JURISDICTION: **OKLAHOMA TAX COMMISSION**
CITE: **2011-03-08-04 / NON-PRECEDENTIAL**
ID: **P-10-729-H**
DATE: **MARCH 8, 2011**
DISPOSITION: **DENIED**
TAX TYPE: **INCOME**
APPEAL: **NO APPEAL TAKEN**

FINDINGS OF FACT AND CONCLUSIONS OF LAW

HUSBAND AND WIFE ("Protestants") appear through CPA, CPA. The Individual Income Tax Section of the Compliance Division ("Division"), Oklahoma Tax Commission, appears through OTC ATTORNEY, Assistant General Counsel, Office of General Counsel, Oklahoma Tax Commission.

PROCEDURAL HISTORY

On August 4, 2010, 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 Office of Administrative Law Judges*.[2] On August 18, 2010, a letter was mailed to the parties stating this matter had been assigned to ALJ, Administrative Law Judge, and docketed as Case Number P-10-729-H. The letter also advised the parties a Notice of Prehearing Conference would be sent by mail and enclosed a copy of the *Rules of Practice and Procedure Before the Office of Administrative Law Judges*.[3] On August 20, 2010, OTC ATTORNEY 2 and OTC ATTORNEY filed an Entry of Appearance as Co-Counsel of record for the Division. On August 31, 2010, the Notice of Prehearing Conference was mailed to the parties setting the prehearing conference for September 13, 2010, at 10:30 a.m.

On September 2, 2010, OTC ATTORNEY 2 filed a Withdrawal of Counsel as Co-Counsel of record for the Division. On September 9, 2010, the Division filed a Status Report In Lieu of Prehearing Conference. On September 13, 2010, the Prehearing Conference Order was issued in accordance with the parties' request that this matter be submitted on stipulations and briefs.

On October 7, 2010, the parties filed Joint Stipulation of Facts and Issues, with Exhibits A through J, attached thereto.

On November 1, 2010, the Protestants' Brief-In-Chief was filed with the Court Clerk.[4] On November 15, 2010, the Brief of the Compliance Division was filed with the Court Clerk.

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

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

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

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

On November 24, 2010, the Protestants' Reply to Commission's Response to Protestants' Brief-In-Chief was filed with the Court Clerk. The record in this matter was closed and this case submitted for decision on November 29, 2010.

STIPULATION OF FACTS

On October 7, 2010, the parties filed Joint Stipulation of Facts and Issues[5], as follows, to-wit:

1. On or about July 7, 2006, Protestants filed their 2005 Oklahoma Income Tax Return. Protestants did not claim the Oklahoma Capital Gains Deduction on their original 2005 return. The 2005 return is attached hereto as **Exhibit A**.

2. On May 4, 2010, an assessment letter was issued to Protestants which assessed additional income tax for tax year 2005 in the amount of $269.00. The assessment was based on a notice of adjustment received from the Internal Revenue Service, Report No. XXXXXXX. The assessment letter is attached hereto as **Exhibit B**.

3. On or about May 18, 2010, Protestants submitted a letter stating that the IRS audit adjustment was based on capital gains received from a disposition of COMPANY corporate stock. Enclosed with the letter was a Form 561 on which the Protestants claimed the Oklahoma Capital Gain Deduction in the amount of $3,916.00. The May 18, 2010, letter is attached hereto as **Exhibit C**.

4. In a letter dated June 4, 2010, the Division responded to Protestants' May 18, 2010, letter. The Division's letter requested additional information to verify that a sale of corporate stock took place. The June 4, 2010 letter is attached hereto as **Exhibit D.** Additional information was requested because the Division's review of the 2006 512-S forms filed by COMPANY showed that Protestants still owned 100% of the shares of the company. The 2006 Small Business Corporation Income Tax Return for COMPANY is attached hereto as **Exhibit E**.

5. Protestants responded by letter dated June 9, 2010; however, no additional information was enclosed. In the June 9, 2010, letter, Protestants explained that the capital gain was result of distributions from COMPANY which were in excess of the taxpayers' basis. Protestants argued that because this gain qualified for capital treatment at the federal level, it should qualify for the Oklahoma exclusion as well. The June 9, 2010, letter is attached hereto as **Exhibit F**.

6. The Division informed Protestants that the gain did not qualify for the Oklahoma Capital Gains Deduction in a letter dated June 15, 2010. The June 15, 2010, letter is attached hereto as **Exhibit G**.

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[5] 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.

7. Protestants responded to the Division's June 15, 2010, letter in a letter dated June 21, 2010, arguing that because federal law treats the distribution as a sale, and taxes it at a capital gains rate, the distribution should also qualify for the Oklahoma deduction. Protestants also stated that the "statute of limitations for the 2005 return tolled on October 15, 2009." The June 21, 2010, letter is attached hereto as **Exhibit H**.

8. The Division sent a letter to Protestants dated July 1, 2010 to acknowledge a phone call with Protestants' representative reminding him that if Protestants intended to file a protest, it must be filed no later than July 4, 2010. The letter went on explain again why the distribution did not qualify and why the statute of limitations did not prevent the May 4, 2010, assessment. The July 1, 2010 letter is attached hereto as **Exhibit I**.

9. On or about July 1, 2010, Protestants filed a protest letter which referenced previous communications in which Protestants had argued that the distribution qualified for capital gains treatment. The protest letter is attached hereto as **Exhibit J**.

STATEMENT OF ISSUES

10. At issue in this matter is whether Protestants are eligible for the Oklahoma Capital Gains Deduction in 2005 for gains received from distributions from COMPANY.

11. Protestants maintain that because the gains were treated as long term capital gains for federal tax purposes, they are also eligible for the Oklahoma Capital Gains Deduction.

12. The Division maintains that the gains were not received as a result of a sale of stock, tangible personal property or real property, and therefore Protestants do not qualify for the Oklahoma Capital Gains Deduction.

CONCLUSIONS OF LAW

1. The Oklahoma Tax Commission is vested with jurisdiction over the parties and subject matter of this proceeding.[6]

2. A corporation electing treatment as a Subchapter "S" Corporation under the Internal Revenue Code ("IRC") is not subject to Oklahoma corporate income tax; however a Subchapter "S" Corporation's shareholders shall include their proportionate share of the corporation's federal income in each shareholder's taxable income in the same manner and to the same extent as provided by the IRS, subject to adjustments provided in the Oklahoma Income Tax Act[7] ("Act").[8]

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

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

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

3. The Act imposes an income tax upon the Oklahoma Taxable Income[9] of every resident or non-resident individual who earns income within Oklahoma.[10]

4. The beginning point of determining Oklahoma taxable income is Federal Adjusted Income.[11]

5. Any term used in the Act shall[12] have the same meaning as when used in a comparable context in the IRC, unless a different meaning is clearly required. For all taxable periods covered by the Act, the tax status and all elections of all taxpayers covered by the Act shall[13] be the same for all purposes material hereto as they are for federal income tax purposes except when the Act specifically provides otherwise.[14]

6. A taxpayer's income tax liability is determined in accordance with the law in effect at the time the income is received.[15]

7. The text of Section 2358(E) of Title 68[16] for the 2005 tax year ("Statute") is as follows, to-wit:

> For all tax years beginning after December 31, 1981, taxable income and adjusted gross income shall be adjusted to arrive at Oklahoma taxable income and Oklahoma adjusted gross income as required by this section.

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[9] OKLA. STAT. tit. 68, § 2353(12) (West Supp. 2005):

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

[10] OKLA. STAT. tit. 68, § 2355 (West Supp. 2005).

[11] OKLA. STAT. tit. 68, § 2353(13) (West Supp. 2005):

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

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

[13] *Id.*

[14] OKLA. STAT. tit. 68, § 2353(3) (West Supp. 2005).

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

[16] OKLA. STAT. tit. 68, § 2358(E) (West Supp. 2005). This is the text as amended by Laws 2005, c. 413, § 9, effective July 1, 2005.

…

E. 1. For taxable years beginning after December 31, 2004, a deduction from the Oklahoma adjusted gross income of any individual taxpayer shall be allowed for qualifying gains receiving capital treatment earned by the individual taxpayer during the taxable year and included in the federal taxable income of such individual taxpayer.

2. As used in this subsection:

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

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

(2) earned on the *sale of stock* or on the sale of an ownership interest in an Oklahoma company, limited liability company, or partnership where such stock or ownership interest has been owned by the individual taxpayer for a holding period of at least three (3) years prior to the date of the transaction from which the net capital gains arise,

b. "holding period" means an uninterrupted period of time, and

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

8. The Statute fails to define "Oklahoma company," but "company" is commonly defined as "A corporation, partnership, association, joint-stock company, trust fund, or organized group of persons, whether incorporated or not…"[17] There is no dispute "Oklahoma company" includes a corporation under state law, including a corporation that has made an "S" Corporation election for income tax purposes.

9. The rules promulgated pursuant to the Administrative Procedures Act are presumed to be valid and binding on the persons they affect and have the force of law.[18]

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

[18] OKLA. STAT. ANN. tit. 75, § 250 *et seq.* (West 2002). *See Toxic Waste Impact Group, Inc. v. Leavitt*, 1988 OK 20, 755 P.2d 626.

10. The Tax Commission Rule on the Capital Gains Deduction[19] ("Rule") for the 2005 tax year, is as follows, to-wit:

> (a) **General provisions.** For tax years beginning on or after January 1, 2005, individual taxpayers can subtract from the Oklahoma adjusted gross income, gains reported on their Oklahoma income tax return and included in federal taxable income receiving capital treatment. The gain must be realized on or after January 1, 2005, in order to be eligible for the Oklahoma exclusion.
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> (b) **Qualifying gains receiving capital treatment.** As used in this Section, **"qualifying gains receiving capital treatment"** means the amount of net capital gains, as defined under Internal Revenue Code Section 1222(11), [IRC §1222(11)]. The gain must be included in the federal income tax return of the individual taxpayer.
>
> (1) **Sale of real or tangible personal property.** To qualify for the Oklahoma deduction, the gain must be earned as a result of the *sale* of real or tangible personal property located within Oklahoma. Individual taxpayers must have held the asset for not less than five (5) uninterrupted years prior to the date of the transaction that created the capital gain.
>
> (2) **Sale of stock or ownership interest.** To qualify for the Oklahoma deduction, the gain must be earned as a result of the *sale of stock* or ownership interest in an Oklahoma company, limited liability company, or partnership and the stock or ownership interest must have been held by the taxpayer for at least three (3) uninterrupted years prior to the date of the transaction that created the capital gain.
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> (3) **Sale of real or tangible personal property by pass-through entities.** Net capital gains earned by member, partner, or shareholder of a pass-through entity as a result of the *sale* of real or tangible personal property located within Oklahoma, and included in the individual's federal taxable income is excludable, provided that the individual has been a member of the pass-through entity for an uninterrupted period of five (5) years and that the pass-through entity has held the asset for not less than five (5) uninterrupted years prior to the date of the transaction that created the capital gain.
>
> (4) **Sale of stock or ownership interests by pass-through entities.** Net capital gains earned by a individual member, partner, or shareholder of a pass-through entity as a result of the *sale of stock* or an ownership interest in an Oklahoma company, limited liability company, or partnership, is excludable, provided that the individual has been a member of the pass-through entity for an uninterrupted period of three (3) years and that the pass-through entity has held the asset for not less than three (3)

[19] OKLA. ADMIN. CODE § 710:50-15-48 (June 11, 2005).

> uninterrupted years prior to the date of the transaction that created the capital gain.
>
> (5) **Installment sales.** Qualifying gains included in an individual taxpayer's federal taxable income for years after December 31, 2004, which are derived from installment sales are eligible for exclusion, provided the appropriate holding periods are met.
>
> (c) **"Oklahoma company"**, **"limited liability company"**, **"partnership".** An Oklahoma company, limited liability company, or partnership is one whose primary headquarters has been located in Oklahoma for at least three (3) years prior to the capital gain transaction. The Oklahoma company, limited liability company, or partnership must meet the three (3) year rule for an uninterrupted period.
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> (Emphasis added.)

11. The goal of any inquiry into the meaning of a legislative act is to ascertain and give effect to the intent of the legislature. The law-making body is presumed to have expressed its intent in a statute's language and to have intended what the text expresses. 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.[20] Statutory construction presents a question of law.[21]

12. Tax exemptions, deductions, and credits depend entirely on legislative grace and are strictly construed against the exemption, deduction or credit.[22]

13. The Statute is a tax exemption or deduction statute, not a tax levying statute; and as such, it must be strictly construed unless authority for the deduction is clearly expressed.[23]

14. Words used in any statute are to be understood in their ordinary sense, except when a contrary intention plainly appears, and except also that the words hereinafter explained are to be understood as thus explained.[24]

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

[21] *Id.* at ¶ 6.

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

[23] *Id.*

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

15. Whenever the meaning of a word or phrase is defined in any statute, such definition is applicable to the same word or phrase wherever it occurs, except where a contrary intention plainly appears.[25]

16. In all proceedings before the Tax Commission, the taxpayer has the burden of proof.[26] A proposed assessment is presumed correct and the taxpayer bears the burden of showing that it is incorrect and in what respects.[27]

STIPULATED STATEMENT OF ISSUE

At issue in this matter is whether Protestants are eligible for the Oklahoma Capital Gains Deduction in 2005 for gains received from distributions from COMPANY.

DISCUSSION

Protestants maintain that because the gains were treated as long term capital gains for federal tax purposes, they are also eligible for the Oklahoma Capital Gains Deduction.[28]

In support of their position the Protestants assert, "Federal law states that a distribution in excess of cost basis is to be treated as *gain from the sale* or exchange of property. The Code doesn't differentiate such a transaction from any other sale. Such transactions appear on the federal Schedule D as any other property sale does, no [sic] on a separate line such as are provided for long-term capital gain distributions. For all intents and purposes, including qualifying for reduced long-term capital gain tax rates, from the federal perspective the excess distribution is a sale. Nothing in Oklahoma law indicates that such a sale for federal tax

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

[26] 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.

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

[28] Stipulation 11.

purposes shall be treated any differently for Oklahoma purposes. Therefore, it is also a sale for Oklahoma purposes."[29] (Emphasis original.)

"The Division maintains that the gains were not received as result of a sale of stock, tangible personal property or real property, and therefore Protestants do not qualify for the Oklahoma Capital Gains Deduction."[30] The Division goes on to state, "The Deduction is unambiguous. According to a plain reading of the Deduction, Protestants would have been entitled to the deduction only if they received a gain which qualified for capital treatment on their individual federal income tax return that was derived from a sale of real or tangible personal property or a sale of stock or ownership interest in an Oklahoma company, limited liability company, or partnership."[31]

In support of its position the Division cites *TPQ*[32] on the issue in this matter. In that case, the taxpayer argued that because it had made a certain election available under the Internal Revenue Code, its investment in a wholly-owned subsidiary be treated as an asset purchase. The taxpayer argued its employment levels rather than those of the subsidiary should have been examined for purposes of qualifying for an Oklahoma investment credit. The Oklahoma Income Act ("Act")[33] did not contain any provision allowing the subsidiary to be treated as a new corporation for purposes of the credit. In *TPQ*,[34] the Court stated:

> Merely because the Internal Revenue Code allows TPQ to treat [the subsidiary] as a new corporation, for purposes of calculating a deduction for assets, does not mean that the federal code overrides the intent of the Oklahoma Legislature in providing tax credits to encourage the creation of new jobs in manufacturing or processing in this state.

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

The Statute is a tax exemption or deduction statute, not a tax levying statute and as such must be strictly construed against the Protestants unless authority for the deduction is clearly expressed.[35] The language of the statute is clear and unambiguous and its terms should be

[29] Protestants' Brief-In-Chief at 2.

[30] *See* Stipulation 12.

[31] *See* Division's Brief at 4.

[32] *See* Note 22, *supra*.

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

[34] *See* Note 22, *supra*.

[35] *See* 22, *supra*.

construed using their ordinary meaning as directed by the Legislature. The Statute does not include an exclusion for gains from distributions from COMPANY for the 2005 tax year. As in *TPQ*,[36] merely because the distributions were treated as a sale on the federal level does not mean that the federal code overrides the intent of the Legislature as expressed in the Statute. To ignore the Legislature's requirement that the gains result from the "sale of stock" would contravene the Legislature's intent from the plain and unambiguous language used in the Statute.

The Protestants have failed to meet their burden of proof that the Division's disallowance of the Capital Gains Deduction taken on the 2005 Return was incorrect and in what respects.

DISPOSITION

It is the ORDER of the OKLAHOMA TAX COMMISSION, based upon the facts and circumstances of this case, the protest to the disallowance of the Oklahoma Capital Gains Deduction for the 2005 Tax Year should be denied.

It is further ORDERED that the amount of income tax and penalty assessed for the 2005 Tax Year be fixed as the deficiency due and owing, including interest, accrued and accruing.

OKLAHOMA TAX COMMISSION

CAVEAT: This decision was NOT deemed precedential by the Commission. This means that the legal conclusions are generally applicable or are limited in time and/or effect. Non-precedential decisions are not considered binding upon the Commission. Thus, similar issues may be determined on a case-by-case basis.

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

[36] *Id.*