JURISDICTION: **OKLAHOMA TAX COMMISSION DECISION**
CITE: **2009-06-23-03 / NON-PRECEDENTIAL**
ID: **P-08-005-H**
DATE: **JUNE 23, 2009**
DISPOSITION: **DENIED**
TAX TYPE: **INCOME**
APPEAL: **NO APPEAL TAKEN**

FINDINGS OF FACT AND CONCLUSIONS OF LAW

PRESIDENT AND WIFE ("Protestants") appear through ATTORNEY 1 and ATTORNEY 2, LAW FIRM. The Amended Section of the Compliance Division ("Division"), Oklahoma Tax Commission, appears through OTC ATTORNEY 1, Assistant General Counsel, and OTC ATTORNEY 2, Assistant General Counsel, Office of General Counsel, Oklahoma Tax Commission.

PROCEDURAL HISTORY

On January 29, 2008, the protest file was received by the Office of Administrative Law Judges for further proceedings consistent with the *Uniform Tax Procedure Code*[1] and the *Rules of Practice and Procedure Before the Oklahoma Tax Commission*.[2] On January 31, 2008, a letter was mailed to Protestants' Counsel stating this matter had been assigned to ALJ, Administrative Law Judge, and docketed as Case Number P-08-005-H. The letter also advised Counsel a Notice of Prehearing Conference would be sent by mail and enclosed a copy of the *Rules of Practice and Procedure Before the Oklahoma Tax Commission.*[3]

On February 6, 2008, OTC ATTORNEY 3, Assistant General Counsel, and OTC ATTORNEY 1 filed an Entry of Appearance as Co-Counsel of record for the Division.

On February 8, 2008, the Notice of Prehearing Conference was mailed to Counsel, setting the prehearing conference for March 5, 2008, at 10:30 a.m.

On March 4, 2008, ATTORNEY 1 filed an Entry of Appearance as a Counsel of record for the Protestants. On March 4, 2008, Counsel submitted an agreed Scheduling Order. On March 5, 2008, Counsel for the Division submitted a Status Report in Lieu of Prehearing Conference. On March 5, 2008, the Scheduling Order was issued setting the hearing on this matter for June 24, 2008, at 9:30 a.m., with position letters or memorandum briefs due on or before June 17, 2008. On March 24, 2008, ATTORNEY 3 filed a Withdrawal of Counsel of Record for the Protestants. On March 25, 2008, the Division's Preliminary Witness and Exhibit

[1] OKLA. STAT. ANN. tit. 68, § 201 et seq. (West 2001).

[2] OKLA. ADMIN. CODE §§ 710:1-5-20 through 710:1-5-47.

[3] *See* Note 2, *supra*.

List and the Protestants' Preliminary Witness and Exhibit List were filed with the clerk of the court ("Clerk").

On April 10, 2008, a Joint Motion for Extension of Scheduling Order and Discovery Requests was filed with the Clerk. On April 11, 2008, an Amended Scheduling Order was issued setting the hearing in this matter for August 26, 2008, at 9:30 a.m., with position letters or memorandum briefs due on or before August 19, 2008.

On June 26, 2008, a Notice of Change in Counsel was filed by GENERAL COUNSEL, Chief Deputy General Counsel, notifying the Clerk that OTC ATTORNEY 3 had passed away on June 16, 2008, but OTC ATTORNEY 1 would remain as Counsel of record for the Division.

On July 16, 2008, a Joint Motion for Extension of Amended Scheduling Order was filed with the Clerk. On July 21, 2008, an Amended Scheduling Order was issued setting the hearing in this matter for November 4, 2008, at 9:30 a.m., with position letters or memorandum briefs due on or before October 27, 2008. On July 29, 2008, ATTORNEY 4 filed a Withdrawal of Counsel of Record for the Protestants and ATTORNEY 2 filed an Entry of Appearance as Co-Counsel of record for the Protestants.

On September 9, 2008, a Joint Motion for Extension of Amended Scheduling Order was filed with the Clerk. On September 11, 2008, an Amended Scheduling Order was issued setting the hearing in this matter for February 3, 2009, at 9:30 a.m., with position letters or memorandum briefs due on or before January 23, 2009.

On October 17, 2008, OTC ATTORNEY 2 filed an Entry of Appearance as Co-Counsel of record for the Division.

On December 17, 2008, the Division's Final Witness and Exhibit List were filed with the Clerk. On December 22, 2008, the Division filed a Motion in Limine to Limit Witness Testimony and Documentary Evidence ("*Motion*") with the Clerk. On December 24, 2008, a letter was mailed to Counsel advising a response to the Division's *Motion* could be filed on or before January 8, 2009. On December 29, 2008, the Protestants' Final Witness and Exhibit List were filed out of time with the Clerk.

On January 6, 2009, the Protestants' Motion to Extend Time to Respond to Division's Motion in Limine was filed with the Clerk. On January 7, 2009, there being no objection by the Division, an Order Granting Motion to Extend Time for filing a response to the Division's *Motion* to January 16, 2009, was issued. On January 13, 2009, a Joint Motion to Move Hearing Date was filed with the Clerk. On January 14, 2009, an Amended Scheduling Order was issued setting the hearing in this matter for February 25, 2009, at 9:30 a.m., with position letters or memorandum briefs due on or before February 18, 2009. On January 16, 2009, the Protestants' Response to Division's Motion in Limine ("*Response*") was filed with the Clerk.

On February 3, 2009, an Order Sustaining Division's Motion in Limine to Limit Witness Testimony and Documentary Evidence ("*Order*") was issued as more fully set forth therein. Counsel was also advised the Protestants would be permitted to make an oral Offer(s) of Proof

("Offer") at hearing, which succinctly described the substance of the evidence excluded and the purpose for which the Protestants sought admission of the evidence, and this oral Offer could be made by Counsel and not through witness testimony. Counsel was further advised the Protestants could make a written Offer, which should be submitted to the Division prior to hearing, with any objections reserved for hearing. On February 18, 2009, the Brief of the Compliance Division and the Protestants' Pre-Hearing Memorandum were filed with the Clerk.

On February 25, 2009, at 9:30 a.m. a closed hearing[4] was held as scheduled with the parties in attendance through Counsel. It was noted for the record by the Administrative Law Judge that the Protestants' Pre-Hearing Memorandum recited that "exhibits" were attached to the brief, but the "exhibits" were not attached as recited. Further, the "exhibits" could not be attached, as it would be in violation of the *Order*.

At hearing, the parties jointly stipulated to Exhibits 1 through 9, which were identified, offered, and admitted into evidence. The Protestants called one (1) witness, CPA, CPA,[5] who testified about the sale of COMPANY and the Protestants' 2006 Federal and State Income Tax Returns. The Protestants' written Offer was admitted into evidence, with the objection of the Division noted for the record. The Division called one witness, AUDITOR, Auditor, Amended Section of the Compliance Division, Oklahoma Tax Commission, who testified about the audit and as custodian of the Division's records. The Division's Exhibits F and G, were identified, offered, and admitted into evidence. At the conclusion of the hearing, the record was held open for the purpose of the parties submitting proposed findings of fact and conclusions of law.

On February 26, 2009, a letter was mailed to Counsel advising that proposed findings of fact and conclusions of law could be filed on or before March 27, 2009, at which time the record in this matter would be closed and the case submitted for decision.

On March 10, 2009, a post-hearing conference was held with Counsel to advise that Joint Exhibits 2 through 9, and Division's Exhibit F, were insufficient upon which to base findings of fact. The Division was directed to provide copies from Tax Commission records of the specified exhibits to be substituted into the record, with copies to Counsel, on or before March 27, 2009. On March 11, 2009, a letter was mailed to Counsel memorializing the post-hearing conference.

On March 27, 2009, the Division filed a Memorandum, with the Substituted Joint Exhibits and Division's Substituted Exhibit F.[6] On March 27, 2009, the parties filed their "Proposed" Findings of Fact and Conclusions of Law ("Proposed Findings") with the Clerk.

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[4] The right to a confidential hearing was invoked by the Protestants through ATTORNEY 1. *See* OKLA. STAT. ANN. tit. 68, § 205 (West Supp. 2009).

[5] CPA has been preparing the Protestants' tax returns for over ten (10) years. Testimony of CPA.

[6] *See* Memorandum filed herein, which states in pertinent part, "Each Substituted Joint Exhibit has two numbers due to the fact that, as filed, the Protestants' federal returns were attached to their state returns; therefore, the returns that were previously admitted as two exhibits are now being admitted as one."

The record in this matter was closed and this case was submitted for decision on March 27, 2009.

FINDINGS OF FACT

Upon review of the file and records, including the record of the proceedings, the exhibits received into evidence, briefs, and the Proposed Findings submitted by the parties, the undersigned finds:

1. COMPANY, an Oklahoma corporation,[7] made a Subchapter "S" election on the federal level effective May 29, 1987.[8] PRESIDENT, the President of COMPANY ("President"), had owned COMPANY for over twenty (20) years.[9]

2. Sometime during August or September 2006, the President of COMPANY began negotiations to sell COMPANY to BUYER ("Buyer"). During October 2006, COMPANY entered into a letter of intent with Buyer, wherein Buyer expressed its intentions to purchase the stock of COMPANY. Before the closing of the transaction, at the Buyer's request, the structure of the transaction was changed from a stock sale to an asset sale because of the "potential liabilities" and the "tax implications" to Buyer associated with a stock sale.[10]

3. On December 22, 2006, the Asset Purchase Agreement[11] was entered into between COMPANY and Buyer. COMPANY sold all of its assets[12] for $14,963,000.00, including "Goodwill" and a "Non-Compete Agreement." The Asset Purchase Agreement was executed by President of COMPANY and by DIRECTOR, Managing Director of Buyer.[13]

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[7] The Administrative Law Judge is taking judicial notice of Oklahoma Secretary of State's website to complete the factual details and background of this matter. OKLA. ADMIN. CODE § 710:1-5-36 (July 11, 1996). According to the Oklahoma Secretary of State's website, COMPANY is a "Domestic For Profit Business Corporation," with an effective date of May 29, 1987. PRESIDENT is listed as COMPANY'S Registered Agent with an address of ADDRESS, which is the business address of COMPANY. http://www.sooneraccess.state.ok.us (April 2, 2009).

[8] Substituted Joint Exhibit 8-6.

[9] Testimony of CPA.

[10] *Id*.

[11] Joint Stipulated Exhibit 1.

[12] *Id*. *See* Article I (Definitions), Section 1.1(a) (Certain Definitions).

[13] *Id*. For purposes of the record, it was noted that an incomplete copy of Joint Stipulated Exhibit 1 was entered into evidence. See Joint Stipulated Exhibit 1 at page 29, which is a "List of Schedules and Exhibits," which are part of the Agreement. Exhibits A through F and Schedules 4.4, 4.6, 4.7, 4.11, 4.13, 4.15 and 7.4 are not attached thereto.

Section 3.1 of the Asset Purchase Agreement[14] allocated the purchase price as follows, to-wit:

Property and Equipment	$ 1,000,000.00
Employment and Non-Compete Agreements	$ 100,000.00
Intangibles/Goodwill	$13,863,000.00
Total	$14,963,000.00

4. At the time of the sale, the sole shareholder of COMPANY'S stock was the PRESIDENT.[15]

5. On May 8, 2007, COMPANY filed its "Original" U.S. Income Tax Return for an "S" Corporation and its "Original" State of Oklahoma Small Business Corporation Income Tax Return (Form512-S) for the 2006 Tax Year.[16]

6. On May 8, 2007, the Protestants filed their "Original" U.S. Individual Income Tax Return (Form 1040) and their "Original" Oklahoma Income Tax Return for the 2006 Tax Year.[17] On the "Original" State Return, the Protestants claimed a deduction for capital gains ("Capital Gains Deduction") of $13,963,000.00.[18]

7. On May 14, 2007, COMPANY filed its "Amended" U.S. Income Tax Return for an "S" Corporation and its "Amended" State of Oklahoma Small Business Corporation Income Tax Return (Form 512-S) for the 2006 Tax Year. COMPANY'S Amended Returns states the reason as "LINE 1. THE K-1 FROM COMPANY WAS AMENDED AND ORDINARY INCOME WAS INCREASED BY 179,707. (SEE AMENDED K-1.)"[19]

8. On May 14, 2007, the Protestants filed their "Amended" U.S. Individual Income Tax Return (Form 1040) ("Protestants' Amended Federal Return") and their "Amended" Oklahoma Income Tax Return for the 2006 Tax Year ("Protestants' Amended State Return").[20] On the

[14] *Id.* at 6. Testimony of CPA.

[15] Substituted Joint Exhibits 5-3, 8-6, and 9-7. *See* Protestants' Proposed Findings of Fact at 1, which states, "The sole shareholder of COMPANY was the TRUST (the "TRUST"), whose grantor and trustee is Protestant PRESIDENT. However, the K-1s attached to the referenced exhibits all list PRESIDENT as owing 100% of COMPANY. The only documentary evidence in the record concerning the "TRUST" is the check written to the Tax Commission, which is attached to Substituted Joint Exhibit 5-3.

[16] Substituted Joint Exhibit 8-6.

[17] Substituted Joint Exhibits 4-2. The Protestants' Original State Income Tax Return for the 2006 Tax Year reflected a refund of $49,873.00. The Division did not examine or adjust the Protestants' Original State Income Tax Return for the 2006 Tax Year.

[18] *Id.*

[19] Substituted Joint Exhibit 9-7.

[20] Substituted Joint Exhibit 5-3. The Protestants' Amended State Return for the 2006 Tax Year reflected tax due as $11,231.00. A check from PRESIDENT, as Trustee of the TRUST for $11,231.00 was attached thereto.

Protestants' Amended State Return, the Protestants claimed a deduction for capital gains ("Capital Gains Deduction") received for $13,963,000.00, attributable to intangible personal property in the form of goodwill.[21]

9. On November 30, 2007, the Division issued an adjustment letter[22] to the Protestants' Amended State Return for the 2006 Tax Year, which in pertinent part states as follows, to-wit:

Line Number	Reason For Adjustment
2	Oklahoma Capital Gain Exclusion: Intangibles are not eligible for exclusion until January 1, 2008. Out-of-State (STATE) Income has been moved to line 4. Indian Employment Exclusion has been moved to line 8.
	…
26	The additional tax due is as follows: Tax Liability: $725,177.00 Amount Paid: (11,231.00) Tax Due: $713,946.00 You may be assessed additional penalties and/or interest on this amount.

10. On January 18, 2008, the Division received a timely filed protest to the adjustment of the Protestants' Amended State Return for the 2006 Tax Year.[23]

CONCLUSIONS OF LAW

1. The Oklahoma Tax Commission is vested with jurisdiction over the parties and subject matter of this proceeding.[24]

2. A corporation electing treatment as a Subchapter "S" Corporation under the Internal Revenue Code ("IRC") is not subject to Oklahoma corporate income tax; however a Subchapter "S" Corporation's shareholders shall include their proportionate share of the corporation's federal income in each shareholder's taxable income in the same manner and to the same extent as provided by the Internal Revenue Service ("IRS"), subject to adjustments provided in the Oklahoma Income Tax Act[25] ("Act").[26]

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[21] Substituted Joint Exhibit 5-3.

[22] Substituted Division's Exhibit F. Only the capital gains deduction is at issue, not the other adjustments.

[23] Division's Exhibit G.

[24] OKLA. STAT. tit. 68, § 221(D) (West Supp. 2002).

[25] OKLA. STAT. tit. 68, § 2351 et seq. (West 2001).

[26] OKLA. STAT. tit. 68, § 2365 (West 2001).

3. The Act imposes an income tax upon the Oklahoma Taxable Income[27] of every resident or non-resident individual who earns income within Oklahoma.[28]

4. The beginning point of determining Oklahoma Taxable Income is Federal Adjusted Income.[29]

5. Any term used in the Act shall[30] have the same meaning as when used in a comparable context in the IRC, unless a different meaning is clearly required. For all taxable periods covered by the Act, the tax status and all elections of all taxpayers covered by the Act shall[31] be the same for all purposes material hereto as they are for federal income tax purposes except when the Act specifically provides otherwise.[32]

6. A taxpayer's income tax liability is determined in accordance with the law in effect at the time the income is received.[33]

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[27] OKLA. STAT. ANN. tit. 68, § 2353(12) (West 2008):

> "Oklahoma taxable income" means "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 hereinafter provided;

[28] OKLA. STAT. ANN. tit. 68, § 2355 (West 2008).

[29] OKLA. STAT. tit. 68, § 2353(13) (West Supp. 2006):

> "Oklahoma adjusted gross income" means "adjusted gross income" as reported to the federal government (or as would have been reported by the taxpayer had a return been filed), or in the event of adjustments thereby by the federal government as finally ascertained under the Internal Revenue Code, adjusted further as hereinafter provided;

[30] "Generally, when the legislature uses the term 'shall,' it signifies a mandatory directive or command." *See Keating v. Edmondson*, 2001 OK 110, ¶ 13, 37 P.3d 882.

[31] *Id.*

[32] OKLA. STAT. ANN. tit. 68, § 2353(3) (West 2008).

[33] *Affiliated Management Corp. v. Oklahoma Tax Commission*, 1977 OK 183, 570 P.2d 335; *Wootten v. Oklahoma Tax Com'n*, 1935 OK 54, 170 Okla. 584, 40 P.2d 672.

7. The text of Section 2358(F) of Title 68[34] ("Statute") for the 2006 tax year is as follows, to-wit:

> For all tax years beginning after December 31, 1981, taxable income and adjusted gross income shall be adjusted to arrive at Oklahoma taxable income and Oklahoma adjusted gross income as required by this section.
>
> ...
>
> F. 1. For taxable years beginning after December 31, 2004, a deduction from the Oklahoma adjusted gross income of any individual taxpayer shall be allowed for qualifying gains receiving capital treatment that are included in the federal adjusted gross income of such individual taxpayer during the taxable year.
>
> 2. As used in this subsection:
>
> a. "qualifying gains receiving capital treatment" means the amount of net capital gains, as defined in Section 1222(11) of the Internal Revenue Code, included in an individual taxpayer's federal income tax return that result from:
>
> (1) the sale of real or tangible personal property located within Oklahoma that has been directly or indirectly owned by the individual taxpayer for a holding period of at least five (5) years prior to the date of the transaction from which such net capital gains arise, or
>
> (2) the sale of stock or the sale of a direct or indirect ownership interest in an Oklahoma company, limited liability company, or partnership where such stock or ownership interest has been directly or indirectly owned by the individual taxpayer for a holding period of at least three (3) years prior to the date of the transaction from which the net capital gains arise,
>
> b. "holding period" means an uninterrupted period of time,
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> c. "Oklahoma company," "limited liability company," or "partnership" means an entity whose primary headquarters have been located in Oklahoma for at least three (3) uninterrupted years prior to the date of the transaction from which the net capital gains arise,
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> d. "direct" means the individual taxpayer directly owns the asset, and
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> e. "indirect" means the individual taxpayer owns an interest in a pass-through entity (or chain of pass-through entities) that sells the asset that gives rise to the qualifying gains receiving capital treatment.
>
> (1) With respect to sales of real or personal property located within Oklahoma, the deduction described in this subsection shall not apply unless the pass-through entity that makes the sale has held the property for not less than five (5) uninterrupted years prior to

[34] OKLA. STAT. tit. 68, § 2358(F) (West Supp. 2006). Although not at issue, the holding period for the sale of stock or ownership interest was changed from three (3) years to two (2) years by Laws 2006, c. 272, § 17 (repealed by Laws 2007, c. 1, § 59), and by Laws 2007, c. 1, § 57.

the date of the transaction that created the capital gain, and each pass-through entity included in the chain of ownership has been a member, partner, or shareholder of the pass-through entity in the tier immediately below it for an uninterrupted period of not less than five (5) years.

(2) With respect to sales of stock or ownership interest in an Oklahoma company, limited liability company, or partnership, the deduction described in this subsection shall not apply unless the pass-through entity that makes the sale has held the stock or ownership interest for not less than three (3) uninterrupted years prior to the date of the transaction that created the capital gain, and each pass-through entity included in the chain of ownership has been a member, partner or shareholder of the pass-through entity in the tier immediately below it for an uninterrupted period of not less than three (3) years.

8. The Statute fails to define "Oklahoma Company," but "company" is commonly defined as "A corporation, partnership, association, joint-stock company, trust fund, or organized group of persons, whether incorporated or not…"[35] There is no dispute "Oklahoma Company" includes a corporation under state law, including a corporation that has made an "S" Corporation election for income tax purposes.

9. The rules promulgated pursuant to the Administrative Procedures Act are presumed to be valid and binding on the persons they affect and have the force of law.[36]

10. The Tax Commission Rule on the Capital Gains Deduction[37] ("Tax Commission Rule") for the 2006 tax year, is as follows, to-wit:

(a) **General provisions.** For tax years beginning on or after January 1, 2005, individual taxpayers can subtract from the Oklahoma adjusted gross income, gains reported on their Oklahoma income tax return and included in federal taxable income receiving capital treatment. The gain must be realized on or after January 1, 2005, in order to be eligible for the Oklahoma exclusion. Effective for tax years beginning on or after January 1, 2006 corporate taxpayers can subtract from the Oklahoma taxable income, gains reported on their Oklahoma income tax return and included in federal taxable income receiving capital treatment. For corporate taxpayers the gain must be realized on or after January 1, 2006 in order to be eligible for the Oklahoma exclusion.

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[35] *Id. See also* BLACK'S LAW DICTIONARY (8th ed. 2004), available at http://web2.westlaw.com (March 19, 2009).

[36] OKLA. STAT. ANN. tit. 75, § 250 et seq. (West 2001). *See Toxic Waste Impact Group, Inc. v. Leavitt*, 1988 OK 20, 755 P.2d 626.

[37] OKLA. ADMIN. CODE § 710:50-15-48 (June 25, 2006).

(b) **Qualifying gains receiving capital treatment.** As used in this Section, **"qualifying gains receiving capital treatment"** means the amount of net capital gains, as defined under Internal Revenue Code Section 1222(11), [IRC §1222(11)]. The gain must be included in the federal income tax return of the taxpayer.

(1) **Sale of real or tangible personal property.** To qualify for the Oklahoma deduction, the gain must be earned as a result of the sale of real or tangible personal property located within Oklahoma. Taxpayers must have held the asset for not less than five (5) uninterrupted years prior to the date of the transaction that created the capital gain.

(2) **Sale of stock or ownership interest.** To qualify for the Oklahoma deduction, the gain must be earned as a result of the sale of stock or ownership interest in an Oklahoma company, limited liability company, or partnership and the stock or ownership interest must have been held by the taxpayer for at least three (3) uninterrupted years prior to the date of the transaction that created the capital gain.

(3) **Sale of real or tangible personal property by pass-through entities.** Net capital gains earned by member, partner, or shareholder of a pass-through entity as a result of the sale of real or tangible personal property located within Oklahoma, and included in the a taxpayer's federal taxable income is excludable, provided that the taxpayer has been a member of the pass-through entity for an uninterrupted period of five (5) years and that the pass-through entity has held the asset for not less than five (5) uninterrupted years prior to the date of the transaction that created the capital gain.

(4) **Sale of stock or ownership interests by pass-through entities.** Net capital gains earned by a member, partner, or shareholder of a pass-through entity as a result of the sale of stock or an ownership interest in an Oklahoma company, limited liability company, or partnership, is excludable, provided that the taxpayer has been a member of the pass-through entity for an uninterrupted period of three (3) years and that the pass-through entity has held the asset for not less than three (3) uninterrupted years prior to the date of the transaction that created the capital gain.

(5) **Installment sales.** Qualifying gains included in an individual taxpayer's federal taxable income for years after December 31, 2004, or a corporate taxpayer's federal taxable income for years after December 31, 2005, which are derived from installment sales are eligible for exclusion, provided the appropriate holding periods are met.

(c) **"Oklahoma company"**, **"limited liability company"**, **"partnership".** An Oklahoma company, limited liability company, or partnership is one whose primary headquarters has been located in Oklahoma for at least three (3) years prior to the capital gain transaction. The Oklahoma company, limited liability company, or partnership must meet the three (3) year rule for an uninterrupted period.

11. The goal of any inquiry into the meaning of a legislative act is to ascertain and give effect to the intent of the legislature. The law-making body is presumed to have expressed its intent in a statute's language and to have intended what the text expresses. Hence, where a statute is plain and unambiguous, it will not be subject to judicial construction, but will be given the effect its language dictates. Only where the intent cannot be ascertained from a statute's text, as occurs when ambiguity or conflict (with other statutes) is shown to exist, may rules of statutory construction be employed. Statutes that provide an exemption from taxation are to be strictly construed against the claimant.[38] Statutory construction presents a question of law.[39]

12. Tax exemptions, deductions, and credits depend entirely on legislative grace and are strictly construed against the exemption, deduction or credit.[40]

13. The Statute is a tax exemption or deduction statute, not a tax levying statute; and as such, it must be strictly construed unless authority for the deduction is clearly expressed.[41]

14. Statutes and statutory amendments are presumed to operate prospectively, and presumption is rebutted only where intention of the Legislature to give statutes retrospective effect is expressly declared or necessarily implied from the language of the statute.[42] Doubt as to whether statute was intended to be prospective or retrospective must be resolved against retrospective application.[43] As in other matters concerning statutory interpretation, whether to give prospective or retroactive effect should be controlled by the fundamental or transcendent canon of statutory construction of giving effect to legislative design.[44]

15. Words used in any statute are to be understood in their ordinary sense, except when a contrary intention plainly appears, and except also that the words hereinafter explained are to be understood as thus explained.[45]

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[38] *Blitz U.S.A., Inc. v. Oklahoma Tax Com'n*, 2003 OK 50, ¶ 14, 75 P.3d 883. (Citations omitted).

[39] *Id*. at ¶ 6.

[40] *TPQ Inv. Corp. v. State ex rel. Oklahoma Tax Com'n*, 1998 OK 13, ¶ 8, 954 P.2d 139. (Citations omitted).

[41] *Id*.

[42] *Department of Human Services ex rel. Pavlovich v. Pavlovich*, 1996 OK 71, 932 P.2d 1080. (Citations omitted).

[43] *Fraternal Order of Police, Lodge No. 165 v. City of Choctaw*, 1996 OK 78, 933 P.2d 261.

[44] *Houck v. Hold Oil Corp*., 1993 OK 166, 1993 OK 167, 867 P.2d 451. (Citations omitted).

[45] OKLA. STAT. ANN. tit. 25, § 1 (West 2008).

16. Whenever the meaning of a word or phrase is defined in any statute, such definition is applicable to the same word or phrase wherever it occurs, except where a contrary intention plainly appears.[46]

17. In all proceedings before the Tax Commission, the taxpayer has the burden of proof.[47] A proposed assessment is presumed correct and the taxpayer bears the burden of showing that it is incorrect and in what respects.[48]

DISCUSSION
PROTESTANTS' STATEMENT OF ISSUE

The gains receiving capital treatment on the Protestants' 2006 Amended federal income tax return were eligible for deduction on Protestants' 2006 Amended Oklahoma Income Tax Return pursuant to Okla. Stat. tit. 68, § 2358(F) (2006) and OAC 710:50-15-48.[49]

PROTESTANTS' FIRST CONTENTION

The Protestants' first contention is the "ambiguous" language found in the Statute and Tax Commission Rule permit the Capital Gains Deduction.[50]

The Division responds the "Protestants have not pointed to any specific language within the statute that causes it to be subject to more than one interpretation."[51] The Division's point is

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[46] OKLA. STAT. ANN. tit. 25, § 2 (West 2008).

[47] OKLA. ADMIN. CODE § 710:1-5-47 (June 25, 1999):

> In all administrative proceedings, unless otherwise provided by law, the burden of proof shall be upon the protestant to show in what respect the action or proposed action of the Tax Commission is incorrect. If, upon hearing, the protestant fails to prove a prima facie case, the Administrative Law Judge may recommend that the Commission deny the protest solely upon the grounds of failure to prove sufficient facts which would entitle the protestant to the requested relief.

OKLA. ADMIN. CODE § 710:1-5-77(b) (June 25, 1999), provides in pertinent part:

> …"preponderance of the evidence" means the evidence which is of greater weight or more convincing than the evidence which is offered in opposition to it; evidence which as a whole shows that the fact sought to be proved is more probable than not.

[48] *See Enterprise Management Consultants, Inc. v. State ex rel. Oklahoma Tax Com'n*, 1988 OK 91, 768 P.2d 359.

[49] Protestants' Proposed Findings at 3.

[50] Protestants' Brief at 2.

[51] Division's Brief at 7.

well taken as to the Protestants' first contention. In fact, the Protestants' discussion[52] of this issue contradicts the first contention by stating as follows-wit:

> That the language of the Statute is "…clear that if a taxpayer has capital gains for federal tax purposes, such capital gains may be deducted for Oklahoma state tax purposes. [The] [Statute] allowed a deduction from Oklahoma adjusted gross income for qualifying capital gains included in the taxpayer's [sic] federal adjusted gross income."[53]

The Protestants state, "At the hearing, it was shown through the tax returns of COMPANY that COMPANY reported long-term capital gains of $13,963,000.00 on both its amended federal and amended state income tax returns for the tax year 2006. Protestants reported the long-term capital gains of $13,963,000.00 on their amended federal income tax return for the tax year 2006 and claimed a deduction for the long-term capital gains of $13,963,000.00 on their Oklahoma amended income tax return for the tax year 2006. Accordingly, Protestants' deduction on their 2006 Oklahoma amended income tax return is consistent with [the] [Statute]."[54]

The Division responds that the language of the Statute and Tax Commission Rule is clear and unambiguous.[55] In support of its position, the Division cites *Loffland Bros.*, where the Supreme Court of Oklahoma held, in defining statutory terms, in absence of specified definitions, the Supreme Court must assume legislature intended for them to have same meaning as that attributed to them in ordinary and usual parlance.[56]

The provisions of the Statute and the Tax Commission Rule cannot be read in isolation as suggested by the Protestants, but must be construed in their entirety.[57]

The Protestants suggest Subsection (F)(1) of the Statute be read without considering the impact of Subsection (F)(2) of the Statute:

> F. 1. For taxable years beginning after December 31, 2004, a deduction from the Oklahoma adjusted gross income of any individual taxpayer shall be allowed for qualifying gains receiving capital treatment that

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[52] Protestants' Proposed Findings of Fact and Conclusions of Law at 3.

[53] *Id.*

[54] Protestants' Proposed Findings at 3-4.

[55] Division's Proposed Findings at 7. The Division notes, "This issue, the ambiguity of the Oklahoma Capital Gains Statute, has been addressed in case number P-08-009-H (Findings, Conclusions and Recommendations issued, currently awaiting a final order by the Commission)."

[56] Division's Proposed Findings at 7-8. *Loffland Bros. Equipment v. White*, 1984 OK 69, 689 P.2d 311.

[57] *Imaging Services, Inc. v. Oklahoma Tax Com'n, Excise Tax Div.*, 1993 OK 164, 866 P.2d 1204. *See Affiliated* at Note 33, *supra*.

are included in the federal adjusted gross income of such individual taxpayer during the taxable year.

2. *As used in this subsection*:
   a. *"qualifying gains receiving capital treatment" means the amount of net capital gains, as defined in Section 1222(11) of the Internal Revenue Code, included in an individual taxpayer's federal income tax return that result from:*
      (1) *the sale of real or tangible personal property located within Oklahoma* that has been directly or indirectly owned by the individual taxpayer for a holding period of at least five (5) years prior to the date of the transaction from which such net capital gains arise, or (Emphasis added).

The Statute contains two (2) categories which are eligible for the Oklahoma Capital Gains Deduction: (1) the sale of property located in Oklahoma and (2) the sale of stock or ownership interest in an Oklahoma company, limited liability company, or partnership (which includes an "S" Corporation).

The Statute permits a deduction for the sale of two types of property: (1) real property and (2) tangible personal property.

The personal property at issue in this matter is "Goodwill," which is "Intangible" Personal Property, not "Tangible" Personal Property, as specifically provided in the Statute. As distinguished from tangible assets, intangibles have no intrinsic value, but do have a value related to the ownership and possession of tangible assets. Some intangibles, such as a trademark, trade name or patent, are related to an identifiable tangible asset. Goodwill, which is another intangible, is not. Often referred to as "the most 'intangible' of the intangibles," goodwill is essentially reputation that will probably generate future business.[58]

The Statute is a tax exemption or deduction statute, not a tax levying statute and as such must be strictly construed against the Protestants unless authority for the deduction is clearly expressed.[59] The language of the statute is clear and unambiguous and the Statute does not contain an exclusion for "Intangible" Personal Property in the form of Goodwill for the 2006 tax year.

[58] "The 'good will' value of any business is the value that results from the probability that old customers will continue to trade with an established concern." *Travis v. Travis*, 1990 OK 57, 795 P.2d.96. (Citations omitted). *See* OKLA. STAT. ANN. tit. 60, § 315 (West 1994): "The goodwill of a business is the expectation of continued public patronage, but it does not include a right to use the name of any person from whom it was acquired." *See also* OKLA. STAT. ANN. tit. 60, § 316 (West 1994): "The goodwill of a business is property, transferable like any other."

[59] *See TPQ* at Note 40, *supra*. *See also R.R. Tway, Inc. v. Oklahoma Tax Com'n*, 1995 OK 129, 910 P.2d 972.

DISCUSSION
PROTESTANTS' SECOND CONTENTION

The Protestants' second contention is the "Amendment" to the Statute, which became effective January 1, 2008, was intended by the Oklahoma Legislature as merely a "clarification" of the Original Capital Gain Deduction Statute.[60]

However, the Protestants' second contention is a bare assertion without the citation to any legal authority to support their argument.[61]

The Division does acknowledge, "When construing a statute which has been amended, [the Court is] mindful that the legislature may have intended either (a) to effect a change in the existing law, or (b) to clarify that which previously appeared doubtful,"[62] but asserts the Protestants have failed to point to any clarifying language.

Before and after the Statute was amended,[63] Section 2358(F)(1) reads in pertinent part, as follows, to-wit:

> "For tax years beginning after *December 31, 2004*, a deduction from the Oklahoma adjusted gross income of any individual taxpayer shall be allowed for qualifying gains receiving capital treatment…" (Emphasis added).

The issue of whether a statute should be applied prospectively or retroactively was addressed by the court in *Cities Services*,[64] which held "Express language will prevail over an effective date or emergency clause." Yet, "In every case of doubt the doubt must be resolved against the retroactive effect."[65]

In *Cities Services*, the statute repealing mileage tax contained both an emergency clause making it effective upon approval (April 18, 1939) and a provision making it effective at a fixed future date ("This Act shall be in full force and effect on and after January 1, 1940), which precluded a taxpayer from recovering mileage taxes paid under protest between the date of approval and the effective date fixed in the statute. The court held, "Under constitutional provision relating to effective date of statutes, the legislature may, by adding an emergency

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[60] *See* Protestants' Brief at 5.

[61] *See* Protestants' Brief at 4-7.

[62] *See Blitz* at Note 38, *supra*. *See also In re Protest of Betts Telecom Oklahoma, Inc.*, 2008 OK CIV APP 19, ¶ 15, 178 P.3d 197.

[63] *See* OKLA. STAT. tit. 68, § 2358 (West Supp. 2006) and OKLA. STAT. tit. 68, § 2358 (West Supp. 2007).

[64] *Cities Service Oil Co. v. Oklahoma Tax Com'n*, 1942 OK 307, 129 P.2d 597.

[65] *State ex rel. Allen v. Board of Ed. of Dist. No. 74 of Muskogee County*, 1952 OK 241, 246 P.2d 368. (Citations omitted).

clause to a statute, cause it to become a law on approval but, by express provision, hold its effectiveness in abeyance until a specified time."[66]

The "Amendment" to the Statute, unlike the statute in *Cities Services*, does not contain an emergency clause making it effective upon approval or an express provision holding its effectiveness in abeyance until a specified time. Further, nothing in the Amendment expressly declares or necessarily implies a legislative intent that the Amendment should be applied to a transaction that took place during the 2006 tax year.[67]

In *Wilson*, the Court held, "Where statute or a portion thereof is submitted by setting forth amended section in full, provisions of original statute which are repeated are to be considered as having been the law from the time they were first enacted, and the new provisions or changed portions are to be understood as enacted at the time the amended act takes effect and not to have any retroactive operation."[68]

The Amendment to the Statute is presumed to operate prospectively unless the legislature expressly declared that the Amendment is to operate retrospectively or such treatment is necessarily implied from the language of the Amendment.

The "Amendment," which became effective on January 1, 2008,[69] in pertinent part, is as follows, to-wit:

> F. 1. For taxable years beginning after December 31, 2004, a deduction from the Oklahoma adjusted gross income of any individual taxpayer shall be allowed for qualifying gains receiving capital treatment that are included in

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[66] *Id. See* OK Const. Art. 5, § 58:

> Time of taking effect of statutes --Emergency measures
>
> No act shall take effect until ninety days after the adjournment of the session at which it was passed, except enactments for carrying into effect provisions relating to the initiative and referendum, or a general appropriation bill, unless, in case of emergency, to be expressed in the act, the Legislature, by a vote of two-thirds of all members elected to each House, so directs. An emergency measure shall include only such measures as are immediately necessary for the preservation of the public peace, health, or safety, and shall not include the granting of franchises or license to a corporation or individual, to extend longer than one year, nor provision for the purchase or sale of real estate, nor the renting or encumbrance of real property for a longer term than one year. Emergency measures may be vetoed by the Governor, but such measures so vetoed may be passed by a three-fourths vote of each House, to be duly entered on the journal.

[67] *See Allen* at Note 65, *supra*. and *Pino v. United States*, 2008 OK 26, ¶ 10, 183 P.3d 1001. *See also Dolese Bros. v. State ex rel. Oklahoma Tax Com'n*, 2003 OK 4, 64 P.3d 1093.

[68] *Wilson v. State ex rel. Okla. Tax Commission*, 1979 OK 62, 594 P.2d 1210.

[69] OKLA. STAT. ANN. tit. 68, § 2358(F) (West Supp. 2009). According to the annotations, the portions of the Statute which were amended are delineated by an underline for additions or the strike-through symbol for deletions.

the federal adjusted gross income of such individual taxpayer during the taxable year.

2. As used in this subsection:

a. "qualifying gains receiving capital treatment" means the amount of net capital gains, as defined in Section 1222(11) of the Internal Revenue Code, included in an individual taxpayer's federal income tax return that result from:

(1) the sale of real property or tangible personal property located within Oklahoma that has been directly or indirectly owned by the individual taxpayer for a holding period of at least five (5) years prior to the date of the transaction from which such net capital gains arise, ~~or~~

(2) the sale of stock or the sale of a direct or indirect ownership interest in an Oklahoma company, limited liability company, or partnership where such stock or ownership interest has been directly or indirectly owned by the individual taxpayer for a holding period of at least two (2) years prior to the date of the transaction from which the net capital gains arise, or

(3) the sale of real property, tangible personal property or intangible personal property located within Oklahoma as part of the sale of all or substantially all of the assets of an Oklahoma company, limited liability company, or partnership or an Oklahoma proprietorship business enterprise where such property has been directly or indirectly owned by such entity or business enterprise or owned by the owners of such entity or business enterprise for a period of at least two (2) years prior to the date of the transaction from which the net capital gains arise,

b. "holding period" means an uninterrupted period of time. The holding period shall include any additional period when the property was held by another individual or entity, if such additional period is included in the taxpayer's holding period for the asset pursuant to the Internal Revenue Code,

c. "Oklahoma company," "limited liability company," or "partnership" means an entity whose primary headquarters have been located in Oklahoma for at least three (3) uninterrupted years prior to the date of the transaction from which the net capital gains arise,

d. "direct" means the individual taxpayer directly owns the asset, ~~and~~

e. "indirect" means the individual taxpayer owns an interest in a pass-through entity (or chain of pass-through entities) that sells the asset that gives rise to the qualifying gains receiving capital treatment.

(1) With respect to sales of real ~~or~~ property or tangible personal property located within Oklahoma, the deduction described in this subsection shall not apply unless the pass-through entity that makes the sale has held the property for not less than five (5) uninterrupted years prior to the date of the transaction that created the capital gain, and each pass-through entity included in the chain of ownership has been a member, partner, or shareholder of the pass-through entity in the tier immediately below it for an uninterrupted period of not less than five (5) years.

(2) With respect to sales of stock or ownership interest in or sales of all or substantially all of the assets of an Oklahoma company, limited liability company, ~~or~~ partnership or Oklahoma proprietorship business enterprise, the deduction described in this subsection shall not apply unless the pass-through entity that makes the sale has held the stock or ownership interest for not less than two (2) uninterrupted years prior to the date of the transaction that created the capital gain, and each pass-through entity included in the chain of ownership has been a member, partner or shareholder of the pass-through entity in the tier immediately below it for an uninterrupted period of not less than two (2) years. For purposes of this division, uninterrupted ownership prior to the effective date of this act shall be included in the determination of the required holding period prescribed by this division, and

f. "Oklahoma proprietorship business enterprise" means a business enterprise whose income and expenses have been reported on Schedule C or F of an individual taxpayer's federal income tax return, or any similar successor schedule published by the Internal Revenue Service and whose primary headquarters have been located in Oklahoma for at least three (3) uninterrupted years prior to the date of the transaction from which the net capital gains arise.

The "Amendment" added an entirely new subsection, "2358(F)(2)(a)(3)", which the Protestants contend qualify them for the Capital Gains Deduction for "Intangible" Personal Property attributable to goodwill. However, this subsection enlarged the Statute's scope to include a new category of personal property, which was not previously included in the Statute, which indicates the Amendment is a substantive change in the law, not a clarification of the Statute as asserted by the Protestants. Enlarging the scope of the Statute to include assets which

were not previously eligible for the Capital Gains Deduction is a change to the Statute, not a Clarification.[70]

The Protestants have failed to overcome the presumption that the Amendment to the Statute is to be applied prospectively. As in *Wilson*, the Amendment sets forth the provisions of Section 2358(F)(1) in full, provisions of the Statute which are repeated are to be considered as having been the law from the time it was first enacted, and the new provisions or changed portions are to be understood as enacted at the time the Amendment takes effect (January 1, 2008), and not to have any retroactive operation.[71]

DISCUSSION
PROTESTANTS' THIRD CONTENTION

Protestants' third contention is the Statute permits the Capital Gains Deduction for capital gains resulting from the sale of COMPANY. The Protestants state, "The Division's argument at the hearing that intangibles were not eligible for deduction pursuant to [the] [Statute] is not relevant. [The] [Statute] provided a deduction from Oklahoma adjusted gross income for the sale of a direct or indirect ownership interest in an Oklahoma company if such ownership interest was owned by the individual taxpayer for at least two (2) years prior to the resulting capital gains."[72]

The Protestants assert there are three (3) components necessary to qualify for the foregoing deduction under the Statute:

1. a direct or indirect ownership interest owned by the individual taxpayers;
2. a sale of such ownership interest; and
3. a holding period of the ownership interest for at least two (2) years prior to the sale.

In support of their position the Protestants state, "At the hearing, the testimony of CPA and the tax returns of Protestant [sic] and COMPANY showed that Protestants, through the TRUST, owned a direct or indirect ownership interest in COMPANY. *See* Component No. 1 above. Such ownership interest was sold by and through that certain Asset Purchase Agreement dated December 22, 2006. *See* Component No. 2 above. It was also shown at the hearing that COMPANY was owned by Protestant for more than two (2) years prior to the Sale. *See* Component No. 3 above. Based on the foregoing evidence, the Court should find that Protestants met all of the statutory requirements of [the] [Statute] and thus the deduction for capital gains resulting from the Sale of COMPANY should be allowed."[73]

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[70] *See Betts* at Note 62, *supra*.

[71] *See Wilson* at Note 68, *supra*.

[72] Protestants' Proposed Findings at 4.

[73] Protestants' Proposed Findings at 4-5.

The Protestants have maintained throughout this matter that the purchase of COMPANY was originally structured as a stock sale, but before the closing of the transaction, the structure was changed from a stock sale to an asset sale, which is evidenced by the "Asset Purchase Agreement,"[74] which states in pertinent parts as follows, to-wit:

> **RECITALS:**
>
> A. Seller owns certain properties and assets comprising the "Assets" as defined herein.
>
> B. Buyer desires to purchase from Seller, and Seller is willing to sell to Buyer, the Assets.
>
> …
>
> **ARTICLE I**
> **DEFINITIONS**
>
> SECTION 1.1. *Certain Definitions.*
>
> (a) As used in this Agreement, the terms set forth below shall have the following respective meanings:
>
> …
>
> "Assets" means (a) the equipment, vehicles, trailers and other facilities described on Exhibit A, (b) the Real Property, (c) the Intellectual Property, (d) any other asset or property owned or held by the Seller appurtenant to the Real Property or used in connection with the operation of the business of the Seller, (e) all licenses and permits necessary to own and operate the Assets in the manner in which Seller has conducted its business, (f) the Contracts listed on Schedule 4.7 and (g) all other assets or property owned or held by the Seller in connection with the conduct of its business, including customer lists and all records, files, driver logs, data, information, books, maintenance logs and other information of any nature related to the foregoing (h) accounts receivable of Seller as of the Closing Date; (i) case, money, checks, deposit accounts (including outstanding balances and accrued interest thereon), certificates of deposit (including accrued interest), treasury bill and notes and notes receivable of Seller as of the Closing Date (except as any of the foregoing are due from an equity owner, employee or Affiliate of Seller; (j) all prepaid insurance premiums, utility charges, taxes, rental and other prepaid items of whatsoever nature of the Seller; (k) all inventory of Seller; and (l) all funds contained in the Suspense Account of Seller.
>
> …

The record does not support that the transaction was the sale of an ownership interest (direct or indirect) owned by the individual taxpayer. The transaction was an asset sale in which $13,863,000.00 of the $14,963,000.00 purchase price was allocated to person property in the form of "Intangibles/Goodwill," which is not eligible for the Capital Gains Deduction for the 2006 Tax Year.

[74] Joint Exhibit 1 at 1.

CONCLUSION

The Protestants have failed to meet their burden of proof the Division's disallowance of the Capital Gains Deduction taken on the Protestants' Amended State Return for the 2006 Tax Year attributable to "Intangible" Personal Property in the form of "Goodwill" was incorrect and in what respects.

DISPOSITION

It is the ORDER of the OKLAHOMA TAX COMMISSION, based upon the facts and circumstances of this case, the protest should 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.