JURISDICTION: **OKLAHOMA TAX COMMISSION**
CITE: **2010-10-26-02 / NON-PRECEDENTIAL**
ID: **P-08-063-H**
DATE: **OCTOBER 26, 2010**
DISPOSITION: **DENIED**
TAX TYPE: **CORPORATE INCOME**
APPEAL: **PENDING; S.CT. 108943**

FINDINGS OF FACT AND CONCLUSIONS OF LAW

INSURANCE COMPANY ("Protestant") appears by and through its attorneys, ATTORNEY 1, FIRM 1 and ATTORNEY 2, FIRM 2. The Corporate Income Tax Section of the Compliance Division ("Division"), Oklahoma Tax Commission, appears by and through OTC ATTORNEY 1, Assistant General Counsel, and OTC ATTORNEY 2, Assistant General Counsel, Office of General Counsel, Oklahoma Tax Commission.

PROCEDURAL HISTORY

On June 13, 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 June 16, 2008, a letter was mailed to Counsel stating that this matter had been assigned to ALJ, Administrative Law Judge, and docketed as Case Number P-08-063-H. The letter also advised the Protestant 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 June 24, 2008, OTC ATTORNEY 1, OTC ATTORNEY 3,[4] and OTC ATTORNEY 4[5] filed an Entry of Appearance as Co-Counsel of record for the Division.

On July 1, 2008, a letter was mailed to Counsel that pursuant to an agreement and request of the parties, an additional status report was to be submitted on or before October 3, 2008.[6] On July 1, 2008, a letter was mailed to ATTORNEY 1 and ATTORNEY 3 requesting verification of

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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 (June 11, 2005).

[3] *Id.*

[4] On December 28, 2009, OTC ATTORNEY 3 filed a Notice of Withdrawal as Co-Counsel of Record for the Division.

[5] On March 18, 2009, OTC ATTORNEY 4 filed a Notice of Withdrawal as Co-Counsel of Record for the Division.

[6] The protest letter dated April 7, 2008, contained a request to consolidate this matter with protests from SUBSIDIARY (P-08-007-H) and SUBSIDIARY 3 (P-08-049-H). Both cases were resolved through the "Clean Slate" 2008 program and closed.

their compliance with the Tort Reform Act in this matter regarding the admission of out-of-state of attorneys.

On August 18, 2008, a Motion to Associate Counsel was filed by Protestant, through ATTORNEY 2, as Local Counsel, for an Order permitting ATTORNEY 1 to practice in this matter. The Motion was supported by the attached "Signed Application" (Exhibit A), "Certificate(s) of Good Standing" (Exhibit B), and the "Certificate of Compliance" from the Oklahoma Bar Association (Exhibit C). On August 19, 2008, an Order Admitting to Practice was issued granting the Protestant's motion to admit ATTORNEY 1 to practice "for purposes of [this] matter only." The Procedural History from August 20, 2008, to October 22, 2008, is omitted herein.

On October 23, 2008, the Division filed the Compliance Division's Notice of Revision ("First Revision") of the proposed assessment against the Protestant. The Procedural History from October 24, 2008, through November 25, 2008, is omitted herein.

On November 26, 2008, the Protestant filed its Revised Protest to the Division's First Revision with the Court Clerk.[7] The Procedural History from November 27, 2008, through February 22, 2009, is omitted herein.

On February 23, 2009, OTC ATTORNEY 2 (formerly MAIDEN NAME) filed an Entry of Appearance as Co-Counsel of record for the Division with the Court Clerk.

On March 6, 2009, the Court Clerk, at the request of the undersigned, placed a call to ATTORNEY 2 to verify that ATTORNEY 3 had not been admitted to practice in this case (which was confirmed by ATTORNEY 2) and advise that ATTORNEY 3 could not submit pleadings under his signature or appear in this matter representing the Protestant. The remaining Procedural History from March 6, 2009, through September 23, 2009, is omitted herein.

On September 24, 2009, a Revised Scheduling Order was issued setting the hearing in this matter for February 18-19, 2010, at 9:30 a.m., with position letters or memorandum briefs due on or before February 11, 2010.

On October 6, 2009, the Division filed the second Compliance Division's Notice of Revision ("Second Revision") of the proposed assessment against the Protestant with the Court Clerk. The Procedural History from October 7, 2009, to December 20, 2009, is omitted herein.

On December 21, 2009, the Division filed its *Motion for Partial Summary Disposition and Brief in Support* ("*Motion*"), with an Exhibit List as more fully set out therein. On December 28, 2009, the Protestant filed by facsimile,[8] a Motion to Extend Date for Response to Motion for Partial Summary Disposition and Request for Hearing with the Court Clerk.

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[7] OKLA. ADMIN. CODE § 710:1-5-10(c)(2) (June 25, 1999).

[8] On December 29, 2009, the original motion was filed with the Court Clerk.

On December 29, 2009, an Order Granting Motion to Extend Date for Response to Motion for Partial Summary Disposition and Setting Oral Argument was issued setting oral argument on the *Motion* for February 16, 2010, at 10:00 a.m., with Protestant's response to the Division's *Motion* due February 1, 2010, and any reply to the Protestant's response due from the Division prior to oral argument on February 16, 2010. The Procedural History from December 30, 2009, through January 26, 2010, is omitted herein.

On January 27, 2010, the Protestant filed a Motion to Extend Date for Filing of Stipulations, along with a binder containing Protestant's Exhibits A through DD, with the Court Clerk. On January 27, 2010, an Order Granting Motion to Extend Date for Filing of Stipulations was issued extending the date of filing stipulations to February 2, 2010.

On February 1, 2010, the Protestant filed its Opposition to Motion for Partial Summary Disposition, Cross-Motion for Partial Summary Disposition and Brief in Support with the Court Clerk. On February 2, 2010, the parties filed the Partial Stipulation of Facts with the Court Clerk. On February 8, 2010, the undersigned issued to the Protestant a Notice to Show Cause Why Pleadings Signed by ATTORNEY 3 Should Not Be Stricken from the Record[9] as follows, to-wit:

> Protestant's Exhibit List filed January 14, 2010
>
> Opposition to Motion for Partial Summary Disposition, Cross-Motion for Partial Summary Disposition and Brief in Support filed February 1, 2010.

The notice advised that a hearing was scheduled for February 16, 2010, at 10:00 a.m. at which time the Protestant could appear and show cause why the above-referenced pleadings should not be stricken from the record. According to the records of the Court Clerk, ATTORNEY 1 was admitted to practice in this matter by the Order Admitting to Practice issued August 19, 2009. According to the records of the Court Clerk, ATTORNEY 3 has not been admitted to practice in this matter. On February 8, 2010, the Division's Amended Final Witness and Exhibit List was filed with the Court Clerk. On February 10, 2010, the Protestant filed its Response to Notice to Show Cause, with properly signed copies of the Protestant's Exhibit List and the *Opposition to Motion for Partial Summary Disposition* ("*Reply*"), *Cross-Motion for Partial Summary Disposition and Brief in Support* ("*Cross-Motion*") for filing out of time with the Court Clerk. On February 10, 2010, an Order Granting Request to Accept Documents filed Out of Time and Striking Show Cause Hearing was issued striking the show cause hearing set for February 16, 2010, at 10:00 a.m. On February 11, 2010, the Court Clerk received an e-mail from ATTORNEY 1 confirming that COURT REPORTER of Independent Reporting Service had been scheduled for the hearings on February 16, 2010, and February 18-19, 2010. On February 11, 2010, the Protestant's Pre-Hearing Legal Memorandum and the Brief of the Compliance Division, with Appendix A and Appendix B attached thereto, were filed with the Court Clerk. On February 12, 2010, the Division's *Response to Protestant's Opposition to Motion for Partial Summary Disposition, Cross-Motion for Partial Summary Disposition and Brief in Support*

[9] On February 8, 2010, the Court Clerk sent the Notice to Counsel for the parties by electronic transmission and by certified mail return receipt requested.

("*Response*"), with Exhibit 94, was filed with the Court Clerk. On February 16, 2010, the Division's Second Amended Final Witness and Exhibit List was filed with the Court Clerk.

On February 16, 2010, at approximately 10:00 a.m., a closed hearing[10] was held as scheduled. The oral argument of the Division's *Motion* was made by OTC ATTORNEY 1 and the oral argument of Protestant's *Cross-Motion* was made by ATTORNEY 1. At the conclusion of oral argument, Counsel stipulated to the admission into evidence of the Division's *Motion* Exhibits 14 through 97, Division's Exhibits 1 through 57, and the Protestant's Exhibits A through DD.[11] Counsel stipulated that there would be no challenges to the four (4) expert witnesses scheduled to testify during the hearing on the merits.[12] On February 17, 2010, Counsel filed Revised Partial Stipulation of Facts with the Court Clerk.

On February 18-19, 2010, at approximately 9:30 a.m., a closed hearing[13] was held as scheduled. The Protestant's Exhibits EE and FF were identified, offered, and admitted into evidence.[14] Counsel stipulated to the admission into evidence of the Revised Partial Stipulation of Facts filed with the Court Clerk on February 17, 2010.[15] The Protestant called eight (8) witnesses to testify. The Protestant's first (1st) witness, AUDITOR, Auditor, Corporate Income Section, Compliance Division, Oklahoma Tax Commission, testified as to his training and experience, the conduct of the audit, and the decisions made with respect to the proposed income tax assessments which are under protest.[16] The Protestant's second (2nd) witness, FORMER DIRECTOR, Former Senior Director of FAST FOOD CHAIN ("FAST FOOD CHAIN") Risk Management (Department), testified about FAST FOOD CHAIN insurance risks covered by the Protestant and the procedure for the filing and payment of FAST FOOD CHAIN insurance claims.[17] The Protestant's third (3rd) witness, CORPORATE COUNSEL, FAST FOOD CHAIN Managing Corporate Counsel, testified about the Licensee Agreements between FAST FOOD CHAIN and its franchisees and FAST FOOD CHAIN and LLC, LLC, and the documents which FAST FOOD CHAIN provides to its franchisees.[18] The Protestant's fourth (4th) witness, MANAGING DIRECTOR, Managing Director, MANAGEMENT COMPANY Management Services, Inc., testified about the operations of the Protestant, the risks that the Protestant insures for FAST FOOD CHAIN, how the Protestant conducts its business, and the regulation of the

[10] The Protestant, through ATTORNEY 1, invoked its right to a confidential hearing as provided by OKLA. STAT. ANN. tit. 68, § 205 (West Supp. 2010).

[11] Pretrial Tr. at 18-19. The Division's *Motion* Exhibits are not numbered sequentially.

[12] Pretrial Tr. at 21-22.

[13] *See* Note 10, *supra*.

[14] Hearing Tr. at 6.

[15] Hearing Tr. at 7.

[16] Hearing Tr. at 19-46

[17] Hearing Tr. at 47-66.

[18] Hearing Tr. at 66-107.

Protestant under Vermont's Insurance Law.[19] The Protestant's fifth (5th) witness, STATE TAX DIRECTOR, Director, FAST FOOD CHAIN State Tax Audits and Special Projects, testified about FAST FOOD CHAIN activities in Oklahoma, the filing of FAST FOOD CHAIN Oklahoma income tax returns and the Division's audit of such returns, the payment and recording of royalty fees to FAST FOOD CHAIN, and FAST FOOD CHAIN payment and recording of royalty fees to LLC.[20] The Protestant's sixth (6th) witness, ECONOMICS PROFESSOR, Professor, Finance and Economics, Tulane University, testified as an expert witness regarding the economic and fiscal policy considerations in determining the fairness and propriety of a state's assertion of its taxing authority upon entities that have no physical or other connection to the state and do not derive any services from, or impose any costs to the states, the economic nature of the transactions at issue, and their relationship to the Protestant and the State of Oklahoma.[21] The Protestant's seventh (7th) witness, CPA, Managing Director/CPA, The CPA Consulting Group, Inc., testified as an expert witness giving accounting testimony about the Division's apportionment method used to assess the Protestant and, in the event the Protestant is found to have a taxable presence in Oklahoma, other apportionment or filing methods that the Division might have used to determine the Protestant's corporate income tax liability.[22] The Protestant's eighth (8th) witness, LAW PROFESSOR, Professor of Law, University of Connecticut Law School, testified as an expert witness regarding nexus and apportionment tax policies.[23]

The Division called three (3) witnesses to testify. The Division's first (1st) witness, AUDITOR, Auditor, Corporate Income Tax Section, Compliance Division, Oklahoma Tax Commission, testified as to his training and experience, the conduct of the audit, the decisions made with respect to the proposed income tax assessment which is under protest, and as custodian of the Division's records.[24] The Division's second (2nd) witness, SUPERVISOR, Special Projects Supervisor, Compliance Division, Oklahoma Tax Commission, testified as to his training and experience, the conduct of the audit, the decisions made with respect to the proposed income tax assessment which is under protest, and as custodian of the Division's records.[25] The Division's third (3rd) witness, FINANCE PROFESSOR, Professor, Department of Finance, Leavey School of Business, Santa Clara University, Santa Clara, California, testified as an expert witness regarding the economic nexus of Protestant and the tax treatment of the trademarks, patents, and copyrights held by Protestant's subsidiary, LLC, LLC.[26] At the conclusion of the hearing on the merits the record was held open to allow time for the completed

[19] Hearing Tr. at 109-123.

[20] Hearing Tr. at 124-153.

[21] Hearing Tr. at 154-180. *See* Protestant's Exhibit BB.

[22] Hearing Tr. at 181-218. *See* Protestant's Exhibit CC.

[23] Hearing Tr. at 219-242. *See* Protestant's Exhibit AA.

[24] Hearing Tr. at 244-268.

[25] Hearing Tr. at 268-327.

[26] Hearing Tr. at 327-371. *See* Division's Exhibit 53.

transcript to be filed with the Court Clerk. It was announced that once the completed transcripts (hearing on the merits) was filed with the Court Clerk, Counsel would have thirty (30) days (on a date certain) to submit their proposed findings of fact and conclusions of law. On February 24, 2010, a letter was mailed to Counsel memorializing the announcements made at the conclusion of the hearing on the merits.

On March 12, 2010, a Joint Motion to Extend Time for Filing Proposed Findings of Fact and Conclusions of Law was filed with the Court Clerk. As of the date of the motion, the completed transcripts had not been filed. Counsel requested ninety (90) days to submit proposed findings of fact and conclusions of law once the completed transcripts were filed. Counsel anticipated that significant time would be required to review the transcripts, and due to the substantial volume of information in this case, Counsel did not believe that thirty (30) days would allow sufficient time to prepare the proposed findings of fact and conclusions of law. On March 15, 2010, an Order Granting Request to Extend Time was granted. On March 18, 2010, "original" completed transcripts for the *Motion* and *Cross-Motion* hearing held on February 16, 2010, at approximately 10:00 a.m. and the hearing on the merits held on February 18-19, 2010, at approximately 9:30 a.m. were filed with the Court Clerk.

On March 23, 2010, a letter was mailed to Counsel stating proposed findings of fact and conclusions of law were to be filed on or before June 16, 2010, at which time the record in this matter would be closed and this case submitted for decision.

On June 14, 2010, the Protestant's Proposed Findings of Fact and Conclusions of Law were filed with the Court Clerk. On June 16, 2010, the Division's Proposed Findings of Fact and Conclusions of Law were filed with the Court Clerk. The record in this matter was closed and this case was submitted for decision on June 16, 2010.

MOTION AND CROSS-MOTION

On December 21, 2009, the Division filed its *Motion* on two (2) issues as follows, to-wit:

> **Motion Issue One**
>
> **Whether there is statutory authority to assert corporate income tax upon Protestant, a Vermont captive insurance company, where there is a statutory exemption from corporate income tax for insurance companies which have paid the Oklahoma insurance premium tax.**
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> **Motion Issue Two**
>
> **Whether imposing corporate income tax on Protestant unconstitutionally discriminates in favor of domestic over foreign corporations.**

On February 1, 2010, the Protestant filed its *Cross-Motion* on one (1) issue as follows, to-wit:

> **Cross Motion Issue**
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> **(The constitutionality of Oklahoma's tax treatment of non-Oklahoma insurance companies) Protestant asserts that the exemption from corporate income tax, restricted under the Oklahoma statute to Oklahoma captive insurance companies, discriminates against non-Oklahoma captive insurance companies, such as Protestant, in violation of the U.S. Constitution.**

In the *Motion* and *Cross-Motion*, the parties incorporate the "Revised" Partial Stipulation of Facts[27] filed with the Court Clerk on February 17, 2010, and the Protestant adopts the Division's Statement of the Case as set out in the Division's *Motion*.[28]

STATEMENT OF THE CASE

1. By letter dated February 21, 2008, the Oklahoma Tax Commission issued its assessment for corporate income tax against INSURANCE COMPANY for the period October 1, 2001, through December 31, 2005, in the amount of $342,541 in income tax, $186,976 in interest and $17,127 in penalty, for a total of $546,644.

2. On April 7, 2008, INSURANCE COMPANY timely protested the Division's assessment.

3. On October 23, 2008, the Division issued a revision to the February 21, 2008, Assessment in the amount of $335,525 in income tax, $211,343 in interest to November 15, 2008, and $16,776 in penalty, for a total assessment of $563,644.

4. On November 26, 2008, INSURANCE COMPANY filed a revised protest to the revised assessment.

5. On October 6, 2009, the Division issued a second revision to the assessment in the amount of $237,467 in income tax, $185,021 in interest to November 30, 2009, and $11,873 in penalty, for a total assessment of $434,361.

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[27] *See* Procedural History herein.

[28] *Cross-Motion* at 3. *See* Division's *Motion* at 4.

MOTION AND CROSS-MOTION

CONCLUSIONS OF LAW

1. The Oklahoma Tax Commission is vested with jurisdiction over the parties and subject matter of this proceeding.[29]

2. A party may file a motion for summary disposition on any or all issues on the ground that there is no substantial controversy as to any material fact.[30] The procedures for such motion are as follows:

> (1) The motion for summary disposition shall be accompanied by a concise written statement of the material facts as to which the movant contends no genuine issue exists and a statement of argument and authority demonstrating that summary disposition of any or all issues should be granted. The moving party shall verify the facts to which such party contends no genuine controversy exists with affidavits and evidentiary material attached to the statement of material facts.
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> (2) If the protest has been set for hearing, the motion shall be served at least twenty (20) days before the hearing date unless an applicable scheduling order issued by the Administrative Law Judge establishes an earlier deadline. The motion shall be served on all parties and filed with the Office of the Administrative Law Judge.
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> (3) Any party opposing summary disposition of issues shall file with the Administrative Law Judge within fifteen (15) days after service of the motion a concise written statement of the material facts as to which a genuine issue exists and the reasons for denying the motion. The adverse party shall attach to the statement evidentiary material justifying the opposition to the motion, but may incorporate by reference material attached to the papers of the moving party. All material facts set forth in the statement of the movant which are supported by acceptable evidentiary material shall be deemed admitted for the purpose of summary disposition unless specifically controverted by the statement of the adverse party which is supported by acceptable evidentiary material.
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> (4) The affidavits that are filed by either party shall be made on personal knowledge, shall show that the affiant is competent to testify as to the matters stated therein, and shall set forth matters that would be admissible in evidence at a hearing. A party challenging the admissibility of any evidentiary material

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

[30] *Id.*

> submitted by another party may raise the issue expressly by written objection or motion to strike such material.
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> (5) If the taxpayer has requested a hearing, the Administrative Law Judge will issue a notice to the parties scheduling the motion for a hearing limited to oral argument. If the taxpayer has not requested a hearing, the Administrative Law Judge will rule on the motion based on the submission of the parties, including the motion, opposition to the motion, and attachments thereto.
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> (6) If the Administrative Law Judge finds that there is no substantial controversy as to the material facts and that one of the parties is entitled to a decision in its favor as a matter of law, the Judge will grant summary disposition by issuing Findings of Fact, Conclusions of Law, and Recommendations. Such Findings of Fact, Conclusions of Law and Recommendations are subject to review by the Commission pursuant to *OAC* 710:1-5-10, 710:1-5-40 and 710:1-5-41. If a motion for summary disposition is denied, the Administrative Law Judge will issue an order denying such motion.
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> (7) If the Administrative Law Judge finds that there is no substantial controversy as to certain facts or issues, the Judge may grant partial summary disposition by issuing an order which specifies the facts or issues which are not in controversy and directing that the action proceed for a determination of the remaining facts or issues. If a hearing of factual issues is required, evidentiary rulings in the context of the summary procedure shall be treated as rulings in limine.[31] Any ruling on partial summary disposition shall be incorporated into the Findings of Fact, Conclusions of Law, and Recommendations issued at the conclusion of the proceedings before the Administrative Law Judge.

3. Insurance companies paying, during or for the taxable year, a tax to this state on gross premium income shall be exempt from the provisions of Oklahoma Income Tax Act[32] and the taxes levied thereby.[33]

4. "Captive insurance company" means a pure captive insurance company, association captive insurance company, captive reinsurance company, sponsored captive insurance company, special purpose captive insurance company, or industrial insured captive insurance company formed or licensed under the Oklahoma Captive Insurance Company Act ("Act"). For purposes

[31] **"in limine"** (in lim-<<schwa>>-nee), adv. [Latin "at the outset"] Preliminarily; presented to only the judge, before or during trial <a question to be decided in limine>. BLACK'S LAW DICTIONARY (8th ed. 2004).

[32] OKLA. STAT. tit. 68, § 2351 et seq. (West 2006).

[33] OKLA. STAT. ANN. tit. 68, § 2359(C) (West 2001).

of the Act,[34] a branch captive insurance company must be a pure captive insurance company with respect to operations in this state, unless otherwise permitted by the Insurance Commissioner.[35]

5. "Pure captive insurance company" means a company that insures risks of its parent, affiliated companies, controlled unaffiliated business, or a combination thereof.[36]

PROCEDURAL ARGUMENTS
DISCUSSION

The Protestant states that the Division's *Motion* "…contravenes the terms and the purpose of a motion for summary disposition under OKLA. ADMIN. CODE § 710:1-5-38 and should be denied. Subsection (a) of Section 710:1-5-38 permits the filing of a motion for summary disposition in two situations: (1) '[w]hen a taxpayer in an administrative proceeding does not request an oral hearing,' or (2) [w]hen 'the parties agree that an oral hearing is not needed.' Neither of those situations exist [sic] in this case."[37]

The Division responds that the Protestant has misread the Tax Commission Rule and states, "There are two parts to [the Rule], part (a) and part (b). Part (a) describes the procedure for submission of a case on briefs while part (b) describes the procedure for a motion for summary disposition."[38] The Division is correct; the Protestant has misread the Tax Commission Rule. Part (a) of the Tax Commission Rule does not apply to a motion for summary disposition. Part (a) applies to the submission of a case on briefs when a hearing has not been requested or the parties agree that an oral hearing is not needed.[39]

The Protestant also states that this matter is not a proper case for partial summary disposition because this matter was filed more than a year and half ago, the parties engaged in extensive discovery, voluminous documents were exchanged, and depositions taken of nine of eleven witnesses to be called at trial, and the Division waited until six weeks before the trial scheduled for February 18 and 19, 2010, to request a partial summary disposition.[40]

In its *Response*, the Division points to the Tax Commission Rule, which states, "If the protest has been set for hearing, the motion shall be served at least twenty (20) days before the hearing date unless an applicable scheduling order issued by the Administrative Law Judge

[34] OKLA. STAT. ANN. tit. 68, § 6470.1 et seq. (West 2009).

[35] OKLA. STAT. ANN. tit. 68, § 6470.2(8) (West 2009).

[36] OKLA. STAT. ANN. tit. 68, § 6470.2(24) (West 2009).

[37] *Cross-Motion* at 1.

[38] *Response to Cross-Motion* at 1-2.

[39] OKLA. ADMIN. CODE § 710:1-5-38(a) (June 25, 1999).

[40] *Cross-Motion* at 6.

establishes an earlier deadline."[41] The Division further responds that the amount of discovery or number of witnesses is irrelevant and "…in a case such as this where there are multiple issues to be resolved, partial summary disposition eases potential confusion on the issues by eliminating those issues to which there are no substantial controversies as to the material facts."[42] The Division's *Motion* complies with the provisions of the Tax Commission Rule. The Division's *Motion* was timely filed and the required notice was given to the Protestant to not only respond, but to file its own *Cross-Motion.*[43] The Protestant's procedural arguments fail.

DISCUSSION ON MOTION ISSUE ONE

Motion Issue One

Whether there is statutory authority to assert corporate income tax upon Protestant, a Vermont captive insurance company, where there is a statutory exemption from corporate income tax for insurance companies which have paid the Oklahoma insurance premium tax.

The Division asserts that there is no substantial controversy as to any material facts relating to two (2) of nine (9) of the Protestant's assignments of error,[44] or as stated by OTC ATTORNEY 1"…the issue that we're here on and that's the subject of the Division's [*Motion*] is a separate issue from that of the receipt of Oklahoma source. And that is an issue that [Protestant] brought up in its protest in which it was essentially argued that the Division is prohibited from even proposing to assess corporate income tax against [Protestant] because [Protestant] is a captive insurance company. The only facts that are in – that are material to this issue are that [Protestant] is, in fact, a captive insurance company; that it was organized under the laws of Vermont and not under the laws of Oklahoma; that it insures FAST FOOD CHAIN and its affiliates; and that it is not conducting insurance business in Oklahoma as a captive or as a traditional insurance company, and thus it has not paid any Oklahoma insurance premium tax."[45]

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[41] OKLA. ADMIN. CODE § 710:1-5-38(b)(2) (June 25, 1999).

[42] *Response* at 2-3.

[43] The deadline for the filing of pre-trial motions and briefs was December 21, 2009. The Division's *Motion* was filed on December 21, 2009. *See* Joint Proposed Scheduling Order filed February 26, 2009.

[44] *See* Division's Hearing Exhibit 51 at 7-8:

> 7. Insurance companies doing business in Oklahoma are not subject to the corporate income tax. There is no statutory authority to assert tax upon INSURANCE COMPANY, an insurance company not doing business in Oklahoma.
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> …
>
> 8. Subjecting INSURANCE COMPANY to Oklahoma Income Tax violates the Due Process and Commerce Clauses of the U.S. Constitution and unconstitutionally discriminates in favor of instate over out-of-state businesses.
>
> …

[45] Pretrial Tr. at 6-7.

Section 2359(C) of Title 68 ("Exemption Statute"), states as follows, to-wit:

> Insurance companies paying, during or for the taxable year, a tax to this state on gross premium income shall be exempt from the provisions of [Oklahoma Income Tax Act][46] and the taxes levied thereby.[47]

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.[48] Statutory construction presents a question of law.[49] Tax exemptions, deductions, and credits depend entirely on legislative grace and are strictly construed against the exemption, deduction or credit.[50]

The Exemption Statute is an income tax exemption statute, not a tax levying statute; and as such, it must be strictly construed unless authority for the deduction is clearly expressed.[51]

The language of the Exemption Statute is clear and unambiguous and its terms should be construed using their ordinary meaning as directed by the Legislature.

The Protestant has stipulated that the Protestant is a corporation organized in Vermont on September 21, 2001, is licensed by the State of Vermont as a captive insurance company,[52] the Protestant did not provide any insurance coverage in Oklahoma during the Audit Period, the Protestant was not licensed to provide insurance coverage in Oklahoma during the Audit Period,[53] the Protestant did not pay any insurance premium tax in Oklahoma nor did it file any

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[46] OKLA. STAT. ANN. tit. 68, § 2351 et seq. (West 2008).

[47] OKLA. STAT. ANN. tit. 68, § 2359(C) (West 2001).

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

[49] *Id.* at ¶ 6.

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

[51] *Id.*

[52] *See* Revised Partial Stipulation No. 17, *infra*.

[53] Division's *Motion* Exhibit 97. *See* Revised Partial Stipulation No. 30, *infra*.

Oklahoma premium tax returns during the Audit Period,[54] and the Protestant did not file Oklahoma corporate income tax returns during the Audit Period.[55]

CONCLUSION ON MOTION ISSUE ONE

Pursuant to the Statute, there is authority to assert corporate income tax upon the Protestant.

DISCUSSION ON MOTION ISSUE TWO AND CROSS-MOTION ISSUE

Motion Issue Two
Whether imposing corporate income tax on Protestant unconstitutionally discriminates in favor of domestic over foreign corporations.

Cross-Motion Issue

That the exemption from corporate income tax, restricted under the Oklahoma statute to Oklahoma captive insurance companies, discriminates against non-Oklahoma captive insurance companies, such as Protestant, in violation of the U.S. Constitution.

The Supreme Court of Oklahoma held in *Dow Jones*,[56] "We agree with the Commission that, as an administrative agency, it is powerless to strike down a statute for constitutional repugnancy. Within the framework of Oklahoma's tripartite distribution of government powers, the authority to invalidate an unconstitutional enactment resides *solely* in the judicial department. Art. 7, § 1, Okl. Const.[57] confers on administrative agencies only that quantum of 'judicial

[54] *See* Revised Partial Stipulation No. 31, *infra*.

[55] *See* Revised Partial Stipulation No. 32, *infra*.

[56] *Dow Jones & Company, Inc. v. State ex rel. Oklahoma Tax Com'n*, 1990 OK 6, 787 P.2d 843. (Citations omitted).

[57] OK Const. Art. 7, § 1, (West 2006) states as follows, to-wit:

> The judicial power of this State shall be vested in the Senate, sitting as a Court of Impeachment, a Supreme Court, the Court of Criminal Appeals, the Court on the Judiciary, the State Industrial Court, the Court of Bank Review, the Court of Tax Review, and such intermediate appellate courts as may be provided by statute, District Courts, and such Boards, Agencies and Commissions created by the Constitution or established by statute as exercise adjudicative authority or render decisions in individual proceedings. Provided that the Court of Criminal Appeals, the State Industrial Court, the Court of Bank Review and the Court of Tax Review and such Boards, Agencies and Commissions as have been established by statute shall continue in effect, subject to the power of the Legislature to change or abolish said Courts, Boards, Agencies, or Commissions. Municipal Courts in cities or incorporated towns shall continue in effect and shall be subject to creation, abolition or alteration by the Legislature by general laws, but shall be limited in jurisdiction to criminal and traffic

power' which is necessary to support their exercise of adjudicative authority in individual proceedings brought before them. The power assigned to boards and commissions is not coextensive with that which is vested in the courts. Every statute is hence constitutionally valid until a court of competent jurisdiction declares otherwise."[58]

CONCLUSION ON MOTION ISSUE TWO AND CROSS-MOTION ISSUE

The Division's position is supported by ample Oklahoma case law. The Statute is deemed constitutionally valid until a court of competent jurisdiction determines otherwise.

FINDINGS OF MATERIAL FACTS AS TO WHICH THERE IS NO CONTROVERSY

Upon review of the file and records, including the *Motion*, *Reply*, *Cross-Motion*, *Response*, exhibits received into evidence, Revised Partial Stipulation of Facts, transcript of the hearing on oral arguments, and Conclusions of Law and discussion herein, the undersigned finds:

1. On September 21, 2001, INSURANCE COMPANY ("Protestant") was incorporated as a Vermont domestic corporation.[59] "The purposes of the Corporation are to engage in the business of insuring and reinsuring various types of risks as a captive insurer pursuant to Chapter 141 of Title 8 of the Vermont Statutes Annotated, conducting all activities necessary or incidental to the foregoing, and engaging in any other lawful business or activity."[60]

2. INSURANCE COMPANY insures various liability and property damage risks of FAST FOOD CHAIN and its affiliates, including but not limited to coverage for food-borne illnesses.[61]

3. INSURANCE COMPANY did not provide any insurance coverage in Oklahoma and was not licensed to provide insurance coverage in this state during the years at issue.[62]

4. INSURANCE COMPANY did not pay any insurance premium tax in Oklahoma nor did it file any Oklahoma premium tax returns during the years at issue.[63]

> proceedings arising out of infractions of the provisions of ordinances of cities and towns or of duly adopted regulations authorized by such ordinances.

[58] *See* Note 56, *supra*. (Citations omitted). (Emphasis original).

[59] Division's *Motion* Exhibit 49. *See* Revised Partial Stipulation 31, *infra*. Protestant is the sole member of LLC, a Vermont limited liability company.

[60] Division's *Motion* Exhibit 50.

[61] Division's *Motion* Exhibit 94.

[62] Division's *Motion* Exhibit 97. *See* Revised Partial Stipulation 30, *infra*.

[63] *See* Revised Partial Stipulation 31, *infra*.

MOTION AND CROSS-MOTION DISPOSITION

It is the ORDER of the OKLAHOMA TAX COMMISSION, based upon the facts and circumstances of this case that the Division's *Motion* should be granted as to Issue One and Issue Two.

It is further the ORDER of the OKLAHOMA TAX COMMISSION, based upon the facts and circumstances of this case, that the Protestant's *Cross-Motion* should be denied.

It is also the ORDER of the OKLAHOMA TAX COMMISSION that the Findings of Material Facts as to which there is no controversy should be adopted as set out herein.

HEARING ON THE MERITS

STIPULATION OF FACTS

On February 17, 2010, the parties filed Revised Partial Stipulation of Facts,[64] as follows, to-wit:

I. PREAMBLE

NOW, THEREFORE, it is stipulated for the purpose of the above-styled Protestant by and between the parties hereto, through their respective representatives, that the facts contained herein shall be taken to be true for purposes of the resolution of this controversy, including appeals, if any, and for no other purpose. The parties specifically reserve the right to offer such additional evidence as may from time to time be permitted by the authority having jurisdiction over this controversy. Further, the parties preserve all rights to object to any stipulation herein on any grounds, including, but not limited to, the ground of relevancy. Unless otherwise indicated, all stipulations hereinafter refer solely to the audit period, September 21, 2001 through January 1, 2006. All Exhibits to the Stipulation are made a part of and incorporated into the Stipulation although not physically attached thereto.

II. PROCEDURAL FACTS

1. By letter dated February 21, 2008, the Division proposed to assess corporate income tax, interest, and penalty against INSURANCE COMPANY for the audit period of September 21, 2001 through January 1, 2006 in the amount of Three Hundred Forty-two Thousand Five Hundred Forty-one Dollars and No. Cents ($342,541.00) in corporate income tax, One Hundred Ninety-Four Thousand Four Hundred Thirty-six Dollars and Eighty-two Cents ($194,436.82) in interest through June 13, 2008, and Seventeen Thousand One Hundred Twenty-seven Dollars

[64] The text of the stipulated facts is set out *in haec verba*. "***in haec vega***" (in heek v<<schwa>>r-b<<schwa>>). [Latin] In these same words; verbatim. BLACK'S LAW DICTIONARY (8TH ed. 2004), available at http://westlaw.com.

and No Cents ($17,127.00) in penalty for a total proposed assessment of Five Hundred Fifty-four Thousand One Hundred Four Dollars and Eighty-two Cents ($554,104.82). See Division's Exhibit 48.

2. INSURANCE COMPANY timely filed a formal Protest objecting to the proposed assessment by letter dated April 7, 2008. See Division's Exhibit 49.

3. On October 23, 2008, the Division filed its Notice of Revision with the court proposing a revised assessment against INSURANCE COMPANY for the audit period of September 21, 2001 through January 1, 2006 in the amount of Three Hundred Thirty-five Thousand and Five Hundred Twenty-five Dollars and No. Cents ($335,525.00) in corporate income tax, Two Hundred Eleven Thousand Three Hundred Forty-three Dollars and No. Cents ($211,343.00) in interest through November 15, 2008, and Sixteen Thousand Seven Hundred Seventy-six Dollars and No Cents ($16,776.00) in penalty for a total revised assessment of Five Hundred Sixty-three Thousand Six Hundred Forty-four Dollars and No Cents ($563,644.00). See Division's Exhibit 50.

4. INSURANCE COMPANY filed a revised protest with the court by letter dated November 25, 2008. See Division's Exhibit 51.

5. On October 6, 2009, the Division filed its second Notice of Revision with the court proposing a revised assessment against INSURANCE COMPANY with respect to royalties and interest received for the audit period of September 21, 2001 through January 1, 2006 in the amount of Two Hundred Thirty-seven Thousand Four Hundred Sixty-seven Dollars and No Cents ($237,467.00) in corporate income tax, One Hundred Eighty-five Thousand Twenty-one Dollars and No Cents ($185,021.00) in interest through November 30, 2009, and Eleven Thousand Eight Hundred Seventy-three Dollars and No Cents ($11,873.00) in penalty for a total revised assessment of Four Hundred Thirty-four Thousand Three Hundred Sixty-one Dollars and No Cents ($434,361.00). See Division's Exhibit 52.

6. The Protest of INSURANCE COMPANY is properly before the Commission.

III. GENERAL FACTS

7. FAST FOOD CHAIN ("FAST FOOD CHAIN"), an Ohio corporation, "itself and through subsidiaries and affiliates, owns and operates quick service restaurants under the name "FAST FOOD CHAIN" and "FAST FOOD CHAIN ALTERNATE NAME" ("FAST FOOD CHAIN Units"), and also franchises others ("FAST FOOD CHAIN Franchisees") to operate FAST FOOD CHAIN Units." See Division's Exhibit 20.

8. On January 1, 1989, FAST FOOD CHAIN ("FAST FOOD CHAIN") assigned its trademarks, patents, and copyrights (the "Intellectual Property") to SUBSIDIARY ("SUBSIDIARY"), a subsidiary of FAST FOOD CHAIN, pursuant of Assignments of Trademarks, Patents, and Copyrights. See Division's Exhibits 1, 2, and 3.

9. On January 1, 1989, SUBSIDIARY granted FAST FOOD CHAIN an exclusive license to use the Intellectual Property in connection with the U.S. operations of FAST FOOD CHAIN and FAST FOOD CHAIN franchisees. In return, FAST FOOD CHAIN paid SUBSIDIARY a license fee of three percent (3%) of sales of all owned and franchised units in the United States. See Division's Exhibit 4.

10. On December 16, 1996, SUBSIDIARY and FAST FOOD CHAIN entered into a First Amendment to License Agreement. See Division's Exhibit 7.

11. On December 16, 1996, SUBSIDIARY formed a subsidiary, SUBSIDIARY 2, a Delaware corporation, to which it granted an option to purchase the Intellectual Property in exchange for the common stock of SUBSIDIARY 2. See Division's Exhibit 8.

12. The accounting firm ACCOUNTING FIRM performed a valuation analysis of the Intellectual Property owned by SUBSIDIARY, as of December 16, 1996. See Division's Exhibit 9.

13. On December 23, 1996, SUBSIDIARY 2 assigned the option to SUBSIDIARY 3" a wholly-owned subsidiary of FAST FOOD CHAIN ("FAST FOOD CHAIN"). See Division's Exhibit 10.

14. On August 31, 1997, SUBSIDIARY 3 exercised its option to purchase the Intellectual Property from SUBSIDIARY and became the licensor of the Intellectual Property to FAST FOOD CHAIN. See Division's Exhibit 11.

15. On August 31, 1997, SUBSIDIARY assigned to SUBSIDIARY 3 all of SUBSIDIARY'S rights and obligations under the License Agreement and First Amendment to License Agreement between FAST FOOD CHAIN and SUBSIDIARY. See Division's Exhibit 12.

16. Effective January 1, 1998, FAST FOOD CHAIN and SUBSIDIARY 3 entered into an Amended and Restated License Agreement. See Division's Exhibit 13.

17. INSURANCE COMPANY ("INSURANCE COMPANY" or "Protestant"), a corporation organized in Vermont on September 21, 2001, is licensed by the State of Vermont as a captive insurance company and is the sole member of LLC, , a Vermont limited liability company. See Division's Exhibits 14, 16, 21, and 22.

18. SUBSIDIARY 3, the sole shareholder of INSURANCE COMPANY, organized LLC in September 2001. See Division's Exhibits 19 and 22.

19. On October 1, 2001, SUBSIDIARY 3 transferred the Intellectual Property to LLC. See Division's Exhibits 23, 24, and 25.

20. On October 1, 2001, SUBSIDIARY 3 assigned to LLC all of SUBSIDIARY 3's rights and obligations under the Amended and Restated License Agreement between SUBSIDIARY 3 and FAST FOOD CHAIN. See Division's Exhibit 26.

21. On October 1, 2001, SUBSIDIARY 3 transferred all of its interest in LLC to INSURANCE COMPANY. INSURANCE COMPANY was designated as the sole member of LLC. The Agreement further provides "[s]o long as the LLC has only one member, the LLC shall be disregarded as an entity separate from its member, solely for tax purposes…and the profits, losses, income, loss, deductions, credits and similar terms of the LLC shall be allocated accordingly." See Division's Exhibit 22.

22. As a disregarded entity LLC's income and deductions flowed through to INSURANCE COMPANY.

23. INSURANCE COMPANY issued its stock to SUBSIDIARY 3, Inc. in exchange for $250,000 and 100% of SUBSIDIARY 3's interest in LLC, LLC. See Division's Exhibit 28.

24. On October 1, 2001, FAST FOOD CHAIN and LLC entered into a Revised Amended and Restated License Agreement. See Division's Exhibit 20.

25. The License Agreement granted FAST FOOD CHAIN "the right to sublicense the rights granted herein to franchisees of FAST FOOD CHAIN Units and other specified permitted sublicensees." See Division's Exhibit 20.

26. During the audit period, LLC licensed the Intellectual Property to FAST FOOD CHAIN in exchange for payment of a royalty fee in the amount of three percent (3%) of the gross sales of all FAST FOOD CHAIN restaurants operating in the U.S., including restaurants owned and operated by unrelated franchisees, such as those in Oklahoma. See Division's Exhibit 20.

27. The Unit Franchise Agreement between FAST FOOD CHAIN and its third party franchisees is the same as the Unit Franchise Agreement between FAST FOOD CHAIN and restaurants owned by its corporate affiliate franchisees ("affiliate franchisees"). See Division's Exhibits 29 and 34.

28. During the audit period, FAST FOOD CHAIN sublicensed the Intellectual Property to both third party franchisees and affiliate franchisees in the U.S. and provided inspection and advisory services, in exchange for a royalty payment in the amount of 4% of each franchisees' [sic] monthly gross sales. See Division's Exhibit 34.

29. In Oklahoma, during the audit period, the Intellectual Property was sublicensed to third party franchisees only. There were no affiliate owned and operated FAST FOOD CHAIN restaurants in Oklahoma. See Division's Exhibit 43.

30. INSURANCE COMPANY did not provide any insurance coverage in Oklahoma and was not licensed to provide insurance coverage in the state during the years at issue.

31. INSURANCE COMPANY did not pay any insurance premium tax in Oklahoma no did it file any Oklahoma insurance premium tax returns during the years at issue.

32. INSURANCE COMPANY did not file Oklahoma corporate income tax returns for the years at issue.

33. INSURANCE COMPANY filed Vermont Captive Insurance Premium Tax Returns during the years at issue. See INSURANCE COMPANY's Exhibits F1-F5.

34. FAST FOOD CHAIN, which owned real property and tangible personal property in Oklahoma, filed 2001 through 2005 Oklahoma corporate income tax returns and reported all of its royalty income, including royalties paid by Oklahoma franchisees. See INSURANCE COMPANY'S Exhibits G1-G5.

35. Neither INSURANCE COMPANY nor LLC owned or leased real or tangible personal property, maintained an office, or had employees or officers in the state of Oklahoma during the years at issue.

36. Every restaurant licensed to use the Intellectual Property, whether a third party franchisee or an affiliate franchisee, is required to maintain and operate the restaurant in conformity with the procedures stated in FAST FOOD CHAIN Operational Procedures Manual (the "Manual"). See Division's Exhibit 55 (pages III, IV, XI, XIII, XIV).

37. The Manual is owned by FAST FOOD CHAIN and contains proprietary information owned by LLC.

38. The Manual is reprinted from time to time to accommodate changes made to procedures. Portions of the Manual stipulated to and included as an exhibit to the Stipulation are from the February 2008 reprint. However, the procedures stated in the February 2008 reprint are substantially the same as during the audit period.

39. As an example of the procedures contained in the Manual, the Manual's section, "GROUND BEEF AND FLAT GRILL" consists of thirty-five (35) pages of detailed instruction to prepare, hold and serve ground beef patties; to prepare meat for chili; to review grill position, maintenance and responsibilities; and to describe grill set-up and cleaning procedures; summarized as:

a. Quick Reference
b. Health and Safety
c. Bulk Meat Storage
d. Peel-Top Packaging
e. Free Standing Meat Well Set-up
f. Grill Set-up
g. Grill Towel/Sanitizer Pan Set-Up
h. Boiling and Chopping Chili Meat

i. Meat for Chili
j. Grill Position Responsibilities, including quality, service and cleanliness/ sanitation
k. Grill Operation – Loading Meat, including Free Standing Meat Well and Swing Away Grill Board Refrigerator
l. Grill Operating – Cooking
    i. Cooking Large Patties, including press sequence and requests for no salt
    ii. Cooking Small Patties, including requests for no salt
    iii. Grill Staging and Projection, including Pull-Up Window staging
    iv. Running a Wet Grill
    v. Cooking Grilled Chicken
    vi. Cooking Homestyle and Spicy Chicken
    vii. Cooking and Serving French Fries
    viii. Cooking Chicken Nuggets and Fish
m. Grill Operation – Serving
    i. Cheese Handling
    ii. Serving Ground Beef, including handling rush periods and the proper method for preparing hamburgers
    iii. Serving Chicken
    iv. Serving Baked Potatoes
    v. Serving Bacon
    vi. Serving Fish
n. Additional Grill Responsibilities, including miscellaneous responsibilities like enhancing productivity of grill operation
o. Taking Meat Temperatures
p. Post-Rush
    i. Changing Meat Pans
    ii. Restocking Meat
    iii. Product Temperatures
    iv. Chili Meat Storage on Service Line
    v. Chili Meat Cool Down
    vi. Counting/Weighing Meat Patties, including full and partial batches
    vii. Filling Out Freezer Bag Labels
    viii. Freezer Storage
    ix. Grease Buckets
    x. Cleaning the Grill
q. Close/Clean-up, including assembling and using the required tools and the proper cleaning of the grill.

FINDINGS OF MATERIAL FACTS AS TO WHICH THERE IS NO CONTROVERSY

Upon review of the file and records, including the *Motion*, *Reply*, *Cross-Motion*, *Response*, exhibits received into evidence, Revised Partial Stipulation of Facts, transcript of the hearing on oral arguments, and Conclusions of Law and Recommendation as to the *Motion* and *Cross-Motion* discussion herein, the undersigned finds:

40. On September 21, 2001, INSURANCE COMPANY ("Protestant") was incorporated as a Vermont domestic corporation.[65] "The purposes of the Corporation are to engage in the business of insuring and reinsuring various types of risks as a captive insurer pursuant to Chapter 141 of Title 8 of the Vermont Statutes Annotated, conducting all activities necessary or incidental to the foregoing, and engaging in any other lawful business or activity."[66]

41. INSURANCE COMPANY insures various liability and property damage risks of FAST FOOD CHAIN and its affiliates, including but not limited to coverage for food-borne illnesses.[67]

42. INSURANCE COMPANY did not provide any insurance coverage in Oklahoma and was not licensed to provide insurance coverage in this state during the years at issue.[68]

43. INSURANCE COMPANY did not pay any insurance premium tax in Oklahoma nor did it file any Oklahoma premium tax returns during the years at issue.[69]

ADDITIONAL FINDINGS OF FACT

Upon review of the file and records, including the transcript of the proceedings, the Revised Partial Stipulation of Facts, exhibits received into evidence, and briefs, the undersigned finds:

44. Under a Management Agreement[70] dated October 1, 2001, MANAGEMENT COMPANY. ("the Company") provided the following management and administrative services on behalf of LLC:

a. Maintain and reconcile the cash and investment accounts;
b. Maintain intercompany receivables;
c. Calculate license fee revenue;
d. Calculate interest on intercompany accounts;
e. Prepare financial statements customized to the Company's needs and provided within the Company's reporting deadlines;
f. Maintain applicable corporate files and records in accordance with Vermont regulations;

[65] Division's *Motion* Exhibit 49. *See* Revised Partial Stipulation 31, *infra.* Protestant is the sole member of LLC, a Vermont limited liability company. *See* Division's Hearing Exhibits 14, 16, 21, and 22.

[66] Division's *Motion* Exhibit 50.

[67] Division's *Motion* Exhibit 94.

[68] Division's *Motion* Exhibit 97. *See* Revised Partial Stipulation 30, *infra.*

[69] *See* Revised Partial Stipulation 31, *infra.*

[70] Protestant's Exhibit Z.

g. Maintain trademark records, including without limitation, records relating to quality control of the marks;
h. Take such other actions as may be required pursuant to the license agreement between FAST FOOD CHAIN and the Company;
i. Provide telephone support; and
j. Organize and participate in meetings with the Company.

45. LLC is a trademark protection company formed to separate the trademarks of the organization (FAST FOOD CHAIN) from other business risks of FAST FOOD CHAIN and to arrange for preservation of the value of the FAST FOOD CHAIN intellectual property, including but not limited to filing of infringement actions whenever and wherever necessary.[71]

46. During the Audit Period the Protestant (or LLC) did not have any employees in the State of Oklahoma or in any other state.[72]

47. The assets of the Protestant on a stand-alone basis consist of cash and cash equivalents held at various financial institutions, interest bearing notes issued to FAST FOOD CHAIN as well as related accrued interest and an investment interest in LLC.[73]

48. The assets of LLC on a stand-alone basis consist of cash and cash equivalents held at various financial institutions, Intellectual Property consisting of the FAST FOOD CHAIN trademarks, service marks, patents, copyrights, and unregistered copyrightable works, including operations manuals, MIS manuals, booklets, videos, posters, newspaper advertisements, ad slicks, miscellaneous newsletters, and computer software as well as accrued revenue on the intellectual property.[74]

49. The Principal Trademarks, Patents, and Copyrights owned by LLC, which are registered with the United States Patent and Trademark Office, include, but are not exclusive of the following,[75] to-wit:

FAST FOOD CHAIN & Girl Design	Registration	935,109
FAST FOOD CHAIN	Registration	935,110
Girl Design	Registration	936,803
"Quality Is Our Recipe"	Registration	981,735
"Old Fashioned Hamburgers"	Registration	1,007,170

[71] Response to Interrogatory No. 12 filed February 3, 2009.

[72] Hearing Tr. at 289.

[73] Response to Interrogatory No. 16 filed February 3, 2009.

[74] Response to Interrogatory No. 17 filed February 3, 2009.

[75] Division's Hearing Exhibits 1-3. *See* Division's Hearing Exhibits 20 and 32. As of June 10, 2005, "…FAST FOOD CHAIN has continued to register, renew and maintain the LLC Trademarks, Patents, and Copyrights, in the name and at the cost of LLC." Division's Hearing Exhibit 33.

Logo Registration 1,146,642

50. The Division's First Notice of Revision ("First Revision") filed October 23, 2008, allocated the premiums Protestant received from FAST FOOD CHAIN and its affiliates to Protestant's domiciliary state (Vermont), and assessed corporate income tax upon LLC's royalties received from FAST FOOD CHAIN under the License Agreement and interest paid by FAST FOOD CHAIN under several notes issued by Protestant and LLC to FAST FOOD CHAIN.[76]

51. The Division's Second Notice of Revision ("Second Revision") filed October 6, 2009, allowed Protestant's amortization of the Intellectual Property, which had been taken on the federal returns.[77]

52. Neither the substance of Protestant nor LLC is contested by the Division.[78]

53. The Division is not attempting to subject Protestant's insurance premiums to Oklahoma income tax or Oklahoma insurance premium tax.[79]

54. The Protestant reported one hundred percent (100%) of its insurance premiums to Vermont during the Audit Period.[80]

55. FAST FOOD CHAIN is obligated to remit to LLC the royalties based on a franchise's gross monthly sales report regardless of whether FAST FOOD CHAIN itself has received a royalty payment from that franchise.[81]

56. FAST FOOD CHAIN remits its royalty payment to LLC in one lump sum as permitted by the Licensing Agreement, but the lump sum is computed using the individual gross sales of each U.S. FAST FOOD CHAIN restaurant.[82]

57. The Division calculated the income tax owed by INSURANCE COMPANY based upon the documentation provided to the Division by FAST FOOD CHAIN on behalf of INSURANCE COMPANY which showed a breakdown of royalty income by state.[83]

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[76] Division's Hearing Exhibit 50. *See* Hearing Tr. at 295-297.

[77] Division's Hearing Exhibit 52.

[78] Hearing Tr. at 117-118.

[79] *See* Note 69, *supra*.

[80] Hearing Tr. at 117-118.

[81] Hearing Tr. at 98-100 and 145-146. *See* Division's Hearing Exhibit 20, Art. 8.1(a).

[82] *Id.*

[83] *Id.* *See* Note 80, *supra*. *See also* Division's Hearing Exhibits 42, 43, and 45.

58. The value of the Intellectual Property is directly tied to how the Intellectual Property fared in each individual restaurant operating under the FAST FOOD CHAIN system, including the Oklahoma franchises.[84]

59. INSURANCE COMPANY operates in multiple states through the licensing and use of the Intellectual Property in those states.[85]

60. The Intellectual Property was used and maintained in the State of Oklahoma during the Audit Period.[86]

61. FAST FOOD CHAIN executed six (6) "Notes"[87] to LLC, which state in pertinent part as follows, to-wit:

> On demand for value received, the undersigned, jointly and severally (if executed by two or more parties), promise to pay to the order of:
>
> LLC
> STREET ADDRESS
> CITY, STATE ZIP CODE
>
> $* with interest thereon, from the date hereof to the business day when the note is paid is full, at a rate of *% per annum.

DATE	AMOUNT	INTEREST RATE
03/08/2002	$15,300,000.00	4.75%
06/11/2002	$18,000,000.00	4.75%
02/19/2003	$16,000,000.00	4.25%
02/21/2003	$15,000,000.00	4.25%
03/05/2003	$17,000,000.00	4.25%
03/21/2003	$17,000,000.00	4.25%

62. FAST FOOD CHAIN executed three (3) "Notes"[88] to the Protestant which state in pertinent part as follows, to-wit:

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[84] *See* Notes 81-83, *supra.*

[85] *Id.*

[86] *Id.*. *See* Division's Hearing Exhibit 53. *See also* Hearing Tr. at 331-347.

[87] Division's Hearing Exhibit 56. The "Notes" are executed on behalf of FAST FOOD CHAIN by VICE PRESIDENT, Executive Vice President and Chief Financial Officer and on behalf of the Protestant by SENIOR VICE PRESIDENT, Senior Vice President and Treasurer.

[88] Division's Hearing Exhibit 57. The "Notes" are executed on behalf of FAST FOOD CHAIN by VICE PRESIDENT, Executive Vice President and Chief Financial Officer and on behalf of the Protestant by SENIOR VICE PRESIDENT, Senior Vice President and Treasurer.

On demand for value received, the undersigned, jointly and severally (if executed by two or more parties), promise to pay to the order of:

INSURANCE COMPANY
STREET ADDRESS
CITY, STATE ZIP CODE

$* with interest thereon, from the date hereof to the business day when the note is paid is full, at a rate of *% per annum.

DATE	AMOUNT	INTEREST RATE
12/04/2001	$16,000,000.00	5.00%
04/01/2002	$24,000,000.00	4.75%
02/14/2003	$ 8,850,000.00	4.25%

MOTION AND CROSS-MOTION
CONCLUSIONS OF LAW

1. Pursuant to the Statute, there is authority to assert corporate income tax upon the Protestant.

2. The Division's position is supported by ample Oklahoma case law. The Statute is deemed constitutionally valid until a court of competent jurisdiction determines otherwise.

HEARING ON THE MERITS
CONCLUSIONS OF LAW

3. The Oklahoma Tax Commission is vested with jurisdiction over the parties and subject matter of this proceeding.[89]

4. The Oklahoma Income Tax Act ("Act")[90] imposes an income tax of six percent (6%) upon the Oklahoma Taxable Income of every corporation doing business in Oklahoma or deriving income from sources within the state.[91]

5. The Tax Commission has promulgated rules as provided by law to facilitate the administration, enforcement, and collection of taxes and other levies enacted by the Oklahoma Legislature with respect to income.[92]

[89] OKLA. STAT. ANN. tit. 68, § 221(D) (West Supp. 2009).

[90] OKLA. STAT. ANN. tit. 68, § 2350 et seq. (West 2008).

[91] OKLA. STAT. tit. 2355(D) (West Supp. 2005).

[92] OKLA. ADMIN. CODE § 710:50-1-1.

6. 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.[93]

7. All adjustments provided for under Oklahoma Income Tax Statutes are made from the starting point of Federal Taxable Income.[94]

8. Bright-line physical presence requirement required by the Commerce Clause for a state or other taxing authority to impose sales and use taxes does not extend to income taxes which may be imposed on a non-resident taxpayer with a substantial nexus to the State.[95]

9. "Unitary Income" means income derived from the conduct of each separate business in more than one state, all the factors of which are essential to determining the ultimate gain derived from the business enterprise as a whole, and not from its component parts which are too closely connected and necessary to each other to justify division or separate allocation. Each corporation must calculate its own Oklahoma Taxable Income/Loss separately, even when included in a Consolidated Return.[96]

10. Non-resident taxpayer had substantial nexus with state to satisfy Commerce Clause requirements for imposition of corporate income tax on royalties for trademark and other intangibles generated by parent corporation's retailing operations in state; real source of taxpayer's income was not licensing agreement but retail customers in the state, taxpayer received benefits of an orderly society in which parent corporation conducted its retail operations, taxpayer received protection, benefits, and opportunities from state, and income tax was rationally related to those benefits.[97]

11. Income or loss derived from a unitary business enterprise shall be apportioned to Oklahoma on the basis of the average of three factors consisting of property, payroll, and sales or gross revenue.[98]

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[93] OKLA. STAT. ANN. tit. 75, § 250 et seq. (West 2002).

[94] OKLA. ADMIN. CODE § 710:50-17-51 (June 25, 2004).

[95] *Geoffrey, Inc. v. Oklahoma Tax Com'n*, 2006 OK CIV APP 27, 132 P.3d 632.

[96] OKLA. ADMIN. CODE § 710:50-17-70. *See Matter of Income Tax Protest of Ashland Exploration, Inc.*, 1988 OK 23, 751 P.2d 1070.

[97] *See* Note 95, *supra*.

[98] OKLA. STAT. tit. 68, § 2358 (A)(5) (West Supp. 2004).

See OKLA. ADMIN. CODE § 710:50-17-71 (June 25, 2001):

> Income or loss derived from a unitary business enterprise shall be apportioned to Oklahoma on the basis of the average of three factors consisting of property, payroll and sales or gross revenue.
>
> …
>
> (1) **Sales factor**.

12. Legislative intent controls statutory interpretation.[99] Intent is ascertained from the whole act in light of its general purpose and objective[100] considering relevant provisions together to give full force and effect to each.[101] The Court presumes that the Legislature expressed its intent and that it intended what it expressed.[102]

13. Statutes are interpreted to attain that purpose and end[103] championing the broad public policy purposes underlying them.[104]

(A) **Sales factor**. The sales factor shall include only sales and does not include sales or revenue which are separately allocated.

(i) Oklahoma does not allow receipts from items other than sales to be included in the formula even though other types of income (royalties, interest, capital gains, and other income) are included in the apportioned income.

(ii) The provisions of (A) and (A)(i) of this paragraph apply to the sales factor for most corporations, with the exception of gross receipts being used as a basis for a financial organization or other organizations whose sales do not represent their principal activity.

(B) **Throwback of Oklahoma sales**. If taxpayer is not doing business in the destination state of the shipment, then those sales of tangible personal property are considered to have a situs in Oklahoma if the property is shipped from an office, warehouse, factory or other place of storage in Oklahoma.

…

(2) **Property factor**.

(A) **Original costs (average).** The property factor is the average value at original cost of the taxpayer's real and tangible personal property owned or rented and used in this State during the tax period to the total average of all real and tangible personal property owned or rented and used everywhere.

…

(C) **Rental property**. Rental property is valued at eight (8) times the net annual rent expense.

(D) **Property separately allocated**. Property, the income from which is separately allocated in 68 O.S. §2358(A)(4), shall not be included in determining the property factor.

(3) **Payroll factor**.

(A) **Payroll factor**. The numerator is the total compensation for services rendered in the state during the tax period, and the denominator is the total compensation for services rendered everywhere during the tax period.

…

(C) **Officers**. Officers' salaries, wages and other compensation are not part of the computation of the payroll factor, for tax years beginning after December 31, 1982.

…

[99] *World Publishing v. Miller*, 2001 OK 49, ¶7, 32 P.3d 829.

[100] *Id.* at ¶7.

[101] *Id.* at ¶7.

[102] *Id.* at ¶7.

[103] *Id.* at ¶7.

[104] *Id.* at ¶7.

14. Only where the legislative intent cannot be ascertained from the statutory language, i.e. in cases of ambiguity or conflict, are rules of statutory construction employed.[105] However, where the statutory language is ambiguous or uncertain, a construction is applied to avoid absurdities.[106]

15. In all proceedings before the Tax Commission, the taxpayer has the burden of proof.[107] A proposed assessment is presumed correct and the taxpayer bears the burden of showing that it is incorrect and in what respects.[108]

16. The "Unitary Business Rule" is a recognition of two imperatives:

> . . . the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the States' authority to tax value or income which cannot in fairness be attributed to the taxpayer's activities within the State.[109]

DISCUSSION

The Protestant's position is best stated by ATTORNEY 1, "I also, Your Honor, want to preserve for the record that we contend that *Geoffrey v. Oklahoma* is wrong. We know you're bound by it. But should this case be appealed for some reason to the Supreme Court, they haven't dealt with that yet. So we contend that the case is wrong. No physical presence, no taxation, period. And that's exactly what they're relying on."[110] (Emphasis added.)

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[105] *Id.* at ¶7.

[106] *Id.* at ¶7.

[107] 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.

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

[109] *Matter of Income Tax Protest of Griffin Television, Inc.*, 1994 OK 35, 877 P.2d 588.

[110] Hearing Tr. at 14.

With the Protestant's position so succinctly stated, and acknowledging the Administrative Law Judge is bound by the case, the Oklahoma Court of Civil Appeals ruling in *Geoffrey, Inc. v. Oklahoma State Com'n*, 2006 OK CIV APP 27, 132 P.3d 632 ("*Oklahoma Geoffrey*") will be used as a starting point.

In *Oklahoma Geoffrey*, the Oklahoma Court of Civil Appeals held that the bright-line physical presence requirement required by the Commerce Clause for a state or other taxing authority to impose sales and use taxes does not extend to income taxes, which may be imposed on a non-resident taxpayer with a substantial nexus to the state.[111] Since much of the Protestant's briefs, exhibits, and witness testimony, goes to the question of "why the taxation of a company with no physical presence violates the Commerce Clause,"[112] that aspect of the Protestant's position will not be addressed in detail herein.

In *Oklahoma Geoffrey*,[113] the taxpayer did not dispute that it was a "Unitary Business Enterprise" and did not raise any error with the approval of the application of the "Modified One-Factor Apportionment Formula." Those oversights were not repeated by the Protestant in this matter.

A.

FIRST ISSUE

Is the Protestant a Unitary Business?

DISCUSSION ON FIRST ISSUE

Protestant asserts it is not a "Unitary Business" and LLC's passive investments were maintained and administered in Vermont, its commercial domicile, where administrative services were performed by MANAGEMENT COMPANY.[114] Further, Protestant asserts that neither LLC nor the Protestant owned or leased real or tangible personal property, maintained an office, or had employees in any state. LLC "merely holds various passive investments and does not actively engage in business activity."[115] Based under these uncontroverted facts, Protestant concludes that a company such as LLC, whose only activity is holding passive investments, does not derive "unitary income…from the conduct of each separate business in more than one state" or—applying the unitary standards described by the Oklahoma Supreme Court in *Ashland*

[111] *Geoffrey, Inc. v. Oklahoma Tax Commission*, 2006 OK CIV APP 27, 132 P.3d 632. *See Geoffrey, Inc. v. South Carolina Tax Com'n*, 313 S.C. 15, 437 S.E. 2d 13 (S.C.1993). As a side note, ATTORNEY represented Geoffrey in both cases.

[112] Hearing Tr. at 219-241.

[113] *See* Note 111, *supra.*

[114] Protestant's Exhibit Z.

[115] Protestant's Exhibit H.

Exploration[116] "LLC did not have "divisional operations conducted in one state [which] benefit or are benefited by operations in…other states, where the various aspects are interdependent and of …mutual benefit." Thus, LLC's income was not derived from a unitary business enterprise. The Protestant asserts that the Division's auditors either misunderstood or misrepresented the Commission's definition of "Unitary Income"[117] and there is no separate standard in Oklahoma for determining whether a company, as opposed to a group of related companies, is engaged in a unitary business. LLC, which has no employees and "merely holds various investments and does not actively engage in business activity," cannot, by definition, earn "unitary income" as defined by in the Commission's Rule.[118]

In response, the Division also cites *Ashland*[119] for the proposition that, "A business that operates in more than one state is a 'unitary business' for income tax purposes when operations conducted in one state benefit and are benefited by operations in one or more other states where the various aspects are so interdependent and of such mutual benefit that they are considered to form one integral business."[120] It is undisputed that the Intellectual Property owned by LLC was licensed during the Audit Period by FAST FOOD CHAIN and was physically used by franchises, whether it was an "Affiliate-Owned Franchise" or a "Third Party Franchise" in all fifty (50) states and the District of Columbia, including the State of Oklahoma,[121] and FAST FOOD CHAIN is obligated to remit to LLC the royalties based on a franchise's gross monthly sales report regardless of whether FAST FOOD CHAIN itself has received a royalty payment from that franchise.[122]

The facts clearly establish that LLC operates in more than one state.[123] The use of LLC's Intellectual Property in one state benefits and is benefited by the use of its Intellectual Property in other states. As FINANCE PROFESSOR testified, FAST FOOD CHAIN wants "…to provide consistent service and a consistent branding across all of their restaurants" as a means to create and increase the value of the Intellectual Property.[124]

LLC's activities relating to the maintenance, preservation, and continued development of the Intellectual Property are so interdependent and of such mutual benefit that they comprise one

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[116] *Matter of Income Tax Protest of Ashland Exploration, Inc.*, 1988 OK 23, 751 P.2d 1070.

[117] *See* Note 96, *supra.*

[118] Protestant's Hearing Exhibit H.

[119] *See* Note 116, *supra.*

[120] *Id.*

[121] *See* Notes 81-86, *supra.*

[122] Hearing Tr. at 98-100 and 145-146. *See* Division's Hearing Exhibit 20, Art. 8.1(a).

[123] Hearing Tr. at 306.

[124] Hearing Tr. at 344-345.

integral business.[125] CORPORATE COUNSEL testified that intellectual property derives value through constant change and evolution, specifically that the value of LLC's Intellectual Property "…is significantly diluted if it's fixed in time and doesn't continue to evolve as the market evolves."[126]

It is the corporate taxpayer's burden to prove, by clear and cogent evidence, that it is not a unitary business subject to apportionment of income for tax purposes.[127]

CONCLUSION ON FIRST ISSUE

The Protestant has failed to meet its burden of proof that it is not a unitary business subject to apportionment of income for tax purposes.

B.

COMBINED SECOND ISSUE

Does the Protestant have substantial nexus with the State of Oklahoma required by the Commerce Clause to impose income tax? Does the Protestant have minimum contacts to satisfy due process requirements for the imposition of income tax?

DISCUSSION ON COMBINED SECOND ISSUE

As to the combined Second Issue, the Protestant asserts that neither the Protestant nor LLC derived income from sources within the State of Oklahoma. The royalty payments by FAST FOOD CHAIN to LLC are governed by the Revised Amended and Restated License Agreement ("License Agreement"). The License Agreement grants FAST FOOD CHAIN the right to use and sublicense the use of FAST FOOD CHAIN Intellectual Property in return for a license fee of three percent (3%) of FAST FOOD CHAIN gross sales from Affiliate Franchises and Third Party Franchises owned by FAST FOOD CHAIN U.S. restaurants. Further, Protestant asserts that under the plain terms of the Unit Franchise Agreement, LLC does not receive any royalty payments from Oklahoma franchises and, therefore, did not receive income from Oklahoma sources.

The Division contends that it may constitutionally impose an income tax on taxpayers, such as the Protestant, who have no in-state physical presence but who generate income from within the state through the use of its Intellectual Property in the State of Oklahoma. Commonly

[125] Revised Stipulation 20. *See* Division's Hearing Exhibit 20, Art 5.1 and Art. 5.4.

[126] Hearing Tr. at 97.

[127] *See* Note 111, *supra.*

referred to as "economic nexus," this issue was settled in *Oklahoma Geoffrey*, which held, "The imposition of Oklahoma income tax attributable to royalty earned by Geoffrey under a licensing agreement which based that royalty on the sales generated within the State of Oklahoma by Geoffrey's licensee does not offend due process or unduly burden interstate commerce."[128] A state is limited in the income taxes it may impose by both the Due Process and the Commerce Clauses of the U.S. Constitution. Although "closely related," they are "analytically distinct," reflecting "difference constitutional concerns."[129]

The Protestant responds that LLC's royalties from FAST FOOD CHAIN differ in significant respects from Geoffrey's royalties. While Geoffrey licensed its parent, "Toys 'R' Us", to use the Geoffrey trademarks in its Oklahoma stores, FAST FOOD CHAIN—not LLC—received royalties from sublicensing the use of the FAST FOOD CHAIN trademarks to Oklahoma franchisees, non of whom were related to FAST FOOD CHAIN (or LLC). The Division's Voluntary Compliance Initiative undertaken on September 8, 2006, as a result of the decision in *Oklahoma Geoffrey,*[130] did not apply to companies receiving royalties from unrelated franchisees but only to companies "licensing intangible property to related parties operating in Oklahoma."[131]

The Oklahoma Court of Civil Appeals in *Oklahoma Geoffrey*[132] citing *South Carolina Geoffrey*[133] found that (1) the real source of Geoffrey's income is not a paper agreement, but the Oklahoma customers of Toys, Inc.; (2) by providing an orderly society in which Toys, Inc. conducts business, Oklahoma has made it possible for Geoffrey to earn income pursuant to its licensing agreement; (3) Geoffrey has received protection, benefits, and opportunities from Oklahoma as manifested by the fact that it earns income in this State; and (4) the tax is rationally related to these protections, benefits, and opportunities because only that portion of Geoffrey's income generated from the use of its intangibles within Oklahoma is being taxed.[134]

The Protestant has maintained from the beginning of this matter that it does not agree with *Geoffrey Oklahoma*[135] and that the case is wrong—"No physical presence, no taxation, period."[136] However, in the State of Oklahoma it is a settled question of law that the "[b]right-line physical presence requirement required by the Commerce Clause for a state or other taxing

[128] *See* Note 111, *supra.* (Citations omitted.)

[129] *Quill v. North Dakota*, 504 U.S. 298, 305, 112 S.Ct. 1904 (1992).

[130] *See* Note 111, *supra.*

[131] Protestant's Hearing Exhibit O.

[132] *See* Note 111, *supra.*

[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] *See* Note 110, *supra.*

authority to impose sales and use taxes does not extend to income taxes, which may be imposed on a non-resident taxpayer with a substantial nexus to the State."[137] It is the licensing of the Intellectual Property for use in the State of Oklahoma and deriving income from its use in the State of Oklahoma that is the basis of taxation, not the relationship between the licensee and the licensor. As stated in *Oklahoma Geoffrey,*[138] "…[T]he real source of Geoffrey's income is not a paper agreement, but the Oklahoma customers of Toys, Inc.… The imposition of Oklahoma income tax attributable to royalty earned by Geoffrey under a licensing agreement which based that royalty on the sales generated within the State of Oklahoma by Geoffrey's licensee does not offend due process or unduly burden interstate commerce.…"

LLC earned income from the use of the Intellectual Property in the State of Oklahoma as evidenced by the fact that (1) LLC licensed FAST FOOD CHAIN to sublicense the Intellectual property anywhere within the U.S., including the State of Oklahoma; (2) FAST FOOD CHAIN did sublicense the Intellectual Property in Oklahoma; (3) LLC acquiesced to the use of its Intellectual Property in the State of Oklahoma; and (4) FAST FOOD CHAIN paid LLC a percentage of the gross sales generated by each Oklahoma FAST FOOD CHAIN restaurant pursuant to the Licensing Agreement. LLC has nexus with the State of Oklahoma because it derives income from Oklahoma sources, not because of any relationship with another entity.

CONCLUSION ON COMBINED SECOND ISSUE

The Protestant has failed to meet its burden of proof that it does not have a substantial nexus with the State of Oklahoma required by the Commerce Clause to impose income tax. The Protestant has failed to meet its burden of proof that it does not have minimum contacts to satisfy due process requirements for the imposition of income tax by the State of Oklahoma.

C.

THIRD ISSUE

Does the proposed corporate income tax assessment fairly apportion the income attributable by the Division to the State of Oklahoma?

DISCUSSION ON THIRD ISSUE

The Protestant's position is that even if any of LLC's royalty income is found to be apportionable, the Division's approach results in the apportionment of income to the State of Oklahoma that is out of all appropriate proportion to, and which does not fairly represent the business, if any, conducted by LLC in the State of Oklahoma. The Protestant relies on the testimony of CPA to illustrate that the Division's use of a single factor to apportion LLC's income results in Oklahoma apportionment factors that are 600% to 2300% greater than the apportionment factors reported on FAST FOOD CHAIN 2001 through 2005 Oklahoma returns,

[137] *See* Note 111, *supra.*

[138] *Id.*

which CPA characterized as distortion.[139] CPA suggested that the most reasonable resolution of this issue would be to recalculate FAST FOOD CHAIN Oklahoma tax liability by disallowing the deductions for royalties paid to LLC, an approach many states have taken.[140] LAW PROFESSOR agreed, "…but the irony…is…the Division is attempting to collect more tax than if FAST FOOD CHAIN had owned the IP itself."[141]

Alternatively, CPA testified that since LLC's income was derived from the Intellectual Property, that such property should have been included in the denominator of the Property Factor.[142] In support of this proposition, the Protestant states that Courts in other states have permitted the inclusion of intangible assets in the apportionment computation under discretionary authority similar to Section 2358(A)(5), to more accurately reflect the income of the company which derived a substantial portion of its income from intangible property.[143]

The Division responds that the plain of the Statute allows the Commission to modify the formula when its use would result in net income being attributed to Oklahoma which is "out of all appropriate proportion to the property owned and/or business transacted within this state" through "elimination, substitution, or use of additional factors, or reduction or increase in the weight of such prescribed factors."[144]

An examination of the Protestant's three (3) factors led the Division to conclude that application of the standard three-factor apportionment formula would grossly distort the Oklahoma apportionable income of the Protestant.[145] The Division determined that during the Audit Period, the Protestant's property and payroll factors were zero.[146] Based on that determination, the Division applied a modified one-factor apportionment formula in accordance with Section 2358(A)(5) ("Statute"),[147] using only the sales factor in order to accurately reflect the Protestant's apportionable Oklahoma income.[148] By eliminating the property and payroll

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[139] Hearing Tr. at 196-197. *See* Note 22, *supra.*

[140] Hearing Tr. at 198-199. *Id.*

[141] Hearing Tr. at 240.

[142] Hearing Tr. at 190.

[143] *See Crocker Equipment Leasing, Inc. v. Oregon Department of Revenue*, 838 P.2d 552, where the Oregon Supreme Court held (1) statutory formula did not fairly represent extent of taxpayer's business activity in state, and (2) taxpayer's proposal to include intangibles in property factor was reasonable method of apportioning income, but this case is easily distinguishable due to the nature and composition of the taxpayer's business versus the Protestant's business in this matter.

[144] *See* Note 98, *supra.*

[145] Hearing Tr. at 289-291.

[146] *Id.*

[147] *See* Note 98, *supra.*

[148] *See* Note 146, *supra. See also* Note 111, *supra.*

factors, the Division has attributed a reasonable portion of income that most accurately reflects LLC's economic nexus to the State of Oklahoma.

The Statute provides, "The sales factor is a fraction, the numerator of which is the total sales or gross revenue of the taxpayer in this state during the tax period, and the denominator of which is the total sales or gross revenue of the taxpayer everywhere during the tax period."[149] The sales factor may include income other than sales where gross receipts are "used as a basis for a financial organization or other organizations whose sales do not represent their principal activity."[150]

The Division determined that the Protestant's sales factors had numerators and denominators for the Audit Period[151], as follows, to-wit:

YEAR	SALES IN OK (NUMERATOR)	SALES EVERYWHERE (DENOMINATOR)	OKLAHOMA RATIO
2001	282,307.00	47,157,394.00	0.005986
2002	1,205,061.00	207,384,178.00	0.005811
2003	1,254,687.00	217,620,152.00	0.005765
2004	1,416,440.00	234,470,739.00	0.006041
2005	1,381,541.00	231,413,458.00	0.005970

This use of a single-factor apportionment formula is supported by the law as applied to the facts in this case. The Protestant has argued that the application of a single-factor apportionment formula grossly distorts the Protestant's apportionable income based on a comparison of FAST FOOD CHAIN apportionment factor to the apportionment factor applied to the Protestant. CPA testified that the apportionment factor used by the Division was 600% to 2300% greater than the apportionment factor used by FAST FOOD CHAIN.[152] One solution suggested by CPA would be to eliminate FAST FOOD CHAIN deduction of the three percent (3%) royalty paid to LLC. CPA's suggestion is problematic. First, LLC owns the Intellectual Property, not FAST FOOD CHAIN. The Protestant spent a tremendous amount of time and effort during the hearing to establish that LLC and the Protestant were "legitimate" entities, even though the Division was not contesting the "legitimacy" of either entity and during the hearing the Division stipulated to the validity of the Protestant.[153] Accordingly, the comparison between FAST FOOD CHAIN and the Protestant is irrelevant. It is like comparing apples to oranges. Secondly, as pointed out by the Division, "Combined Filing" as used by the Protestant is not

[149] *See* Note 98, *supra.*

[150] OKLA. ADMIN. CODE § 710:50-17-71(1)(A)(ii).

[151] Division's Hearing Exhibit 45.

[152] Hearing Tr. at 196.

[153] Hearing Tr. at 121.

allowed in Oklahoma. A taxpayer may file a consolidated return in the State of Oklahoma, but that is at the taxpayer's election.[154] Even under consolidated filing, the income or loss of each company contained in the consolidated return is calculated based on its own factors.[155]

CONCLUSION ON ISSUE THREE

The Protestant has failed to meet its burden of proof that the proposed corporate income tax assessment does not fairly apportion the income attributable by the Division to the State of Oklahoma.

D.

FOURTH ISSUE

Did the Division correctly include the Protestant's interest income from the Demand Notes in total apportionable income?

DISCUSSION ON FOURTH ISSUE

The Division assessed as apportionable income interest paid by FAST FOOD CHAIN, an Ohio corporation with its principal place of business in Dublin, Ohio, to the Protestant and LLC

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[154] OKLA. STAT. ANN. tit. 68, § 2367 (West 2001):

> The provisions of the Internal Revenue Code, 26 U.S.C., Section 1 et seq., applicable to consolidated corporate income tax returns, shall not apply to taxpayers under this act, except that:
>
> 1. If two or more corporations file federal income tax returns on a consolidated basis, and if all of such corporations derive all of their income from sources within Oklahoma, then such corporations shall be required to file consolidated returns for purposes of determining their Oklahoma income tax liability.
>
> 2. If two or more corporations file federal income tax returns on a consolidated basis, and if one or more of such corporations derive a portion of their income from sources outside the State of Oklahoma, then such corporations shall not be required to file consolidated returns for purposes of determining their Oklahoma income tax liability except as hereinafter provided in subsection 3 of this section.
>
> 3. The Oklahoma Tax Commission shall permit an affiliated group of corporations described in subsection 2 of this section to elect to file a consolidated return for Oklahoma income tax purposes provided such group files an appropriate election in accordance with regulations to be promulgated by the Tax Commission. If an affiliated group of corporations elects to file a consolidated Oklahoma income tax return under the provisions of this section, such election shall be binding and the affiliated group of corporations shall be required to file a consolidated Oklahoma income tax return for future tax years unless the Oklahoma Tax Commission releases the affiliated group of corporations from such election. If an affiliated group of corporations elects to file a consolidated Oklahoma income tax return under the provisions of this subsection, the group's consolidated income, loss or deductions shall be determined on a component member by component member basis in accordance with the provisions of Sections 2358 and 2362 of this title.

[155] *Id.*

pursuant to Nine (9) Demand Notes.[156] The Protestant states that the interest income from the Demand Notes was not derived from Oklahoma sources[157] and the Division's witnesses offered no evidence to support a finding that interest paid by FAST FOOD CHAIN on Demand Notes was derived from Oklahoma sources.

It is the Division's position that pursuant to the Statute, "Net income or loss as used in this paragraph includes that derived from patent or copyright royalties, purchase discounts, and *interest on accounts receivable relating to or arising from a business activity*, the income from which is apportioned pursuant to this subsection, including the sale or other disposition of such property and any other property used in the unitary enterprise."[158] (Emphasis added.)

SUPERVISOR testified that "The evidence in this case that was provided to us by the taxpayer showed that all the money that the royalty income generated was loaned back to FAST FOOD CHAIN in the form of demand notes."[159]

CONCLUSION ON FOURTH ISSUE

The Protestant has failed to meet its burden of proof that the Division's inclusion of interest income from the Demand Notes in total apportionable income was incorrect and in what respects.

HEARING ON THE MERITS

DISPOSITION

It is the ORDER of the OKLAHOMA TAX COMMISSION, based upon the facts and circumstances of this case, that the protest to the "Second Revised" income tax assessment for the Audit Period should be denied.

It is further ORDERED that the total amount of income tax and penalty assessed for the Audit Period should be fixed as the Protestant's deficiency and those amounts should be determined as due and owing, including interest, accrued and accruing.[160]

OKLAHOMA TAX COMMISSION

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[156] *See* Notes 87-88, *supra.*

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

[158] *See* Note 98, *supra.*

[159] Hearing Tr. at 295.

[160] The Protest includes what amounts to a Petition for Waiver of Penalty and Interest, if it was determined that the Protestant was subject to income tax. The Office of Administrative Law Judges does not have the authority to waive penalty and/or interest. The authority to waive penalty and/or interest rests exclusively with the Commissioners or their designee, pursuant to OKLA. STAT. ANN. tit. 68, § 220 (West 2001).

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.