

JURISDICTION: OKLAHOMA TAX COMMISSION
CITE: 89-10-19-006 (PRECEDENTIAL)
ID: P-86-355
DATE: OCTOBER 19, 1989
DISPOSITION: DENIED
TAX TYPE: INCOME
APPEAL: S.CT. APPEAL 74,431 DISMISSED

FINDINGS OF FACT AND CONCLUSIONS OF LAW

A hearing was had before ALJ, Administrative Law Judge, at which hearing Protestant appeared and was represented by ATTORNEY, Attorney at Law. The Income Tax Division of the Oklahoma Tax Commission (“Division”) appeared and was represented by OTC ATTORNEY, Assistant General Counsel of the Legal Division of the Oklahoma Tax Commission. Exhibits, not herein itemized, were received into evidence, testimony was heard, and, upon receipt of Proposed Findings of Fact and Conclusions of Law from the parties, this case was submitted for decision.

STATEMENT OF FACTS

1. Protestant corporation is a Colorado domiciliary doing business in Oklahoma.
2. In June, 1985, the Division conducted a field audit of Protestant’s books and records and, as a result, issued to Protestant a proposed additional assessment of income tax for 1978 through 1983. The proposed assessment was subsequently revised, and Protestant’s tax liability was partially reduced. Protestant, however, timely protested the resulting proposed liability.
3. Protestant is a corporate entity which was formed in 1967 by the merger of COMPANY 1 with COMPANY 2. Following the merger, two Divisions were established, the Cement Division and the Potash Division. The Cement Division produced Portland cement in Oklahoma and sold Portland cement in Oklahoma and in other states. The Potash Division mined and distributed potash from New Mexico, Saskatchewan, Canada and New Brunswick, Canada. A single sales staff sold the potash. The potash was sold in the United States, including Oklahoma, as well as in international markets.
4. In 1973, Protestant entered into an agreement in Canada under which Protestant obtained the right to explore for and mine potash in New Brunswick. The agreement provided that, within a period of time, Protestant would incorporate its Canadian potash mining operation under the laws of Canada after it had attained a certain level of production. The agreement further provided that, after meeting this level of production, a certain percentage of the shares of the subsidiary would be sold to the Canadian public. Several delays in exploration and development occurred, and the conditions of various elements of the agreement were modified to some degree to allow for Protestant to meet its obligation to meet the agreed upon level of production. The entity in Canada finally became fully operational in 1983.

5. The exploration and production of potash at the New Brunswick mine did not meet agreed upon levels and two dispositions of Protestant's Potash Division were made. First, in 1984, Protestant incorporated the mining operation in Canada, transferring its assets in the New Brunswick mine and its profitable operation in Saskatchewan into the Canadian corporation by June, 1984. Second, in 1985, Protestant sold all its assets in its Canadian corporation, and in COMPANY 2 (a Division of Protestant) to a Canadian buyer. The latter sale was completed in early 1986. Testimony of WITNESS. Tr. pp. 12-14.

6. On its 1978 through 1983 corporate income tax returns, Protestant claimed as an expense the interest paid for the funds borrowed and invested in exploration, development and operation of the New Brunswick mine. The Protestant apportioned some of this expense to Oklahoma, using the three-factor formula under Section 2358 A.5. (formerly Section 2358 A.4.). The formula, used to reflect income and expenses under this statute, applies to businesses considered to be unitary in nature, that is, with centralized management and control of more than one corporation.

7. All the expenses claimed as a deduction for work in process relating to the development of the potash mine in New Brunswick were disallowed by the Division. The basis for the disallowance was that any income produced by the mine would not have been taxable by Oklahoma.

8. It is the policy of the Division to use a formula to govern the allocation of interest expense under 68 O.S. §2358 A.4. in certain cases, and a formula was used to disallow a portion of Protestant's interest expense for the years 1978-1983 based on figures from Protestant's federal income tax returns.

9. The formula used by the Division to disallow a portion of Protestant's interest expense is as follows:

$$\frac{\text{Investments}^*}{\text{Total Assets}} \times \text{Interest Expense} = \text{Disallowed Interest Expense}$$

* Obligations of the United States and other investments (including New Brunswick development costs)

10. Protestant had prior notice of the allocation formula as it had been utilized by the Division in an audit of Protestant's 1975 corporate income tax return resulting in a proposed assessment dated June 28, 1977, to which no protest was filed. On Oklahoma corporate income tax returns for 1977 and 1978, Protestant allocated expenses.

ISSUES AND CONTENTIONS

Protestant herein challenges the Division's use of an unpublished formula to allocate certain expenses to a State other than Oklahoma. In its audit, the Division had used this formula to allocate exploration, development and mining expenses arising out of activities in Canada, rather than allowing Protestant to apportion part of those expenses to Oklahoma. The Division likewise allocated away from Oklahoma the interest paid on capital borrowed to develop the

New Brunswick mine. Protestant also protests the Division's allocation of interest expense away from Oklahoma. The substance of Protestant's protest is that the Division's allocation is based on a legal fiction, and the allocation was made because the Division would not have been able to tax the future income from the mine because the Protestant divested itself of any ownership in the mining operation in the year after the period of assessment.

The Division contends that the allocation formula has been in use by the Division for many years, and in fact has been used to adjust Protestant's taxable income in Oklahoma in past years. The Division further contends that the allocation formula is supported only by facts, which although occurring subsequent to the audit period, were intended by Protestant to transpire, and that the allocation was made to clearly reflect income and expenses related to Oklahoma. The Division's statutory authority for this allocation by formula is Section 2366 of Title 68 of the Oklahoma Statutes. Finally, the Division contends that the formula applied to taxpayer herein has been in use for many years, and is a method used when the taxpayer does not produce books or records which reveal the precise amounts of income and expenses related to each income generating activity.

The issues are:

1. Whether the formula used by the Division for many years pursuant to statutory authority, but which formula is unpublished, is in violation of Protestant's right to due process and equal protection of the law.
2. Whether the Division may allocate expenses incurred in development of a business enterprise in another taxing jurisdiction to the state in which such activity is conducted when the expenses incurred bear no relationship to Oklahoma taxable income.

APPLICABLE LAW

This action arises under the Oklahoma Income Tax Code, specifically 68 O.S. Supp. 1978, §2358, 68 O.S. 1981, §2358, 68 O.S. 1971, §2366 and 68 O.S. 1981, §2366. The Oklahoma Tax Commission has jurisdiction to hear this protest under the Uniform Tax Procedure Code. 68 O.S. 1981, §207.

Protestant contends that its Due Process and Equal Protection rights guaranteed by the United States Constitution were violated because the allocation formula used by the Division to allocate expenses and income to another taxing jurisdiction was unpublished. Since the formula is unpublished, it could be either changed without notice or applied to some taxpayers and not others, according to Protestant. Finally, Protestant contends that the formula does not reflect the proper allocation of income and expenses.

Protestant's Due Process and Equal Protection claim in reality questions the Division's statutory authority to apply an unpublished formula to allocate or apportion the income and expenses of a corporation.

Protestant's constitutional challenge is not supportable because Protestant cannot deny that it had notice of the Division's use of the formula in question. Testimony at the hearing revealed that the formula had been used in audits of Protestant's returns in the past. Because of the Protestant's past audit experience, its obligations were unambiguous. Moreover, Protestant objected only to the appropriateness of the result and not to the failure of the Division to notify Protestant that the formula might be applied if necessary. Protestant was provided the opportunity at hearing to show why the formula produced a disproportionate result. What is required under the Due Process Clause is that the taxpayer be allowed the right to show by clear and cogent evidence that the application of a formula pursuant to statute produces a result out of proportion to the business transacted. See Moorman Manufacturing Co. v. Bair, 437 U.S. 272, 98 S.Ct. 2340, 57 L.Ed.2d 197 (1978). See also Hellerstein, *State Taxation; Corporate Income and Franchise Taxes* (1983). Protestant has been provided that opportunity but has not met its burden of proof.

At the hearing, testimony for the Division was that the allocation formula is widely used among state taxing authorities. The Division maintains that the allocation formula seeks to carry out the allocation and apportionment guidelines of Sections 2358 of the Income Tax Code. The Division further maintains that Section 2366 is statutory authority for allocating income and expense between business entities to clearly reflect net income and expenses attributable to Oklahoma. Following this line of argument, the allocation, pursuant to Section 2366, was proper according to the Division because the income and expenses which relate to the establishment of a separate Canadian corporation were non-unitary in nature and thus allocable either to the domiciliary situs of the parent corporation or to the situs of the mining exploration and development in Canada.

Section 2358 A.4. of Title 68 of the 1981 Oklahoma Statutes specifically provides for the items of property that are allocable:

§ 2358. Adjustments to arrive at Oklahoma taxable income and Oklahoma adjusted gross income.

* * *

A. The taxable income of any taxpayer shall be adjusted to arrive at Oklahoma taxable income for corporations . . . 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. . . .
- c. Net income or loss from a business activity which is not part of a 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.

Section 2366 provides for allocation of income and deductions:

§ 2366. Allocation of income and deductions

The Tax Commission may allocate gross income, gains, losses, deductions, credits or allowances between two or more organizations, trades or businesses (whether or not incorporated, or organized in the United States or affiliated) owned or controlled directly or indirectly by the same interests, if the Tax Commission reasonably determines such allocation is necessary to prevent evasion of taxes or to clearly reflect income of the organizations, trades or businesses. Each such organization shall be deemed to be transacting business in Oklahoma and subject to all the provisions of this act. This section shall apply only with respect to related organizations, trades or businesses which in the aggregate derive income both within and outside the State of Oklahoma and then only with respect to such income deductions, credits or allowances related thereto.

The purpose of the unitary business principle generally is to attribute to a particular taxing jurisdiction the values upon which the jurisdiction's net income tax should be assessed when a business operates in more than one state. Whether the Division's allocation of Protestant's income and expenses attributable to the Canadian mining operation was proper under subsection A.4.c. of Section 2358 and Section 2366 is the very core of this case.

The Oklahoma Supreme Court, in Ashland Exploration, Inc. v. Oklahoma Tax Commission, 751 P.2d 1070 (Okl. 1988), defined a unitary business as follows:

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 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. Oklahoma Tax Commission v. Southwestern Bell Telephone Co., 396 P.2d 500, 504 (Okl. 1964); Webb Resources, Inc. v. McCoy, 194 Kan. 758, 401 P.2d 879 (1965); Maurice L. Rothschild & Co. v. Comm’r. of Taxation, 270 Minn. 245, 133 N.W.2d 524 (1965).

Id. at 1072.

In Ashland the Protestant argued, and the Court agreed, that income of a non-unitary nature should be taxed by way of allocation. The Court further supported its holding by recognizing that Section 2358 A. distinguishes between “income derived from unitary business activities and income not so derived.” Id. at 1073. Holding that Protestant’s oil and gas income was partly from within and partly from without Oklahoma, the Court pointed out that the Income Tax Division had not determined as a matter of fact whether any of the Protestant’s income was not of a unitary nature. Such is not the case in the protest at hand. The Division specifically determined that Protestant’s exploration and development expenses of the Canadian venture were unrelated to Oklahoma; thus, Oklahoma should not, the Division argued, absorb a portion of the expenses by allowing for a proportionate reduction on Protestant’s Oklahoma return.

The Oklahoma Supreme Court, in Oklahoma Tax Commission v. Southwestern Bell Telephone Co., 396 P.2d 500 (Okl. 1964), considered the circumstances under which allocation or apportionment were proper. In Southwestern Bell, the taxpayer was engaged in both interstate and intrastate business in Oklahoma. The taxpayer kept its intrastate income and expenses separable so that income and expenses from the sale of intrastate business was clearly distinguishable from its interstate business. The Tax Commission took the position that the taxpayer’s intrastate and interstate activities were so commingled in a single business enterprise that separate allocation of income and expenses could not be made. The Court supported the trial court’s test for whether a business activity was separate or unitary. The trial court found that a business was separate where the in-state business was capable of being maintained as an independent business, and where the business was capable of producing a profit in and of itself. There, the taxpayer’s books were kept so as to allocate related income and expenses to Oklahoma. Where this could be done, the Court stated that allocation should be applied where practicable, citing Magnolia Petroleum Co. v. Oklahoma Tax Commission, 190 Okl. 172, 121 P.2d 1008 (Okl. 1941).

As to its interstate business, however, Southwestern Bell argued that its method of keeping its books showed that it could likewise be maintained as an “independent” business; thus its interstate income and expenses should be allocated to states other than Oklahoma. The Court in effect decided that this was not practicable where it could not be shown that the taxpayer’s interstate business overall was sufficiently separable from that portion of interstate business which depended upon the existence of intrastate facilities and services. The Court concluded that the apportionment statute was proper where the use of property partly within and partly without the state was involved.

Although Southwestern Bell was decided many years ago under the former Income Tax Act, the intent of the legislature as expressed by the 1961 statutes regarding allocation and apportionment is substantially the same as the statutes in effect at the time of the proposed assessment protested by Protestant herein. The purpose of apportionment is to allow the state to tax the interstate income to which intrastate income contributed, and to allow proportionate deduction of expenses related to earning that income. The facts in this case support the conclusions which follow, in sum, that Protestant's exploration and development expenses related to the Canadian potash mine did not constitute a part of a unitary business to which Protestant's business in Oklahoma was essential for its operation or even related thereto. They were thus allocable, under Section 2358 A.3. of the Supplement 1978 Oklahoma Statutes (currently Section 2358 A.4.c.), to reflect the proper character of the income and related expenses.

CONCLUSIONS OF LAW

In view of the above and foregoing findings of fact and law applicable thereto, the undersigned Administrative Law Judge finds as follows:

1. The Oklahoma Tax Commission has jurisdiction in this matter. 68 O.S. 1981, §207.
2. Net income and related expenses of a corporation, which are not of a unitary character, are allocable to the state in which such income producing activity is conducted. 68 O.S. Supp. 1978, §2358 A. (Currently codified in 68 O.S. 1981, §2358 A.4.c.)
3. The income and expenses related to the exploration and development of Protestant's Canadian potash mining operation are allocable. This allocation for 1978 through and including 1983 is appropriate because the income and related expenses of Protestant's potash mine were wholly separate and unrelated to Protestant's business in Oklahoma. Ashland Exploration, Inc. v. Oklahoma Tax Commission, 751 P.2d 1070 (Okla. 1988); Oklahoma Tax Commission v. Southwestern Bell Telephone Co., 396 P.2d 500 (Okla. 1964); Magnolia Petroleum Co. v. Oklahoma Tax Commission, 190 Okla. 172, 121 P.2d 1008 (1942).
4. Protestant's Due Process rights guaranteed by the Fourteenth Amendment to the United States Constitution are not violated by the use of a formula which has been employed by the Division to adjust Protestant's net income. The formula has also been widely used in other taxing jurisdictions and was known by Protestant to have been used in the past by the Oklahoma Tax Commission. The Protestant's net income was subject to readjustment by the Division upon a showing by Protestant that the resulting arithmetical proportion of Protestant's taxable income and related expenses was incorrect due to application of the formula. Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 98 S.Ct. 2340, 57 L.Ed.2d 197 (1978).
5. Protestant's protest should therefore be denied.

DISPOSITION

It is the ORDER of the OKLAHOMA TAX COMMISSION, based upon the specific facts and circumstances of this case, that the income protest of PROTESTANT be denied.

OKLAHOMA TAX COMMISSION