable in less than 1 yr" figure, the amended returns have been disregarded. Moreover, the slight reduction in Protestant's amended indebtedness does not change the fact that the Division believes the debt at issue – an ongoing line of credit from XYZ BANK– constitutes long-term indebtedness. The Division, therefore, believes that its assessment is correct and does not require adjustment or correction.

⁶ Footnote 2 which is original to the Stipulation of Facts and Statement of Issue states:

On or about July 6, 2005, in response to the Division's assessment, Protestant filed an amended 2004 franchise tax return, reducing its "indebtedness payable three years or less after issuance" (See Line 21, balance sheet of 2004 franchise tax return) from \$2,574,716.00 as originally claimed to an amended amount of \$2,569,640.00. Because Protestant has provided no indication that it has filed a modified federal return for the 2002 federal tax year which would modify the 1120-S, Schedule L/balance sheet, line 17 "mortgages, notes, and bonds payable in less than 1 yr" figure,

5. On or about September 16, 2003, Protestant filed its 2002 Oklahoma 512-S corporate Income tax return (with 2002 federal 1120-S corporate return attached, both) for the period of January 1, 2002 through December 31, 2002. [Exhibit 4.]

6. On its 2004 Franchise Tax Return, Protestant sought to claim Two Million, Five Hundred Seventy-four Thousand Seven Hundred Sixteen Dollars (\$2,574,716.00) of long-term debt as current liabilities. [Exhibit 3 (balance sheet, line 21 of 2004 franchise tax return) and 4 (Schedule L/Balance Sheet, line 17 and statement 13, 2002 federal 1120-S).]

7. On or about August 31, 2004, Protestant filed its 2005 Oklahoma Franchise Tax Return⁷ for the period of July 1, 2004 through June 30, 2005 (with a balance sheet as of tax year ended 12/31/03). [Exhibit 5.]

8. On or about September 15, 2004, Protestant filed its 2003 Oklahoma 512-S corporate income tax (with 2003 federal 1120-S corporate return attached, both) for the period of January 1, 2003 through December 31, 2003. [Exhibit 6.]

9. On its 2005 franchise tax return, Protestant sought to claim Two Million Four Hundred Thirty-eight Thousand, Five Hundred Sixty-one Dollars (\$2,438,561.00) of long-term debt as current liabilities. [Exhibit 5 (franchise tax return balance sheet, line 21) and 6 (Schedule L/balance sheet, line 14, and statement 13, 2003 federal 1120-S).]

10. Based on an office audit of Protestant's franchise and Oklahoma corporate tax returns, on or about May 19, 2005 [sic] the Division issued its assessment of additional franchise tax due for tax years 2002-2005 in the amount of Fifteen Thousand, Fifty-nine [sic] Dollars and Eighty-seven Cents (\$15,059.87), consisting of additional tax in the amount of Ten Thousand, Nine Hundred Forty-eight Dollars and Seventy-five Cents (\$10,948.75), penalty in the amount of One Thousand, Ninety-four Dollars and Eighty-eight Cents (\$1,094.88) and interest in the amount of Three Thousand Sixteen Dollars and Twenty-four Cents (\$3,016.24) [sic] through July 19, 2005. [Exhibit 7.]

the amended returns have been disregarded. Moreover, the slight reduction in Protestant's amended indebtedness does not change the fact that the Division believes the debt at issue – an ongoing line of credit from XYZ BANK– constitutes long-term indebtedness. The Division, therefore, believes that its assessment is correct and does not require adjustment or correction.

⁷ Footnote 3 which is original to the Stipulation of Facts and Statement of Issue states:

On or about July 6, 2005, in response to the Division's assessment, Protestant filed an amended 2005 franchise tax return, reducing its "indebtedness payable three years or less after issuance" (See Line 21, balance sheet of 2005 franchise tax return) from \$2,438,561.00 as originally claimed to an amended amount of \$2,433,485.00. Because Protestant has provided no indication that it has filed a modified federal return for the 2003 federal tax year which would modify the 1120-S, Schedule L/balance sheet, line 17 "mortgages, notes, and bonds payable in less than 1 yr" figure, the amended returns have been disregarded. Moreover, the slight reduction in Protestant's amended indebtedness does not change the fact that the Division believes the debt at issue – an ongoing line of credit from XYZ BANK– constitutes long-term indebtedness. The Division, therefore, believes that its assessment is correct and does not require adjustment or correction.

11. On or about [sic] June 22, 2005, Protestant timely filed its protest in this matter. [Exhibit 8.]

12. If called as a witness at a hearing in this matter, PRESIDENT would testify as set forth in the Affidavit of PRESIDENT, including identifying and sponsoring the Exhibits Nos. A-1 through G referenced therein and submitted herewith in a separate bound volume. [Exhibit 9.]

13. If called as a witness at hearing in this matter, CONTROLLER would testify as set forth in the Affidavit of CONTROLLER, including the Exhibit A attached thereto. [Exhibit 10.]

14. If called as a witness at a hearing in this matter, CPA would testify as set forth in the Affidavit of CPA, including the Curriculum Vitae attached thereto. [Exhibit 11.]

15. If called as a witness in a hearing in this matter, BANK VICE-PRESIDENT would testify as set forth in the Affidavit of BANK VICE-PRESIDENT. [Exhibit 12.]

B. Additional findings:

1. At all times relevant herein, Protestant was an S corporation, organized and existing under the laws of the State of Oklahoma. Exhibits 2, 4 and 6. Protestant owns and operates five (5) full line retail music stores, two (2) of which are located in Oklahoma and the remaining located in Arkansas. Exhibits 9 and A-3.

2. Protestant has a line of credit financing arrangement with XYZ BANK by which a secured line of credit is extended to Protestant for its use in purchasing inventory and providing financing for the rentals of instruments. Exhibit 9.

3. The Promissory Note between Protestant and XYZ BANK was originally executed on March 15, 2000, and was made payable at sight of \$3,000,000.00 or as much as was disbursed, with monthly payments of interest only commencing April 15, 2000 and a final installment of all unpaid principal and interest due April 15, 2001. Exhibit A-1. The Note was secured by the Loan Agreement executed March 15, 2000, and the parties consented to the extension of time of payment and the renewal of the Note. Exhibit A-1.

4. The Note was collateralized by Protestant's inventory, accounts receivable and rental contracts, then owned or thereafter acquired. Exhibit A-2.

5. The original Loan Agreement provided for a revolving line of credit of the lesser of \$3,000,000.00 or the borrowing base and was used to refinance an existing line of credit Protestant had with ABC BANK and to provide working capital for general corporate purposes. Exhibit A-8. The entire principal balance and all unpaid interest were made due and payable on April 15, 2001. Exhibit A-8. Advances under the Loan could not exceed the borrowing base which was defined as Eighty percent (80%) of eligible accounts receivable, forty percent (40%) of eligible inventory and sixty percent (60%) of instrument rental contracts. Exhibit A-8. The lender was not obligated to renew or extend the Loan at maturity. Exhibit A-8. Protestant was required to maintain an annual debt service coverage of 1.5 to 1.00 which debt service coverage was defined as "net income plus

interest expense plus other non-cash expenses * * * divided by current maturities of long-term debt plus interest expense to be measured on a calendar quarter basis”. Exhibit A-8.

6. The effective dates of the First Amended Promissory Note and First Amended Loan Agreement were July 15, 2001. Exhibit B-1. The last paragraph of the note provides: “This Note is executed, delivered and accepted not in payment of, but for the purpose of amending and renewing that certain Promissory Note dated March 15, 2000, as amended by that certain Loan Modification Agreement dated April 26, 2001 (collectively ‘Prior Note’) in favor of XYZ BANK. Exhibit B-1. The Note was made payable by monthly payments of interest only commencing August 15, 2001, and a final installment due on the maturity date of July 15, 2002, to include all unpaid principal and interest. Exhibit B-1. The Note was secured by the First Amended Loan Agreement and the parties consented to the extension of time of payment and the renewal of the Note. Exhibit B-1.

7. The effective dates of the Second Amendment to Loan Agreement and Second Amended Promissory Note were September 1, 2002. Exhibits C-1 and C-2. Under the Second Amendment to Loan Agreement, XYZ BANK agreed to extend the maturity date of the loan to August 15, 2003. Exhibit C-1. XYZ BANK was not obligated to extend the term of the loan beyond the new maturity date. Exhibit C-1. The Second Amended Promissory Note was executed for purposes of amending and renewing that certain Promissory Note dated March 15, 2000, as amended by that certain First Amended Promissory Note dated July 18, 2001. Exhibit C-2. The maturity date of the Note was likewise extended to August 15, 2003, and the parties consented to the extension of time of payment and the renewal of the Note. Exhibit C-2.

8. The Third Amendment to Loan Agreement dated August 15, 2003, extended the maturity date of the Loan to August 15, 2004. Exhibit D-1. The advance rate on eligible inventory was modified to sixty-five percent (65%). Exhibit D-1.

9. Protestant and XYZ BANK entered into a Commercial Loan Agreement dated August 15, 2004, providing for a revolving draw loan not to exceed the maximum outstanding principal balance of \$2,750,000.00, and initial advance of \$2,404,631.00 and a maturity date of August 15, 2006. Exhibit E-1. Debt under the Note was governed by the borrowing base defined as 80% of eligible accounts receivable, 60% of eligible inventory for the first and second quarters of the year and at 40% for the third and fourth quarters of the year and 60% of eligible rental contracts. Exhibit E-1. A minimum debt service coverage ratio of 1.50 to 1 was required to be maintained on a rolling four quarters basis. Exhibit E-1.

10. By Affidavit, PRESIDENT, Protestant’s president states that “I have always considered the * * * debt to [XYZ BANK] Bank to be short term debt because, under normal business practices, a debt secured by inventory and other fast turning collateral, is by nature short term, regardless of the set term.” Exhibit 9.

11. By Affidavit, CONTROLLER, Protestant’s Controller, states “[i]n my opinion, the indebtedness due from [Protestant] to [XYZ BANK] Bank is best characterized as short term indebtedness due to it being collateralized by current assets * * * If the levels of current assets dropped below the minimums specified in the loan agreement, [XYZ BANK] Bank would be entitled to immediately collect the balance due.” Exhibit 10.

12. By Affidavit, CPA, Certified Public Accountant, states “[t]he * * * debt has consistently been considered short-term debt * * * It is secured by current assets, i.e., inventory and receivables.” Exhibit 11.

13. By Affidavit, BANK VICE PRESIDENT, Senior Vice-President and Senior Commercial Lender with XYZ BANK, states:

The * * * loan is fully secured by inventory and accounts receivable which are current assets. In my opinion, the loan should be classified as a current or short term loan because it is collateralized by current or short term assets. If the collateral value of the assets calculated for the Borrowing Base Certificate of [Protestant] falls below the parameters set forth in the loan document, the loan becomes immediately due and payable.

The loan has been renewed from time to time. Each time the loan is renewed, it goes through the same scrutiny by the loan committee and approval process as does a new loan and is the functional equivalent of a new loan. In my opinion, to draw a distinction between extending, renewing, or making a new loan under the circumstances here involved is an extreme case of elevating form over substance.

14. The following is an excerpt from a transcript of the *OSCPA Questions & OTC Answers* during the January 13th OSCP/OTC Liaison Meeting⁸:

Question 7: Corp. has a line of credit which is a percentage of accounts receivable and inventory (both current assets). The amount fluctuates with the level of inventory and receivables, and the line has a due date 2 years away, but is normally renewed on the same terms every 2 years. In the past, the liability was considered to be current for franchise tax because it was directly tied to the level of inventory and receivables. Has the OTC policy on this changed?

Answer: The policy of the Commission has not changed.

ISSUE AND CONTENTIONS

The issue to be decided, as stipulated by the parties, is “whether the Division properly adjusted Taxpayer’s total current liabilities and capital employed in Oklahoma for Franchise Tax years 2003, 2004 and 2005.” The issue is best described in Protestant’s *Brief in Chief* wherein it is stated “[t]he single proposition that is determinative of this case is whether [Protestant’s] line of credit indebtedness to XYZ BANK qualifies as short-term indebtedness under [68 O.S. 2001, § 1209(a)].”

⁸ An attachment to Protestant’s *Brief in Chief* filed January 3, 2007. The answer is attributable to ADMINISTRATOR, Administrator, Oklahoma Tax Commission.

Protestant contends that the note should be excluded from capital in the computation of the amount of its annual franchise tax payable to Oklahoma. In support of this contention, Protestant argues that the note qualifies as short-term indebtedness; i.e., payable in less than three years, because each renewal or extension of the note was the functional equivalent of a new loan and the note is secured by short-term assets; i.e., cash and cash equivalents, inventory and accounts receivable.

Protestant further contends that to find the note as anything other than short-term indebtedness violates the Fourteenth Amendment to the United States Constitution, and the Equal Protection Clause (art. 2, § 7) and Uniformity provision (art. 10, § 5(B)) of the Oklahoma Constitution. In support of this contention, Protestant argues that line of credit indebtedness is the equivalent of short-term indebtedness, and to classify it otherwise, is arbitrary and capricious, and bears no rational relationship to the goal of discouraging thinly capitalized corporations.

The Division contends that because Protestant and XYZ BANK extended the original note beyond three years, the loan was properly reclassified as capital and includable in the calculation of franchise tax. In support of this contention, the Division argues that the parties' treatment of the note and Protestant's expectations from it support reclassification. The Division further contends that the Tax Commission is not bound by nor can it be estopped by inaccurate statements of its employees. Further, the Division denies the allegation that it has separately classified short-term debt and debt incurred through a line of credit.

CONCLUSIONS OF LAW

WHEREFORE, premises considered, the undersigned concludes as a matter of law that:

1. The Tax Commission is vested with jurisdiction over the parties and subject matter of this protest. 68 O.S. 2001, § 221(D).
2. Every corporation organized under the laws of this state, or qualified to do, or doing business in Oklahoma in a corporate or organized capacity by virtue of creation or organization under the laws of this or any other state, territory or district, or a foreign country is subject to the terms of the Franchise Tax Code ("Code"). 68 O.S. 2001, §1201 et seq. See, *Great Lakes Pipe Line Co. v. Oklahoma Tax Commission*, 204 Okla. 518, 1951 OK 123, 231 P.2d 655.
3. A "franchise or excise tax" is imposed upon every corporation or other business organization "equal to One Dollar and twenty-five cents (\$1.25) for each One Thousand Dollars (\$1,000.00) or fraction thereof of the amount of capital [or its equivalent] used, invested or employed" within Oklahoma. 68 O.S. 2001, § 1204. The amount of capital involved is not the subject of the tax but is the yardstick by which the amount of tax is measured. *Scott-Rice Co. v. Oklahoma Tax Commission*, 1972 OK 75, 503 P.2d 208.
4. Franchise tax is levied on each corporation organized under the laws of this state and is measured by the amount of capital used, invested, or employed in the exercise of any power,

privilege or right inuring to such organization within this state. 68 O.S. Supp. 2001, §1203. The term “capital” as used in § 1203 is construed to include:

Outstanding capital stock, surplus and undivided profits, which shall include any amounts designated for the payment of dividends until such amounts are definitely and irrevocably placed to the credit of stockholders subject to withdrawal on demand, plus the amount of bonds, notes, debentures or other evidences of indebtedness maturing and payable more than three (3) years after issuance. The term "capital" stock where herein used shall include all written evidence of interest or ownership in the control or management of a corporation or other organization. The term "evidence of indebtedness" where herein used shall not include any deposit made in any bank. (Emphasis Added)

68 O.S. 2001, § 1209(a).

5. “Current Liability” is defined to mean “any bond, note, debenture, or other evidences of indebtedness, or any portion thereof, payable within three (3) years or less after issuance.” OAC, 710:40-1-2, ¶ 4. Current liability does not include “that portion of a debt which matures more than three (3) years after issuance. *Id.*”

6. The Tax Commission has previously determined that notes which are short-term on their face, but which are renewed or extended at maturity, are in fact capital and includable in a taxpayer’s franchise tax base. OTC Order No. 92-06-04-018. In that case, the Commission reasoned that the notes were renewed on a yearly basis without additional consideration, collateralization or negotiations, the notes were issued based on an underlying outstanding line of credit and the notes were secured by the taxpayer’s accounts receivable and equipment. The Commission also reasoned that the borrowings were invested in the business for production of profits and wealth rather than used to defray the costs of taxpayer’s day to day business operations.

7. This case is controlled by the decision of the Court of Appeals in ***Big D Enterprises, Inc. v. Oklahoma Tax Commission***, 1995 OK CIV APP 32, 895 P.2d 743. The material facts as recited by the Court were; “Big D did not refinance its original note or roll it over into a new obligation, thereby extinguishing its original note”, and “[i]nstead, Big D and its lender agreed they would ‘hereby extend the time of payment of the principal indebtedness of the note’ ”. *Id.* at 745. Based on these facts, the Court held “[i]n so agreeing, [the] note * * * became payable six years after issuance, and the unpaid portion of that note became capital under § 1209(a)”, citing *Mazzio’s Corporation v. Oklahoma Tax Commission*, 1989 OK CIV APP 86, 789 P.2d 632. The Court reasoned that “the extension agreement was not a new note but was an agreement to extend the maturity date of the old note.” *Id.*

8. Here, the facts show that the maturity date of the original note was extended beyond three (3) years by three (3) separate financial transactions between Protestant and XYZ BANK. Thus, the portion of the indebtedness maturing and payable more than three (3) years after issuance was by definition “capital” and required to be included in the computation of the amount of annual franchise tax levied upon and payable by Protestant. ***Big D, supra.***

9. Estoppel generally does not apply against the state acting in its sovereign capacity because of unauthorized acts of its officers, *State ex rel. Cartwright v. Dunbar*, 1980 OK 15, 618 P.2d 900; or because of mistakes or errors of its employees, *State ex rel. Cartwright v. Tidmore*, 1983 OK 116, 674 P.2d 14; *State ex rel. Oklahoma Tax Commission v. Emery*, 1982 OK CIV APP 13, 645 P.2d 1048. Application of estoppel is not allowed against state, political subdivisions, or agencies, unless the facts and circumstances implicate the interposition of estoppel would further some prevailing principal of public policy or interest. *Tice v. Pennington*, 2001 OK CIV APP 95, 30 P.3d 1164; *Burdick v. Independent School District*, 1985 OK 49, 702 P.2d 48, 26 Ed. Law Rep. 486. Where there is no power to act, a public official cannot bind a government entity even if he or she mistakenly or falsely asserts such authority. *Hiland Dairy Foods Company, LLC. v. Oklahoma Tax Commission*, 2006 OK CIV APP 68, ¶ 11, 136 P.3d 1072, citing *Indiana Nat'l Bank v. State Dept. of Human Services*, 1993 OK 101, 857 P.2d 53, 64.

10. Every statute is deemed constitutionally valid until a court of competent jurisdiction declares otherwise. See, *State ex rel. York v. Turpen*, 1984 OK 26, 681 P.2d 763, 767. The Tax Commission as an administrative agency is not empowered to decide the constitutional validity of a taxing statute. See, *Dow Jones & Company, Inc. v. Oklahoma Tax Commission*, 1990 OK 6, 787 P.2d 843, 845. Notwithstanding, the Division did not reclassify the Note until after the indebtedness represented by the Note was maturing and payable more than three (3) years after issuance. Accordingly, the Division's reclassification of the Note is within the dictates of the statute and is permissible.

11. Protestant's protest to the proposed franchise tax assessment should be denied.

RECOMMENDATIONS

Based on the above and foregoing findings of fact and conclusions of law, it is ORDERED that the protest of Protestant, MUSIC COMPANY, be denied. It is further ORDERED that the amount in controversy, 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 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.