JURISDICTION: **OKLAHOMA TAX COMMISSION**
CITE: **2009-11-24-03 / NON-PRECEDENTIAL**
ID: **P-08-002-K**
DATE: **NOVEMBER 24, 2009**
DISPOSITION: **SUSTAINED**
TAX TYPE: **INCOME**
APPEAL: **NO APPEAL TAKEN**

FINDINGS OF FACT AND CONCLUSIONS OF LAW

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

STATEMENT OF THE CASE

The Division audited Protestants' 2006 Oklahoma income tax return, disallowed the Oklahoma Capital Gains Deduction claimed on the return in the amount of $1,023,915.00 and by letter dated November 7, 2007, notified Protestants that their refund claim in the amount of $64,091.00 had been reduced to $151.00. Protestants timely protested the Division's proposed adjustment by letter dated November 12, 2007.

On January 9, 2008, the protest file was referred to 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] The protest was docketed as Case Number P-08-002-K and assigned to ALJ, Administrative Law Judge.[3]

A pre-hearing conference was scheduled for February 12, 2008, by *Prehearing Conference Notice* issued January 23, 2008. A *Status Report in Lieu of Prehearing Conference* was filed requesting additional time to exchange and review additional documentation. Pursuant to the parties' request of March 10, 2008, a *Scheduling Order and Notice of Hearing* was issued setting forth the procedure by which the protest would be submitted for decision.

On June 30, 2008, the Division filed three (3) Motions to Quash the depositions of three (3) employees of the Oklahoma Tax Commission, namely: ADMINISTRATOR, Administrator; DIRECTOR, Director of the Tax Policy Division; and ANALYST, Tax Policy Analyst. The *Motions* were later withdrawn due to a decision to deny such motions in a similar case pending before the Oklahoma Tax Commission. On July 17, 2008, a new *Scheduling Order* was issued pursuant to the *Joint Motion for Extension of Scheduling Order* filed July 16, 2008.

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[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).

On July 18, 2008, the *Compliance Division's Notice of Correction* was filed which advised that an adjustment letter correcting the November 7, 2007 adjustment letter had been issued to Protestants.

Another *Scheduling Order* was issued September 10, 2008, pursuant to the *Joint Motion for Extension of Scheduling Order* filed September 9, 2008. *Final Witness and Exhibits Lists* were filed January 5, 2009 in accordance with the *Scheduling Order*. On January 7, 2009, the Division filed a *Motion in Limine to Limit Witness Testimony and Documentary Evidence. Protestants' Response to Division's Motion in Limine* was filed January 22, 2009. On January 22, 2009, the *Order Granting Joint Motion to Move Hearing Date* was issued which rescheduled the hearing set in the latest *Scheduling Order* for March 10, 2009.

On February 6, 2009, the *Order Granting Motion in Limine to Limit Witness Testimony and Documentary Evidence* was issued which *Order* concluded as a matter of law:

> The stated purpose of the testimony of the objected to proposed witnesses (WITNESS, DIRECTOR, ADMINISTRATOR and ANALYST) and the proffered documents (Exhibits 19 through 35, Final Witness and Exhibit List) is irrelevant to the determination of the issue presented in this cause.

On March 3, 2009, *Protestants' Pre-hearing Memorandum* was filed. The Division's *Motion to Strike Exhibits and References Attached to and Made Part of Protestants' Pre-hearing Memorandum* was filed March 5, 2009. On March 9, 2009, *Protestants' Response and Objection to Division's Motion to Strike Exhibits and References Attached to and Made Part of Protestants' Pre-hearing Memorandum* was filed.

On March 10, 2009, an open hearing[4] was held as rescheduled. As a preliminary matter, the undersigned without further comment sustained the Division *Motion to Strike* and ordered that any and all references to and exhibits of testimony and exhibits in and attached to *Protestants' Pre-hearing Memorandum* which were excluded by the *Order Granting Motion in Limine to Limit Witness Testimony and Documentary Evidence* issued February 6, 2009 be stricken from *Protestants' Pre-hearing Memorandum*.

Protestant called two (2) witnesses: WIFE a/k/a MAIDEN NAME, who testified with respect to the purpose for creating the subchapter S corporation, COMPANY and the purchase and subsequent sale of the APARTMENT COMPLEX; and CPA a Certified Public Accountant who testified with respect to the preparation of Protestants' 2006 Federal and State income tax returns. Exhibits 1 through 6 were identified, offered and admitted into evidence without objection. The Division called one witness: MANAGER, Revenue Unit Manager who testified with respect to the Division's records and the reason for denying the Oklahoma Capital Gains Deduction. Exhibits B through G were identified, offered and admitted into evidence without objection.

[4] Confidentiality of the proceedings was waived. *See* 68 O.S. 2001, § 205.

Closing statements were made, and the record was held open for the submission of written proposed findings of fact and conclusions of law. On May 22, 2009, *Protestants' Proposed Findings of Fact and Conclusions of Law* and the *Division's Proposed Findings of Fact and Conclusions of Law* were filed. The record was thereafter closed and the protest was submitted for decision[5].

FINDINGS OF FACT

Upon review of the file and records, including the transcript of the hearing, the exhibits received into evidence and the proposed findings of fact and conclusions of law, the undersigned finds:

1. Protestant, WIFE purchased the APARTMENT COMPLEX ("Apartments") located in ANY TOWN, Oklahoma from her mother in December, 2003.[6] Tr. 4-5. Her family had owned the Apartments since the late 1970s. Tr. 4. Protestant managed the operations of the Apartments through COMPANY, a subchapter S corporation. Tr. 5.

2. On June 22, 2006, Protestant entered into a *Real Estate Purchase Agreement* ("*Agreement*") to sell the Apartments. Exhibit 1. The purchase price for the Apartments was based on Ten (10) times the net operating income from the Apartments. Tr. 7. The sale of the Apartments closed on September 11, 2006. Tr. 6; Exhibit 5, pages 35 and 36[7].

3. The *Agreement* provides in part:

> SALE AGREEMENT: PROPERTY. The Seller agrees to sell to the Buyer and the Buyer agrees to purchase from the Seller, * * * the properties commonly known as ADDRESS, ANY TOWN, OK (hereinafter called the "Property"), more particularly described as follows: APARTMENT COMPLEX., 80 unit apartment complex.
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> > Real Property. All of the real property situated in ANY TOWN, Oklahoma, * * * together with the buildings, improvements and fixtures located thereon and together all and singularly rights and appurtenances pertaining thereto, including any right, title and interest of Seller in and to any adjacent streets, alleys, rights-or-way and easements (collectively the "Real Property"), * * *.
> >
> > Personal Property. All tangible personal property located on the Real Property and used in the ownership, operation or maintenance thereof, and all intangible personal property used in connection with the ownership, operation or maintenance of the Real Property

[5] *OAC*, 710:1-5-39(a).

[6] Protestants' 2006 U.S. Individual Income Tax Return (Form 4797, page 2) reports an acquisition date of January 1, 2004. Exhibit 5.

[7] Pages 35 and 36 are page 2 to Form 4797 to Protestants' 2006 Federal income tax return.

> including, all contract rights, deposits, instruments, documents of title and business records (collectively the "Personal Property").

The Personal Property included: "[a]n Assignment and Assumption of Leases and Service Contracts (the "Assignment") duly executed by Seller, with a certified rent roll and list of service and other contracts relating to the Property" and "[a]ll security deposits made by tenants of the Property". Exhibit 1.

4. With respect to employment contracts, the *Agreement* provides:

> Seller represents that the Buyer shall have the right to terminate any management and other employment contracts affecting the Property as of the Closing Date and Seller shall pay all wages, accrued vacation and fringe benefits and other sums owing to any terminated employee or managing agent and shall indemnify and hold the Buyer harmless with respect thereto.

5. Protestants reported a net long term capital gain of $1,023,915.00 from the sale of the Apartments on their 2006 Federal Income Tax Return. Tr. 15; Exhibit 5.

6. Protestants deducted the capital gain from the sale of the Apartments from their federal adjusted gross income to arrive at Oklahoma adjusted gross income on their 2006 Oklahoma Income Tax Return. Tr. 15-16; Exhibits 5 and 6.

7. The Division reviewed Protestants' Oklahoma return and additional information submitted by Protestants in response to letters of inquiry by the Account Maintenance Division, to-wit: Form 561 "Oklahoma Capital Gain Deduction For Residents Filing Form 511"; Schedule D and Form 4797 to Protestants' federal return; and "Seller's Final Settlement Statement", TITLE COMPANY. Tr. 20; Exhibits B, C and D.

8. Upon review of the Oklahoma return and additional information, the Division denied the deduction on the basis that the capital gain was attributable to the sale of real and tangible personal property and Protestants had not held the property for the requisite number of years. Tr. 21-23.

9. By letter dated November 7, 2007, with an enclosed copy of Protestants' 2006 Oklahoma Income Tax Return as adjusted, the Division notified Protestants of the disallowance of the Oklahoma Capital Gain Deduction which reduced the amount of the refund claimed on the return of $64,091.00 to a proposed refund of $151.00. Exhibit E.

10. Protestants timely protested the proposed adjustment by letter dated November 12, 2007. Exhibit F.

11. The stated reason for the adjustment or disallowance of the deduction, as corrected is:

> The capital gain exclusion for the sale of personal property has been disallowed. According the [sic] Oklahoma Statutes Title 68 Section 2358 the Oklahoma Capital Gains exclusion is limited to the sale of real or tangible personal property for tax year 2006 that has been held for a period of at least five uninterrupted years.

Exhibit G.

12. The amount in controversy is $63,940.00. Exhibit E.

ISSUES AND CONTENTIONS

The issue presented for decision is whether the sale of the Apartments was a sale of a direct or indirect ownership interest in an Oklahoma company.

Protestants contend that the Division erred in denying the deduction of the capital gains received from the sale of the Apartments. In support of this contention, Protestants argue that the two (2) year holding period is applicable to the capital gain received from the sale of the Apartments because they sold more than just the land and buildings, but rather sold an Oklahoma business.

The Division contends that the capital gains deduction was properly denied because Protestants sold the property of the Apartments, not an ownership interest in the Apartments and they did not own the Apartments for the requisite five (5) year period. In support of this contention, the Division argues that the *Agreement*, Final Settlement Statement and Protestants' federal and state returns clearly show that the asset sold was property, not an ownership interest. The Division further argues that "[s]elling all the assets of a company does not change the structure of the sale from one of assets to one of ownership interest for tax purposes." *Brief of the Compliance Division*, page 11.

CONCLUSIONS OF LAW

1. The Oklahoma Tax Commission is vested with jurisdiction over the parties and subject matter of this proceeding. 68 O.S. 2001, § 207.

2. "Taxation is an exclusively legislative function that can be exercised only under statutory authority and in the manner specified by statute." ***State, ex rel. Oklahoma Tax Commission v. Texaco Exploration & Production, Inc.,*** 2005 OK 52, ¶ 7, 131 P.3d 705, 707. Accordingly, the basis for assessing income tax must be found in the Oklahoma Income Tax Act ("Act").[8]

3. A taxpayer's income tax liability is determined in accordance with the law in effect at the time the income is received. ***Affiliated Management Corp. v. Oklahoma Tax Commission***,

[8] 68 O.S. 2001, § 2351 et seq.

1977 OK 183, 570 P.2d 335; ***Wootten v. Oklahoma Tax Commission***, 1935 OK 54, 170 Okla. 584, 40 P.2d 762.

4. The provision of the Act at issue is the capital gains deduction codified at § 2358(F)[9] which provides:

> 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.
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> 2. As used in this subsection:
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> 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 two (2) years prior to the date of the transaction from which the net capital gains arise,
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> b. 'holding period' means an uninterrupted period of time,
>
> 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
>
> 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

[9] Laws 2006, c. 272, § 17. Section 27 of Chapter 272, Laws 2006 provides that § 17 shall become effective January 1, 2006. The amendment changed the holding period required for the deduction of capital gains from the sale of stock or the sale of a direct or indirect ownership interest in an Oklahoma company, limited liability company, or partnership from three (3) years to two (2) years.

> 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 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 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.

5. "Deductions [and credits against tax] are a matter of legislative grace rather than judicial intervention." ***Flint Resources Company v. Oklahoma Tax Commission***, 1989 OK 9, 780 P.2d 665, 673. In order to be allowed, authority for the deduction sought must be clearly expressed. ***Home-State Royalty Corporation v. Weems***, 1935 OK 1043, 175 Okla. 340, 52 P.2d 806 (1935). None may be allowed in absence of a statutory provision therefor. *Id. See*, ***New Colonial Ice Co. v. Helvering***, 292 U.S. 435, 440, 54 S.Ct. 788, 78 L.Ed. 1348 (1934).

6. Neither the Act nor the rules promulgated by the Oklahoma Tax Commission define the phrase "Oklahoma company." See, *OAC*, 710:50-15-48. The term "Oklahoma" is used in § 2358(F)(2)(a)(2) as an adjective to denote that the primary headquarters of the "company, limited liability company or partnership" must be located in Oklahoma. See, § 2358(F)(2)(c).

7. Words of a statute are generally assumed to be used by the Legislature as having the same meaning as attributed to them in ordinary and usual parlance. ***Neer v. Oklahoma Tax Commission***, 1999 OK 41, 982 P.2d 1071, corrected. When common words are used in statutes, principles of statutory construction require that the words be given their common and ordinarily accepted meaning. ***In re Skaggs***, 196 B.R. 865 (W.D.Okla. 1996). The words of a statute may not be construed in a manner as to defeat statutory intent. ***McNeill v. City of Tulsa***, 1998 OK 2, 953 P.2d 329. The primary goal of rules of statutory construction is to ascertain the legislature's intent; such intent must be gleaned from the statute as a whole in view of its general purpose and object. ***DeLaughter v. State ex rel. Oklahoma State Dept. of Mental Health & Substance Abuse Services***, 2001 OK 61, 47 P.3d 462.

8. The term "company" as used in § 2358(F) is commonly defined as "[a] business enterprise" and includes an "[o]rganization engaged in business as a proprietorship, partnership,

corporation, or other form of enterprise." See, http://dictionary.reference.com; http://www.thefreedictionary.com; and http://www.answers.com. "Business" and "enterprise" are synonyms of "company". Roget's II *The New Thesaurus*, p. 176 (1980). One definition of business is "a person, partnership, or corporation engaged in commerce, manufacturing, or a service; profit-seeking enterprise or concern." See, http://www.dictionary.com.

9. Protestants sustained their burden of proving that the denial of the capital gains deduction on their 2006 Oklahoma Income Tax Return is erroneous. Protestant, WIFE sold more than just the real and tangible personal property associated with the Apartments. She sold her ownership interest in a business enterprise or "company" within the meaning of § 2358(F)(2)(a)(2).

DISPOSITION

Based on the above and foregoing findings of fact and conclusions of law, the undersigned ORDERS that the income tax protest of Protestants, HUSBAND AND WIFE, be sustained.

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.