JURISDICTION: **OKLAHOMA TAX COMMISSION**
CITE: **2010-08-03-06 / NON-PRECEDENTIAL**
ID: **P-09-036-H**
DATE: **AUGUST 3, 2010**
DISPOSITION: **SUSTAINED**
TAX TYPE: **INCOME**
APPEAL: **NO APPEAL TAKEN**

FINDINGS OF FACT AND CONCLUSIONS OF LAW

The above matter comes on for entry of a final order of disposition by the Oklahoma Tax Commission. Having reviewed the files and records herein, including the Findings of Fact, Conclusions of Law and Recommendations made and entered by the Administrative Law Judge on the 31st day of July, 2009, the Commission denies the application of the Compliance Division for a hearing en banc and makes the following Findings of Fact and Conclusions of Law and enters the following order.

PROCEDURAL HISTORY

On March 18, 2009, 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 March 24, 2009, a letter was mailed to the Protestants stating this matter had been assigned to ALJ, Administrative Law Judge, and docketed as Case Number P-09-036-H. The letter also advised the Protestants that 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 March 31, 2009, OTC ATTORNEY 1 and OTC ATTORNEY 2 filed an Entry of Appearance as Counsel of record for the Division.

On April 2, 2009, the Notice of Prehearing Conference was mailed to the last-known address of the Protestants, setting the prehearing conference for April 21, 2009, at 11:00 a.m.[4] On April 6, 2009, the Division filed a Memorandum with the clerk of the court ("Clerk") on behalf of the parties requesting a continuance of the prehearing conference to April 28, 2009, 11:00 a.m. On April 7, 2009, another Notice of Prehearing Conference was mailed to the last-known address of the Protestants, setting the prehearing conference for April 28, 2009, at 11:00 a.m.

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[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] *Id.*

[4] OKLA. STAT. ANN. tit. 68, § 208 (West 2001). The notice was mailed to the Protestants at ADDRESS.

On April 28, 2009, at 11:00 a.m., the prehearing conference was held by telephone as scheduled. On April 30, 2009, pursuant to the prehearing teleconference, an Order Setting Briefing Schedule was mailed to the parties.

On June 2, 2009, the Joint Stipulation of Facts and Issues were filed with the Clerk, with Exhibits 1 through 13 attached thereto. On June 9, 2009, the Protestants' Brief was filed with the Clerk.

On July 9, 2009, the Brief of the Compliance Division was filed with the Clerk. On July 10, 2009, the Protestants' Response Brief, Response Brief #2, Response Brief #3, and Response Brief #4 were filed with the Clerk. On July 15, 2009, what is deemed as Protestants' Response Brief #5 was filed with the Clerk by electronic transmission, which was forwarded to Division's Counsel.

JOINT STIPULATION OF FACTS AND ISSUES

This matter was submitted for decision on briefs at the request of the parties.[5] The following facts and issues were stipulated,[6] as follows, to-wit:

1. On or about December 8, 2005, Protestant sold his accounting practice, including all client information and work paper files, to BUYER, CPA. A copy of the purchase agreement is attached hereto as Exhibit 1. Protestant was a CPA at the time of the sale of the practice. Private practices of CPAs are regulated and governed by the Oklahoma Accountancy Act which was last amended March 2005. A copy of Protestant's practice permit is attached hereto as Exhibit 2.

2. On August 3, 2007, Protestant filed an amended 2005 Oklahoma Income Tax Return. On the amended return, Protestant claimed the Oklahoma Capital Gain Deduction in the amount of $10,103 for the sale of his accounting practice. The refund claimed on the amended return was paid by the Tax Commission. A copy of the 2005 amended return is attached hereto as Exhibit 3.

3. On February 11, 2008, Protestant filed his 2007 Oklahoma Income Tax Return, on which he claimed the Oklahoma Capital Gain Deduction in the amount of $9,167 for the sale of his accounting practice. A copy of the 2007 return is attached hereto as Exhibit 4.

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[5] OKLA. ADMIN. CODE § 710:1-5-38(a) (June 25, 2009):

> When a taxpayer in an administrative proceeding does not request an oral hearing, or the parties agree that an oral hearing is not needed, the Administrative Law Judge will base the Findings, Conclusions and Recommendations on the position letters and briefs submitted by the parties. The Administrative Law Judge will mail notice of a date certain for each party to submit a position letter or brief setting out therein the statement of facts, issues to be determined, contentions and statutory and case law relied upon to support his contentions. The Administrative Law Judge may schedule a conference between the parties if it is deemed necessary to clarify the positions of the parties.

[6] The text of the Joint Stipulation of Facts and Issues are set out verbatim.

4. On April 9, 2008, Protestant filed an amended 2006 Oklahoma Income Tax Return. On the amended return, Protestant claimed the Oklahoma Capital Gain Deduction in the amount of $9,062 for the sale of his accounting practice. A copy of the 2006 Amended return is attached hereto as Exhibit 5.

5. On July 15, 2008, a request was sent to Protestant to furnish additional information to supplement his 2006 tax return to support the claim for refund. Protestant complied, and provided a copy of his 2006 Federal Schedule D, a copy of his Federal Schedule K1, and a copy of the purchase agreement. The Federal Schedule K1 shows net long-term capital gain in the amount of $9,061.76 arising from the sale of Protestant's accounting practice, PRACTICE. A copy of the request letter and the federal forms provided are attached hereto as Exhibit 6.

6. On August 18, 2008, an adjustment letter was issued to Protestant denying the Oklahoma Capital Gain Deduction for the 2006 tax year for the reason that the Deduction did not qualify under 68 O.S. § 2368. A copy of the adjustment letter is attached hereto as Exhibit 7.

7. On September 20, 2008, Protestant protested the adjustment in a letter to the Commission disagreeing with the adjustment to his 2006 tax return and explaining why he believed he was eligible for the deduction. A copy of the letter is attached hereto as Exhibit 8.

8. On February 2, 2009, assessment letters for tax years 2005 and 2007 were sent to Protestant, citing as the reason for adjustment that the assets sold did not qualify for the Oklahoma Capital Gain deduction. These assessment letters are attached hereto as Exhibits 9 and 10, respectively.

9. On February 3, 2009, Protestant protested the 2005 and 2007 assessments, claiming that his sale of tangible personal property qualified for the Oklahoma Capital Gain Deduction. Protestant's letter is attached hereto as Exhibit 11.

10. The files and records sold as part of the sale of the accounting practice were personal property of Protestant. They were transferred to BUYER as part of the sale, as acknowledged by BUYER'S letter of March 4, 2009, attached hereto as Exhibit 12. A description of the content of the accounting files is attached as Exhibit 13.

STATEMENT OF ISSUES

11. At issue in this matter is whether Protestant is eligible to take the Oklahoma Capital Gain Deduction for the sale of his accounting practice, including files and records that were transferred as part of the sale, specifically whether those files constitute tangible personal property.

12. Protestant contends that the files and records transferred to BUYER as part of the sale of Protestant's accounting practice are tangible personal property. The Division contends that the files are not tangible personal property, and because they cannot be qualified as such, did not qualify for the Oklahoma Capital Gain Deduction.

ADDITIONAL FINDING OF FACT

13. According to the Protestants' Amended Oklahoma Return for the 2005 tax year ("2005 Amended Return"), PROTESTANT began his CPA practice September 1, 1977.[7]

14. The Protestants' 2005 Amended Return was filed to claim the Oklahoma Capital Gain Deduction from the sale of his CPA practice. The 2005 Amended Return claimed $10,103.00 as the portion of the "Installment Sale" received during the 2005 tax year.[8]

15. The Protestants' 2006 Amended Return was filed to claim the Oklahoma Capital Gain Deduction in the amount of $9,062.00 from the second installment received from the "Installment Sale" of his CPA practice.[9]

16. The Protestants' 2007 Return was filed to claim the Oklahoma Capital Gain Deduction in the amount of $9,167.00 from the last installment received from the "Installment Sale" of his CPA practice.[10]

17. The Division initially disallowed the Protestants' deduction for the 2005, 2006, and 2007 tax years ("Audit Periods") because "goodwill" does not qualify for the Oklahoma Capital Gain Deduction.[11]

18. Subsequent to the disallowance of the Oklahoma Capital Gain Deduction for the Audit Periods, the Division agreed that "goodwill" was not at issue in the sale of PROTESTANT'S CPA practice.

CONCLUSIONS OF LAW

1. The Oklahoma Tax Commission is vested with jurisdiction over the parties and subject matter of this proceeding.[12]

2. A taxpayer's income tax liability is determined in accordance with the law in effect at the time the income is received.[13]

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[7] Exhibit 3.

[8] *See* Note 7, *supra.*

[9] Exhibit 5.

[10] Exhibit 4.

[11] Exhibits 7, 9, and 10.

[12] OKLA. STAT. ANN. tit. 68, § 221(D) (West Supp. 2007).

[13] *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.

3. The text of Section 2358(F) of Title 68[14] in effect for the Audit Periods 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.
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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 three (3) 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,
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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.

[14] 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.

(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 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.

4. 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.[15]

5. The Tax Commission Rule on the Capital Gains Deduction[16] in effect for the Audit Periods, 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.

(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),

[15] 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.

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

[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.

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. In Tax Commission Order No. 2009-11-24-03 the Commission concluded that 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.

DISCUSSION

The parties stipulated that the issue in this matter was whether the Protestants were eligible to take the Oklahoma Capital Gain Deduction for the sale of PROTESTANT'S CPA practice, including files and records that were transferred as part of the sale, specifically whether those files constitute tangible personal property.

If the installment sale in this matter is a sale of an ownership interest in an Oklahoma company, limited liability company or partnership, then the capital gains exclusion applies and the protest should be sustained. The Purchase Agreement provides that it is an agreement for the sale of an accounting practice. Neither the words "limited liability company", nor the abbreviation "LLC" appear anywhere in the purchase agreement. The "K-1"s filed with protestant's 2005 and 2006 income tax returns reflect that the PROTESTANT had a 100% ownership interest in a limited liability company named "PRACTICE" and that such limited liability company had a long term capital gain for the relevant tax year. The burden of proof is on the protestant to show that the sale in question was eligible for the capital gains exclusion, either because it was the sale of an ownership interest in an Oklahoma company, limited liability company or partnership or because it was a sale of tangible personal property. The record in this case is sufficient to show that the protestant's CPA practice was a business enterprise. The purchase agreement recites that it is for the sale of protestant's "accounting practice." Applying the previous Tax Commission conclusion of law with regard to the definition of "company" we find that the sale in question was a sale of an ownership interest in an Oklahoma company.

ORDER

The OKLAHOMA TAX COMMISSION orders that the protest to the Division's adjustments of protestant's income taxes 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.

NOTE: The distinction between a Commission Order designated as "Precedential" or "Non-Precedential" has been blurred because all OTC Orders resulting from cases heard by the Office of Administrative Law Judges are now published, not just "Precedential" Orders. *See* OKLA. STAT. ANN. tit.68, § 221(G) (West Supp. 2009) and OKLA. STAT. ANN. tit. 75, § 302 (West 2002). *See also* OTC Orders 2009-06-23-02 and 2009-06-23-03 (June 23, 2009), which also conclude the language of the Statute is "clear and unambiguous."