JURISDICTION: **OKLAHOMA TAX COMMISSION**
CITE: **2018-09-20-05 / NON-PRECEDENTIAL**
ID: **P-14-012-H, P-15-062-H**
DATE: **SEPTEMBER 21, 2018**
DISPOSITION: **DENIED**
TAX TYPE: **CORPORATE INCOME**
APPEAL: **NONE TAKEN**

ORDER

The above matter comes on for entry of a final order of disposition by the Oklahoma Tax Commission. Having reviewed the files and records herein, the Commission hereby adopts the Post Remand Findings of Fact, Conclusions of Law and Recommendation made and entered by the Administrative Law Judge on the 21st day of September, 2018, appended hereto, together herewith shall constitute the Order of the Commission.

SO ORDERED

POST REMAND
FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

NOW on this 21st day of September 2018, the above-styled and numbered causes come on for consideration under assignment regularly made by the Oklahoma Tax Commission to ALJ, Administrative Law Judge. PROTESTANT ("Protestant") appears through ATTORNEY 1, and ATTORNEY 2, FIRM. The Compliance Division ("Division"), Oklahoma Tax Commission, appears through DGC, Deputy General Counsel, and AGC, Assistant General Counsel, Office of General Counsel, Oklahoma Tax Commission.

PROCEDURAL HISTORY

On February 5, 2014 and June 8, 2015, the protest files, respectively were 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*

[1] OKLA. STAT. ANN. tit. 68, § 201 *et seq.* (West 2014).

Law Judges.[2] The Court Clerk mailed the Introductory Letters to the Protestant that ALJ, Administrative Law Judge ("ALJ") had been assigned to each matter, and docketed as Case Numbers P-14-012-H and P-15-062-H. On November 2, 2015, the parties filed a Joint Motion to Consolidate Cases. On November 2, 2015, the ALJ granted the Motion.

On November 3, 2016, the parties filed Joint Stipulation of Facts and Issues, with Joint Exhibits 1 through 23.

On January 4, 2017, the parties filed Agreed Supplement to Joint Stipulation of Facts and Issues, with Joint Exhibits 24 through 38. On January 24, 2017, the Protestant filed its Brief-In-Chief, with Protestant's Exhibits 48-59. On February 9, 2017, the Division filed its Response Brief. On February 16, 2017, the Protestant filed its Reply Brief, with attachments. On March 14, 2017, the parties filed Second Agreed Supplement to Joint Stipulation of Facts and Issues, with Joint Exhibits 39 through 48.

On March 15, 2017, at approximately 10:20 a.m. the ALJ convened a closed hearing.[3] DGC announced for the record that the hearing on the HOLDING COMPANY cases was held earlier in the day, and if the issues overlap in these two matters, the parties agree that the testimony would be the same.[4] The Division called ADMINISTRATOR, Administrator, Compliance Division, Oklahoma Tax Commission, who testified on her training and experience, the conduct of the audit, the decisions made regarding the liabilities of the Protestant, which are under protest, and as custodian of the Division's records.

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[2] OKLA. ADMIN. CODE §§ 710:1-5-20 through 710:1-5-49.

[3] The Protestant, through ATTORNEY 1, invoked confidentiality. *See* OKLA. STAT. ANN. tit. 68, § 205 (West Supp. 2018). Tr. at 5

[4] ATTORNEY 1 confirmed DGC'S announcement. Tr. at 4-5.

On May 31, 2017, the ALJ advised the parties to submit Proposed Findings of Fact and Conclusions of Law by August 14, 2017. On August 14, 2017, the parties filed Agreed Correction to the Joint Stipulation of Facts and Issues. On August 14, 2017, the parties filed their respective Proposed Findings of Fact and Conclusions of Law. On August 22, 2017, the ALJ closed the record and submitted this matter for decision.

On May 11, 2018, the ALJ issued Findings, Conclusions, and Recommendations. On July 24, 2018, the Commissioners issued Commission Order No. 2018-07-24-06 remanding these matters with instructions.

JOINT STIPULATION OF FACTS AND ISSUES

On November 3, 2016, the parties filed Joint Stipulation of Facts and Issues:

STATEMENT OF ISSUES

1. Whether the payroll of Protestant's employees, which it leases from SUBSIDIARY, LLC, should be included in the calculation of Protestant's apportionment factors under 68 O.S. § 2358(A)(5) and Okla. Admin. Code § 710:50-17-71;

2. Whether the Division erred in excluding income from items other than sales from the sales factor in the calculation of Protestant's apportionment factors under 68 O.S. § 2358(A)(5) and Okla. Admin. Code § 710:50-17-71;

3. Whether the Division correctly apportioned the interest income for the 2006 tax year pursuant to 68 O.S. § 2358(A)(5);

STATEMENT OF FACTS

1. On or about May 14, 2013, Protestant filed its amended 2006 partnership tax return.

2. On or about May 14, 2013, Protestant filed its amended 2007 partnership tax return.

3. On or about May 14, 2013, Protestant filed its amended 2009 partnership tax return.

4. On or about May 14, 2013, Protestant filed its amended 2010 partnership tax return.

5. On its 2006 return, Protestant stated:

    a. Protestant claimed a combined deduction for state, local, and foreign taxes paid in the amount of $OMITTED;
    b. Protestant reported no payroll within or without Oklahoma on line 2(c) of the Apportionment formula which resulted in a 0.00% payroll factor;
    c. Protestant reported total sales within Oklahoma to be $OMITTED and total sales within and without Oklahoma to be $OMITTED which resulted in a 0.4693% sales factor; and,
    d. Protestant included in its sales factor calculation, the following items:

        i. Royalty income of $OMITTED;
        ii. Gain from the sale of assets for $OMITTED;
        iii. Other interest income for $OMITTED;
        iv. Other income in the amount of $OMITTED;
        v. Service income of $OMITTED; and,
        vi. Rental income of $OMITTED.

6. By letter dated November 4, 2013, the Division made the following adjustments to Protestant's 2006 amended return:

    a. The Division disallowed Protestant's claimed deduction for state, local, and foreign taxes paid for $OMITTED;
    b. The Division separately allocated Protestant's partnership income;
    c. The Division included Protestant's Interest income in unitary apportionable income;
    d. The Division adjusted Protestant's sales factor from 0.4693% to 0.5182%; and,
    e. The Division adjusted Protestant's payroll factor from 0.00% to 3.1782% to include the payroll of the employees leased by Protestant from SUBSIDIARY LLC;

7. On its 2007 return, Protestant stated:

    a. Protestant reported no payroll within or without Oklahoma on line 2(c) of the Apportionment formula which resulted in a 0.00% payroll factor;
    b. Protestant reported total sales within Oklahoma to be $OMITTED and total sales within and without Oklahoma to be $OMITTED which resulted in a 0.4592% sales factor; and,
    c. Protestant included in its sales factor calculation, the following items:

i. Royalty income of $OMITTED;
ii. Gain from the sale of assets for $OMITTED;
iii. Other interest income for $OMITTED;
iv. Other income in the amount of $OMITTED;
v. Service income of $OMITTED; and,
vi. Rental income of $OMITTED.

8. By letter dated November 4, 2013, the Division made the following adjustments to Protestant's 2007 amended return:

a. The Division separately allocated Protestant's partnership income;
b. The Division included Protestant's Interest income in unitary apportionable income;
c. The Division adjusted Protestant's sales factor from 0.4592% to 0.4747%; and,
d. The Divisions adjusted Protestant's payroll factor from 0.00% to 3.0438% to include the payroll of the employees leased by Protestant from SUBSIDIARY LLC;

9. On its 2009 return, Protestant stated:

a. Protestant reported no payroll within or without Oklahoma on line 2(c) of the Apportionment formula, which resulted in a 0.00% payroll factor;
b. Protestant reported total sales within Oklahoma to be $OMITTED and total sales within and without Oklahoma to be $OMITTED which resulted in a 0.4144% sales factor; and,
c. Protestant included in its sales factor calculation, the following items:

i. Royalty income of $OMITTED;
ii. Gain from the sale of assets for $OMITTED;
iii. Other interest income for $OMITTED;
iv. Other income in the amount of $OMITTED;
v. Service income of $OMITTED; and,
vi. Rental income of $OMITTED.

10. By letter dated November 4, 2013, the Division made the following adjustments to Protestant's 2009 amended return:

   a. The Division included Protestant's Interest income in unitary apportionable income;
   b. The Division adjusted Protestant's sales factor from 0.4144% to 0.5955%; and,
   c. The Division adjusted Protestant's payroll factor from 0.00% to 3.6625% to include the payroll of the employees leased by Protestant from SUBSIDIARY LLC;

11. On its 2010 return, Protestant stated:

   a. Protestant reported no payroll within or without Oklahoma on line 2(c) of the Apportionment formula which resulted in a 0.00% payroll factor;
   b. Protestant reported total sales within Oklahoma to be $OMITTED and total sales within and without Oklahoma to be $OMITTED which resulted in a 0.4563% sales factor; and,
   c. Protestant included in its sales factor calculation, the following items:

      i. Royalty income of $OMITTED;
      ii. Dividend income of $OMITTED;
      iii. Gain from the sale of assets in the amount of $OMITTED;
      iv. Other interest income in the amount of $OMITTED;
      v. Other income in the amount of $OMITTED;
      vi. Service income of $OMITTED; and,
      vii. Rental income of $OMITTED.

12. By letter dated November 4, 2013, the Division made the following adjustments to Protestant's 2010 amended return:

   a. The Division included Protestant's Interest income in unitary apportionable income;
   b. The Division adjusted Protestant's sales factor from 0.4563% to 0.6745%; and,
   c. The Division adjusted Protestant's payroll factor from 0.00% to 3.9358% to include the payroll of the employees leased by Protestant from SUBSIDIARY LLC;

13. By letter dated January 2, 2014, Protestant timely protested the adjustments to the 2006 amended return. This letter specifically protested the Division's adjustment of the Protestant's sales factor and payroll factor.

14. By letter dated January 2, 2014, Protestant timely protested the adjustments to the 2007 amended return. This letter specifically protested the Division's adjustment of the Protestant's sales factor and payroll factor.

15. By letter dated January 2, 2014, Protestant timely protested the adjustments to the 2009 amended return. This letter specifically protested the Division's adjustment of the Protestant's sales factor and payroll factor.

16. By letter dated January 2, 2014, Protestant timely protested the adjustments to the 2010 amended return. This letter specifically protested the Division's adjustment of the Protestant's sales factor and payroll factor.

17. On or about October 6, 2014, Protestant filed its second amended 2006 partnership tax return.

18. By letter dated March 23, 2015, the Division made the following adjustments to Protestant's second amended 2006 return:

a. The Division included Protestant's interest income in apportionable income resulting in a change to Protestant's distributable Oklahoma income from $OMITTED to $OMITTED;
b. The Division adjusted Protestant's apportionment factors incorporating changes in an earlier adjustment dated November 4, 2013;

19. By letter dated May 13, 2015, Protestant timely protested the adjustments to the second amended 2006 return. This letter specifically protested the Division's previous

adjustment of the Protestant's sales factor and payroll factor and additionally protested the Division's adjustments treating Protestant's interest income as unitary apportionable income.

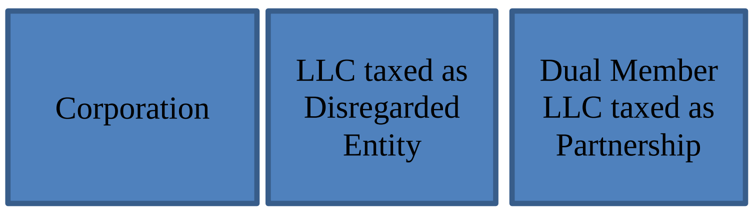
20. The Protestant's protest is properly before the Administrative Law Judge.

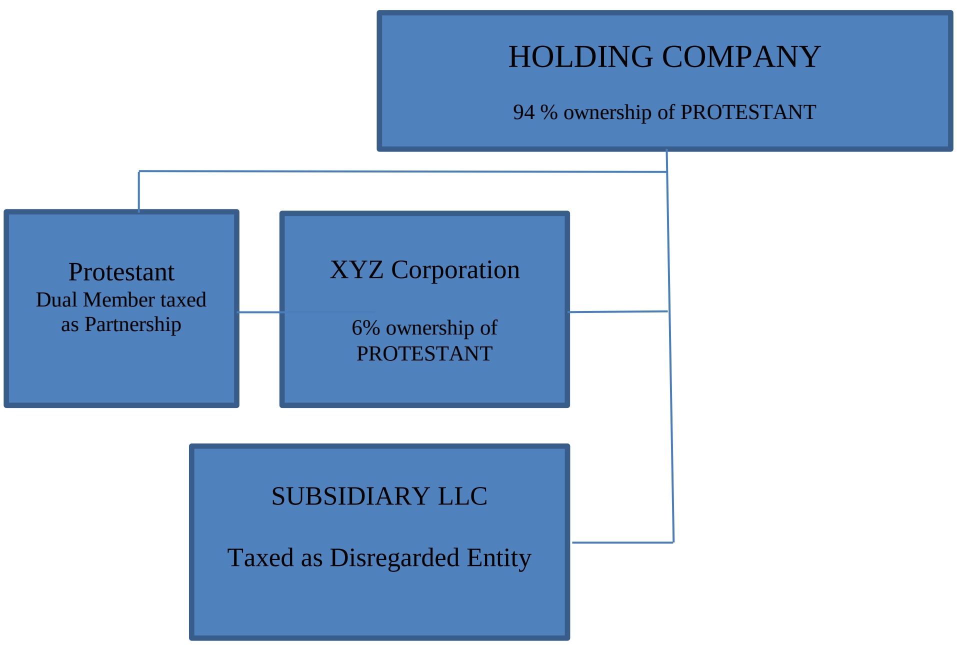
ADDITIONAL FINDING OF FACT

Upon review of the file and records, including the record of the proceedings, the exhibits received into evidence, the ALJ finds:

1. Protestant's Simplified Structure[5]:

Legend





[5] *See* ALJ Exhibit 1.

2. Protestant leased employees from SUDSIDIARY LLC, under an Employee Leasing Agreement.

3. Protestant reported payroll for the employees it leased from SUDSIDIARY LLC as an expenses on its federal partnership returns. Under the Employee Leasing Agreement SUBSIDIARY LLC charged Protestant for the expenses of the employees plus an additional amount equal to two percent (2%) of the expenses.

CONCLUSIONS OF LAW

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

2. The Oklahoma Income Tax Act[7] ("Act") imposes an income tax upon the Oklahoma taxable income of every corporation doing business in Oklahoma or deriving income from sources within the state.[8]

3. Any term used in the Act shall have the same meaning as when used in a comparable context in the Internal Revenue Code, unless a different meaning is clearly required. For all taxable periods covered by the Act, the tax status and all elections of all taxpayers shall be the same for all purposes material hereto as they are for federal income tax purposes except when the Act specifically provides otherwise.[9]

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[6] OKLA. STAT. ANN. tit. 68, § 221(C) (West 2014).

[7] OKLA. STAT. ANN. tit. 68, § 2351 *et seq.* (West 2017).

[8] OKLA. STAT. ANN. tit. 68, § 2355(D) (West 2017).

[9] OKLA. STAT. tit. 68, § 2353(3) (West 2017).

4. The beginning point of determining Oklahoma taxable income is federal taxable income.[10]

5. Under the Act, net income from unitary, multistate business operations is apportioned to Oklahoma based on the arithmetical average of three factors consisting of property, payroll and sales or gross revenue.[11]

6. The taxable income of any taxpayer shall be adjusted to arrive at Oklahoma taxable income for corporations and Oklahoma adjusted gross income for individuals, as follows:

> 4. Items of the following nature shall be allocated as indicated. Allowable deductions attributable to items separately allocable in subparagraphs a, b and c of this paragraph, whether or not such items of income were actually received, shall be allocated on the same basis as those items:
>
> a. Income from real and tangible personal property, such as rents, oil and mining production or royalties, and gains or losses, from sales of such property, shall be allocated in accordance with the situs of such property;
>
> b. Income from intangible personal property, such as interest, dividends, patent or copyright royalties, and gains or losses from sales of such property, shall be allocated in accordance with the domiciliary situs of the taxpayer, except that:
>
> 1. where such property has acquired a nonunitary business or commercial situs apart from the domicile of the taxpayer such income shall be allocated in accordance with such business or commercial situs; interest income from investments held to generate working capital for a

[10] OKLA. STAT. tit. 68, § 2353(12) (West 2017).

[11] OKLA. STAT. ANN. tit. 68, § 2358(A)(5) (West Supp. 2018).

> unitary business enterprise shall be included in apportionable income; …
>
> …
>
> 3. income from such property which is required to be allocated pursuant to the provisions of paragraph 5 of this subsection shall be allocated as herein provided;
>
> c. Net income or loss from a business activity which is not a part of business carried on within or without the state of a unitary character shall be separately allocated to the state in which such activity is conducted;[12]

7. 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.[13]

8. "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.[14]

9. 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 benefitted by operations in one

[12] OKLA. STAT. ANN. tit. 68, § 2358(A)(4)(a) through (c) (West Supp. 2018).

[13] OKLA. STAT. ANN. tit. 75, § 250 *et seq.* (West 2018).

[14] OKLA. ADMIN. CODE § 710:50-17-70.

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.[15]

10. Every partnership shall make a return for each taxable year, stating the taxable income and the adjustments to arrive at Oklahoma income.[16]

11. The term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization, through or by means of which any business, financial operation or venture is carried on, and which is not a trust or estate or classed as a corporation within the provisions of this article; and the term "partner" includes a member of such syndicate, group, pool, joint venture or organization.[17]

12. For purposes of determining the adjusted gross income from Oklahoma, the following shall be includable:

> 4. The distributive share of the Oklahoma part of partnership income, gains, losses or deductions;
>
> …
>
> 9. The distributive share of the Oklahoma part of limited liability company income, gains, losses or deductions.[18]

13. The Oklahoma distributive share of partnership income as determined under 68 O.S. § 2358 and 68 O.S. § 2362 shall be allocated to Oklahoma.[19]

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[15] *See Matter of Income Tax Protest of Griffin Television, Inc.*, 1994 OK 35, 877 P.2d 588. *See also Matter of Income Tax Protest of Ashland Exploration, Inc.*, 1988 OK 23, 751 P.2d 1070.

[16] OKLA. STAT. ANN. tit. 68, § 2368(D) (West Supp. 2018).

[17] OKLA. STAT. ANN. tit. 68, § 202(i) (West 2014).

[18] OKLA. STAT. ANN. tit. 68, § 2362(F)(4) and (9) (West 2013).

[19] *See* OKLA. ADMIN. CODE § 710:50-17-51(15)(B) (July 11, 2010).

14. The term "Limited Liability Company" means an organization other than a corporation or partnership, which is organized pursuant to Section 2000 *et seq.* of Title 18 of the Oklahoma Statutes. Except as otherwise specifically provided, for all purposes under Title 68 of the Oklahoma Statutes, a domestic limited liability company shall be treated the same and taxed as a domestic partnership and a foreign limited liability company shall be treated the same and taxed as a foreign partnership, provided that such domestic or foreign limited liability companies are classified as partnerships for federal income tax purposes.[20]

15. A taxpayer's income tax liability is determined under the law in effect when the income is received.[21]

16. In all proceedings before the Tax Commission, the taxpayer has the burden of proof.[22] A proposed assessment is presumed correct and the taxpayer bears the burden of showing that it is incorrect and in what respects.[23]

DISCUSSION
ISSUE ONE

The Protestant contends that due to SUBSIDIARY LLC's status as a disregarded entity, SUBSIDIARY LLC is treated as a division of HOLDING COMPANY, rather than a separate entity and that SUBSIDIARY LLC's activities are combined with and into the operations of HOLDING COMPANY for federal and Oklahoma income tax purposes. This treatment is

[20] OKLA. STAT. ANN. tit. 68, § 202(j) (West 2014).

[21] *See Affiliated Management Corp. v. Oklahoma Tax Commission*, 1977 OK 183, 570 P.2d 335. *See also Wootten v. Oklahoma Tax Com'n*, 1935 OK 54, 40 P.2d 672.

[22] *See* OKLA. ADMIN. CODE § 710:1-5-47 (June 25, 1999). *See also* OKLA. ADMIN. CODE § 710:1-5-77(b) (June 25, 1999).

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

entirely distinct from a parent/regarded subsidiary corporation arrangement. Rather, Protestant and HOLDING COMPANY are one company for federal and Oklahoma income tax purposes.

The Division acknowledges that HOLDING COMPANY owns a 100% interest in SUBSIDIARY LLC, but points out that on HOLDING COMPANY'S Oklahoma income tax returns for the 2004, 2005, 2006, 2007, 2009, and 2010 tax years, HOLDING COMPANY reported payroll and sales factors based on the activities SUBSIDIARY LLC and Protestant.

An entity, which derives income from sources within the state, has an Oklahoma income tax filing requirement and will be subject to Oklahoma income tax. The parties stipulated that SUBSIDIARY LLC is treated for federal and Oklahoma purposes as a single member LLC that has not elected to be treated as an entity separate from its parent under U.S. Treas. Reg. Sec. 301.7701-1 through 301.7701.3. As a disregarded entity, HOLDING COMPANY treats SUBSIDIARY LLC's activities as a sole proprietorship, branch, or division of the owner.

As a disregarded entity, SUBSIDIARY LLC's apportionment factors are allowed to HOLDING COMPANY. The question is what are those factors? HOLDING COMPANY argues that it should be allowed both the payroll factor of SUBSIDIARY LLC and a sales factor based upon the receipts SUBSIDIARY LLC receives from leasing employees to Protestant. The Division argues that payroll should be assigned to the entity for which employees perform their services.

The payroll factor is a fraction, the numerator of which is the total compensation for services rendered in the state, and the denominator of which is the total compensation for services rendered everywhere. Compensation only includes those paid-for services related to the unitary business. Here, the services rendered in this state related to the unitary business were rendered to Protestant. "Rendered" is defined as "to do (a service) for another."[24] No services were rendered to SUBSIDIARY LLC in this state.

The sales factor is a fraction, the numerator of which is the total sales or gross revenue of the taxpayer in this state, and the denominator of which is the total sales or gross revenue of the taxpayer everywhere. Receipts for performing services are included in the numerator if the receipts derive from customers within Oklahoma or are otherwise attributable to this state's market place. The sales factor does not include sales or gross revenue separately allocated in § 2358(A)(4).

Protestant's unitary business is the manufacturing of computer hard disc drives for customers throughout the world. Protestant is not in the unitary business of leasing employees.

CONCLUSION ISSUE ONE

The payroll of Protestant's employees, which it leases from SUBSIDIARY LLC, should be included in the calculation of Protestant's apportionment factors under § 2358(A)(5) and OKLA. ADMIN. CODE § 710:50-17-71.

ISSUE TWO

DISCUSSION

The Protestant's contention is that the Division's exclusion of revenues related to Service and Rental Income from the Protestant's apportionment calculation leads to an artificially low sales factor denominator, but notes that none of the Service or Rental Income is related to Oklahoma activity, so there is no impact to Protestant's sales factor numerator.

The Division adjusted only the denominator of Protestant's reported sales factor ("Everywhere Sales"). The numerator of the factor, the Oklahoma sales, was not changed. The

[24] WEBSTER'S NINTH COLLEGIATE DICTIONARY (1987), 997.

Division adjusted the denominator, based on information provided by Protestant, to remove items other than sales from the calculation of the sales factor.

The Division properly excluded items other than sales from the Protestant's sales factor under the plain and unambiguous language[25] of OKLA. ADMIN. CODE § 710:50-17-71(1)(A)(i).

CONCLUSION ISSUE TWO

The Division correctly excluded Service and Rental Income in the calculation of Protestant's sales factor, under § 2358(A)(5) and OKLA. ADMIN. CODE § 710:50-17-71(1).

ISSUE THREE

DISCUSSION ISSUE THREE

The Protestant contends that the Division must prove that its interest income/loss should be treated as unitary for the 2006 Tax Year.

The Protestant has the burden of proof, not the Division. The Protestant is a separate and distinct unitary business, whose apportionment factors are determined by § 2358(A)(5). The Division correctly apportioned the Protestant's interest income for the 2006 Tax Year.

CONCLUSION ISSUE THREE

The Division's adjustment to the Protestant's interest income for the Tax Year 2006 was correct.

RECOMMENDATIONS

The ALJ recommends denying the protest as set forth.

OKLAHOMA TAX COMMISSION

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

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 2014) and OKLA. STAT. ANN. tit. 75, § 302 (West 2002).