

JURISDICTION: OKLAHOMA TAX COMMISSION
CITE: 2019-12-17-16 / NON-PRECEDENTIAL
ID: P-19-089-K
DATE: DECEMBER 17, 2019
DISPOSITION: DENIED
TAX TYPE: 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 Findings of Fact, Conclusions of Law and Recommendation made and entered by the Administrative Law Judge on the 1st day of November , 2019, as corrected by Errata on 4th day of November, 2019, appended hereto, together herewith shall constitute the Order of the Commission.

SO ORDERED

FINDINGS OF FACT, CONCLUSIONS OF LAW AND RECOMMENDATION

NOW on this 1st day of November, 2019, the above styled and numbered cause comes on for decision under assignment regularly made by the Oklahoma Tax Commission to ALJ, Administrative Law Judge. Protestants, HUSBAND and WIFE, husband and wife are represented by CPA, FIRM. The Account Maintenance Division (“Division”), Oklahoma Tax Commission is represented by AGC, Assistant General Counsel, Office of General Counsel, Oklahoma Tax Commission.

STATEMENT OF THE CASE

The Division audited Protestants’ 2016 Oklahoma income tax return, disallowed as deductions from federal adjusted gross income the wage/salary expenses equal to the Empowerment Zone Employment Credit and the employer social security credit on employee tips allowed at the federal level and by adjustment letter dated June 7, 2018, proposed the assessment of additional

income taxes against Protestants. Protestants timely protested the proposed assessment by unverified letter dated June 25, 2018, and resubmitted on August 1, 2018.

On May 8, 2019, the protest and corresponding records were referred to the Office of the Administrative Law Judges to initiate proceedings consistent with the Uniform Tax Procedure Code¹ and the Oklahoma Income Tax Act² and the Rules of Practice and Procedure before the Office of the Administrative Law Judges³. The protest was docketed as Case No. P-19-089-K and assigned to the undersigned.

A pre-hearing teleconference was scheduled for July 2, 2019. The conference was held as scheduled. Pursuant to the conference, a hearing was scheduled for August 20, 2019, by *Notice of Hearing* issued July 3, 2019.

The hearing was held as scheduled. Neither Protestants nor Protestants' representative appeared. As noted in the record, because there was no dispute regarding the material facts, the Division presented its case by standing on its memorandum brief. Documents marked as Exhibits A through E were identified by counsel for the Division and admitted into evidence by official notice⁴. Counsel for the Division made a brief closing statement; whereupon, the record closed and the protest submitted for decision.⁵

FINDINGS OF FACT

Upon review of the file and records, including the exhibits received into evidence and the memorandum brief of the Division, the undersigned finds:

1. Together, Protestants own 100% of LLC, d/b/a RESTAURANT, an Oklahoma limited liability company. Schedules K-1, Exhibit C; <https://www.sos.ok.gov/corp/corpInformation.aspx?id=3512136513>.

¹ 68 O.S. 2011, § 201 et seq., as amended.

² 68 O.S. 2011, § 2351 et seq., as amended.

³ Rules 710:1-5-20 through 710:1-5-47 of the Oklahoma Administrative Code ("OAC").

⁴ OAC 710:1-5-36(a)

⁵ OAC 710:1-5-39(a)

2. Protestants on their 2016 Oklahoma Resident Income Tax Return (“2016 Return”) subtracted as a Schedule 511-A, Oklahoma Subtraction, the amount of \$41,502.00 from federal adjusted gross income to arrive at Oklahoma adjusted gross income. Exhibit A.

3. The subtracted amount equals the increase in federal adjusted gross income Protestants would have been allowed to deduct as business expenses (wages/salaries paid) if they had not elected to take the following federal employment tax credits: (1) the Empowerment Zone Employment Credit (“EZEC Credit”) and (2) the Employer Social Security Credit on employee tips (“ESSC Credit”). Statement 1, Exhibit C.

4. The overpayment of income tax claimed on the 2016 Return of \$565.00 was to be applied to Protestants’ 2017 estimated tax. Exhibit A.

5. The Division disallowed the Schedule 511-A, Oklahoma subtraction of \$41,502.00 and by adjustment letter dated June 7, 2018, proposed the assessment of additional income taxes against Protestants in the amount of \$1,510.00. Exhibit B.

6. By unverified letter dated June 25, 2018, and resubmitted on August 1, 2018, Protestants timely protested the proposed assessment. Exhibits C and D.

ISSUE AND CONTENTIONS

The issue presented for decision is whether, to arrive at the appropriate amount of Oklahoma adjusted gross income, Protestants are statutorily allowed to subtract from federal adjusted gross income the increase in federal adjusted gross income resulting from Protestants’ election to take at the federal level the EZEC and ESSC Credits rather than deducting the wage/salary expenses.

Protestants pose the following question: “if you reclass [sic] part of wage/salary business expenses to federal jobs credit, can you, for Oklahoma Income Tax purposes, still deduct 100% of salaries and wage expenses? Protestants argue that because Oklahoma does not provide for the same or similar jobs tax credits, the employee wage/salary expenses are reinstated and allowed as a subtraction in arriving at Oklahoma adjusted gross income.

The Division argues that Protestants have cited no statutory authority for the subtraction taken on their 2016 Return and maintains no statutory authority exists for the subtraction. The Division contends that Protestants' federal election to take the EZEC and ESSC Credits rather than deducting the wage/salary expenses controls in determining Protestants' Oklahoma taxable income.

CONCLUSIONS OF LAW

Wherefore, premises considered the undersigned concludes as a matter of law:

I. JURISDICTION AND BURDEN OF PROOF

1. Jurisdiction of the parties and subject matter of this proceeding is vested in the Oklahoma Tax Commission. 68 O.S. 2011, § 221.

2. The taxpayer must prove the action or proposed action of the Oklahoma Tax Commission is incorrect, and in what respect. OAC 710:1-5-47. *In re Adway Properties, Inc.*, 2006 OK CIV APP 14, 130 P.3d 302; *Geoffrey, Inc. v. Oklahoma Tax Commission*, 2006 OK CIV APP 27, 132 P.3d 632. If the taxpayer fails to prove a prima facie case, the protest may be denied solely on the grounds of failure to prove sufficient facts which would entitle the taxpayer to the requested relief. OAC 710:1-5-47; *Enterprise Management Consultants, Inc. v. State ex rel. Oklahoma Tax Commission*, 1988 OK 91, 768 P.2d 359, 362, citing *Continental Oil Co. v. Oklahoma State Bd. of Equalization*, 1976 OK 23, 570 P.2d 315, 317.

3. The burden of proof standard is "preponderance of evidence." 2 Am.Jur.2d *Administrative Law* § 357. "Preponderance of evidence" means "[e]vidence which is of greater weight or more convincing than the evidence offered in opposition to it; that is, evidence which as a whole shows the fact sought to be proved is more probable than not * * * evidence which is more credible and convincing to the mind * * * that which best accords with reason and probability." BLACK'S LAW DICTIONARY 1064 (5th ed. 1979). Each element of the claim must be supported by reliable, probative, and substantial evidence of sufficient quality and quantity as to show the existence of the facts supporting the claim are more probable than their nonexistence. 2 Am.Jur.2d *Administrative Law* § 357.

4. An order of the Tax Commission must be supported by substantial evidence. *Dugger v. State ex rel. Oklahoma Tax Commission*, 1992 OK 105, 834 P.2d 964. Likewise, the audit upon which a portion of the record is formed and order issued, must be supported by substantial evidence. Oklahoma Tax Commission Order No. 2003-07-22-09, 2003 WL 2347117.

5. An audit is supported by substantial evidence when an evidentiary foundation for the audit has been established. Usually the evidentiary foundation will be established by the records reviewed by the auditor. Where an evidentiary foundation has been established, the taxpayer must prove the action of the Tax Commission in assessing the tax is incorrect, and in what respect. OAC 710:1-5-47; *Enterprise Management Consultants, Inc.*, supra. However, where an evidentiary foundation has not been laid or the records upon which the audit is based establish no basis for assessing a tax, the audit and assessment in the initial instance cannot be sustained as supported by substantial evidence. *Dugger*, supra.

II. OKLAHOMA INCOME TAX AND FEDERAL ELECTIONS

1. “Taxation is an exclusively legislative function that can be exercised only under statutory authority and in the manner specified by statute.” *State, ex rel. Oklahoma Tax Commission v. Texaco Exploration & Production, Inc.*, 2005 OK 52, ¶ 7, 131 P.3d 705, 707. The levy and collection of Oklahoma income tax is governed by the Oklahoma Income Tax Act (“Act”).⁶

2. Oklahoma income tax is “imposed on the Oklahoma taxable income⁷ of every resident or nonresident individual”. 68 O.S. 2011, § 2355(C). See, OAC 710:50-3-1.⁸ “Every resident individual having a gross income, or gross receipts, for the taxable year in an amount sufficient to require the filing of a federal income tax return” and “[e]very nonresident individual having

⁶ 68 O.S. 2011, § 2351 et seq., as amended.

⁷ Defined to mean “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”.

⁸ This rule provides: “[a]ll taxpayers must file Oklahoma Income Tax Returns. ‘Taxpayer’ means any person subject to income tax imposed by Oklahoma Statutes, or whose income is in whole or in part, subject to income tax imposed by any provision of the Oklahoma Statutes.”

Oklahoma gross income for the taxable year of One Thousand Dollars (\$1,000.00), or over” are required to “make a return stating specifically the taxable income and, where necessary, the adjusted gross income and the adjustments provided in the [Act] to arrive at Oklahoma taxable income and, where necessary, Oklahoma adjusted gross income”. 68 O.S. 2011, § 2368(A)(1) and (3).

3. The starting point for determining the “Oklahoma adjusted gross income” of an individual taxpayer is the “taxable income” with respect to the taxpayer as defined in the Internal Revenue Code (“IRC”) as it applies to such taxpayer. 68 O.S. 2011, §§ 2358(A) and 2353(10). *See*, OKLA. CONST. ART. 10, § 12⁹. *See also*, ***General Accessory Manufacturing Company v. Oklahoma Tax Commission***, 2005 OK CIV APP 75, ¶9, 122 P.3d 476, 479, citing *Dugger, supra*, ¶4.¹⁰ Taxable income is the base figure upon which Oklahoma income tax is computed and this figure is adjusted according to the provisions of § 2358 of the Act to arrive at Oklahoma adjusted gross income for individuals. 68 O.S. 2011, §§ 2358(A), and 2353(11) and (13). *See*, ***Getty Oil Co. v. Oklahoma Tax Commission***, 1977 OK 19, 563 P.2d 627, 630.¹¹

⁹ This section provides:

The Legislature shall have power to provide for the levy and collection of license, franchise, gross revenue, excise, income, collateral and direct inheritance, legacy, and succession taxes; also graduated income taxes, graduated collateral and direct inheritance taxes, graduated legacy and succession taxes; also stamp, registration, production or other specific taxes.

In the exercise of the powers provided for in this section, and notwithstanding any other provision of this Constitution, the Legislature may, with or without exceptions, modifications, or adjustments, define the amount on, in respect to, or by which any such tax or taxes are imposed or measured (a) by reference to any provisions of the laws (including administrative regulations, determinations, and interpretations) of the United States, as such laws may be or become effective at any time or from time to time; (b) by reference to any amount or amounts finally ascertained in determining amounts subject to taxation by the United States; or (c) by reference to any amount or amounts of tax finally ascertained to be payable to the United States.

Amended by State Question No. 444, Legislative Referendum No. 160, adopted at election held Aug. 27, 1968. Amendment proposed by Laws 1967, p. 689, S.J.R. No. 30.

¹⁰ In ***General Accessory***, citing *Dugger*, the Court recognized that the “federal/state ‘piggy-back’ system” has been in effect since the 1971 enactment of the Act, pursuant to constitutional amendment in 1968, and the statutory definitions of “Oklahoma taxable income” and “Oklahoma adjusted gross income” mirror the constitutional language in OKLA. CONST. ART. 10, § 12. *Id.*, ¶9.

¹¹ In ***Getty***, the Court found that notwithstanding Oklahoma had incorporated portions of the Internal Revenue Code into its tax law subject to certain statutory adjustments and limitations, no statutory provision in the Act specifically adopted all federally allowed deductions. *Id.*, 630

4. “Itemization of deductions by taxpayers for the purpose of reporting and paying Oklahoma income tax, if allowed, is done on the taxpayers’ federal return.” Op.Atty.Gen. No. 82-137 (June 23, 1982).¹² “Oklahoma accepts all ‘lawful deductions’ taken on the taxpayers’ federal return, pursuant to the Internal Revenue Code, as adjustments to ‘adjusted gross income’, as defined by * * * §§ 2358(11) and (13), prior to the determination of ‘Oklahoma taxable income’, defined in § 2353(12), * * * in addition to those exemptions and/or deductions statutorily allowed by Oklahoma in accordance with * * * § 2358.” *Id.*

5. Tax exemptions, deductions and credits depend entirely upon legislative grace and are strictly construed against the exemption, deduction or credit. *TPQ Investment Corporation v. Oklahoma Tax Commission*, 1998 OK 13, ¶ 8, 954 P.2d 139, 141. *See, Getty*, supra, 630-631.¹³ Deductions and credits are allowed only where authority for such is clearly expressed. *Home-Stake Royalty Corp. v. Weems*, 1935 OK 1043, ¶ 12, 52 P.2d 806, 808. “Certain exemptions, deductions and adjustments must be made to Federal taxable income to arrive at Oklahoma taxable income.” OAC 710:50-15-1.

6. The tax status and all elections of all taxpayers shall be the same for purposes of the Act as they are for federal income tax purposes. 68 O.S. 2011, § 2353(3). *General Accessory*, supra, ¶ 11; *Matter of Income Tax Protest of Flint Resources*, 1989 OK 9, 780 P.2d 665, 673. “The language of § 2353(3) and (12), indicates that the Legislature intended that federal elections be controlling in determining Oklahoma taxable income.” *Id.*

7. The facts of this case are similar to those presented in *Flint Resources*, supra. In *Flint Resources*, the taxpayer claimed a deduction for foreign taxes paid on its Oklahoma income tax return, notwithstanding that it claimed and was allowed a foreign taxes paid credit on its federal

¹² It is the duty of public officers to follow, and not disregard, the advice of the Attorney General. *Rasure v. Sparks*, 1919 OK 231, 183 P.2d 495, 498. The duty to follow the advice of the Attorney General continues until a court of competent jurisdiction or the Supreme Court holds otherwise. *Pan American Petroleum Corporation v. Board of Tax-Roll Corrections of Tulsa County*, 1973 OK 52, 510 P.2d 680, 681, citing *State v. District Court of Mayes County*, 1967 OK 228, 440 P.2d 700, 707.

¹³ The *Getty* Court held: “any change in the method of computing deductible losses for income tax purposes is within the province of the Legislature” and not the courts. *Id.*, 631.

income tax return. On appeal, the Oklahoma Supreme Court affirmed the disallowance of the deduction of the foreign taxes paid, holding:

Corporations choosing to take the federal foreign tax credit, rather than a deduction for foreign taxes paid, must include the amount representing foreign taxes within Oklahoma taxable income.

Id., 667; **General Accessory**, *supra*, ¶ 11.

In so holding the Supreme Court reasoned:

Deductions are a matter of legislative grace rather than judicial intervention. The language of § 2353(3) and (12), indicates that the Legislature intended that federal elections be controlling in determining Oklahoma taxable income. The Legislature’s use of the word ‘allowable’ as opposed to ‘allowed’ in § 2358(A)(4)(b) cannot reasonably and harmoniously be construed to mean that Oklahoma taxpayers were intended to have the option under the Income Tax Act to reevaluate federal deductions for the purpose of calculating Oklahoma taxable income.

(Footnotes omitted). **Flint Resources**, *supra*, 673-674. See, **General Accessory**, *supra*, ¶ 11.¹⁴

ANALYSIS

1. Protestants elected to claim the EZEC and ESSC Credits on their 2016 federal return for certain wages paid to qualified employees and excess social security tax paid on employee tips. IRC §§ 38(a)(2) and (b)(9); 1396(a) and (b) and 45B. As a consequence, the wages/salaries generating the credits could not be deducted as business expenses. IRC § 280C. Notwithstanding the federal election, Protestants now seek to deduct those wages/salaries from federal adjusted gross income to arrive at Oklahoma adjusted gross income, arguing the deduction must be allowed to accurately reflect Protestants’ federal adjusted gross income. Protestants also argue, without an offer of proof, that “most likely” thousands of Oklahoma returns are filed annually with the similar subtractions resulting in 100% wage expense deductions in determining Oklahoma taxable income. They contend the deduction of the wages/salaries from federal adjusted gross income only became an issue because they filed a paper return.

¹⁴ Non-resident taxpayers characterized a sale of stock in an Oklahoma corporation as a sale of assets on their federal return, thus the gain on the sale was required to be characterized the same way on their state tax return, and not as a sale of stock.

2. Protestants' federal adjusted gross income, despite any argument to the contrary was accurately reflected on the 2016 Oklahoma return. Because Protestants elected to claim the EZEC and ESSC Credits they were not allowed to deduct from federal adjusted gross income the wage/salary expenses generating the credits. IRC § 280(a). A taxpayer cannot elect to be treated one way for federal tax law purposes and another way for state tax law purposes. *In Re: Protest to the Denial of the Application of Oklahoma Metafund Community Development Corporation*, 2007 OK CIV APP 32, ¶ 15, 159 P.3d 1142, 1145.

3. Federal elections, i.e.: whether to take a credit or a deduction or whether to characterize a sale as a sale of assets or a sale of stock, are controlling in determining Oklahoma taxable income. *Flint Resources, supra; General Accessory, supra*. No statutory provision in the Act specifically adopts all federally allowed deductions. *Getty, supra*. Unlike the Indian employment tax credit¹⁵, no provision of the Act allows the deduction of the wages/salaries generating the EZEC and ESSC federal income tax credits. *See*, 68 O.S. 2011, § 2358(A)(8).¹⁶

4. The fact that the Act does not contain a provision allowing the deduction of the wages/salaries equal to the credits does not discriminate against Protestants. The Legislature has power to establish classes of taxpayer possessing varied deductions from income, for purpose of computing state income tax liability. *Oklahoma Tax Commission v. Smith*, 1980 OK 74, 610 P.2d 794. All that is required is that there be reasonable classification and reasonable opportunity for uniform or equal incidence upon the classes created. *Fent v. State ex rel. Oklahoma Tax Commission*, 2004 OK 59, 99 P.3d 241. Tax statutes must be applied uniformly upon all taxpayers

¹⁵ IRC § 45A.

¹⁶ The subsection provides:

In taxable years beginning after December 31, 1995, all qualified wages equal to the federal income tax credit set forth in 26 U.S.C.A., Section 45A, shall be deducted from taxable income. The deduction allowed pursuant to this paragraph shall only be permitted for the tax years in which the federal tax credit pursuant to 26 U.S.C.A., Section 45A, is allowed. For purposes of this paragraph, 'qualified wages' means those wages used to calculate the federal credit pursuant to 26 U.S.C.A., Section 45A.

See, Oklahoma Tax Commission Order No. 2006-08-22-07 which upheld the disallowance of the deduction of the Work Opportunity Credit as an Oklahoma subtraction from federal adjusted gross income.

similarly situated, *In re O'Carroll*, 1998 OK 6, 952 P.2d 45; however, an equal protection challenge shall be decided in reference to the general classification, rather than by the chance incidents of the tax in a particular situation on a certain taxpayer, for inequalities that result not from hostile discrimination but occasionally in the application of a system that is not arbitrary will not invalidate an act. *Smith, supra*.

RECOMMENDATIONS

Protestants' protest should be denied. The additional income taxes as proposed by the adjustment letter, inclusive of penalty and interest, accrued and accruing, should be fixed as the deficiency due and owing.

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