OKLAHOMA TAX COMMISSION

TAX POLICY DIVISION
DAWN CASH, DIRECTOR

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August 28, 2007

Re: Our file number LR 07-083; Income Tax Capital Gain Transaction

Dear

This is in response to your inquiry of June 25, 2007 wherein you requested a ruling concerning a transaction that gives rise to capital gain transaction. What follows is verbatim your facts and requested ruling and our response thereto.

**Facts:**

The S Corp and its shareholders were approached about a possible transaction pursuant to which the shareholders would sell 70% of the outstanding stock of the S Corp to an acquiring entity (the "Purchaser"). However, because of federal tax considerations (primarily relating to the limitation that an S corporation can only have one class of stock, and certain federal basis rules), the alternative transaction structure described below is being used in lieu of an outright sale by the shareholders of 70% of the stock in S Corp.

S Corp was formed as an Oklahoma corporation in 1998 and has, since that time, actively conducted business in Oklahoma. S Corp has always had its principal place of business in . The shareholders of S Corp have remained unchanged for more than five years prior to the present time. S Corp is primarily engaged in the provision of services to various businesses, in part through the use of software which is proprietary to S Corp.

In the proposed transaction, S Corp will contribute substantially all of its operating business assets (subject to all existing liabilities) to a newly-formed limited liability company (the "New LLC") in exchange for 99% of the aggregate membership interests in the New LLC. The interests in the New LLC held by S Corp immediately after these contributions will be of two types: (i) a 69.3% preferred interest (the "Preferred Interest") and (ii) a 29.7% common interest (the "Common Interest") in the New LLC. All of the assets contributed to the New LLC by S Corp will either: (i) have been held for more than three years by S Corp, or (ii) in the case of a relatively nominal amount of computer equipment and office furniture acquired during the last three years, be assets having a fair market value less than their basis, meaning that no gain would be recognized if they were sold directly to Purchaser. No real property will be contributed to or owned by the New LLC.

Following the contribution of substantially all of S Corp's operating business assets and liabilities to the New LLC in exchange for the Preferred Interest and the Common Interest, S Corp will sell the entire Preferred Interest, representing 69.3% of the aggregate membership interests in the New LLC, to Purchaser for cash.

**Ruling Requested.**

Based on the foregoing facts, we believe it is clear that, if 70% of the stock of S Corp had been sold directly to the Purchaser, Oklahoma's capital gain exclusion or deduction under Section 2358(F) would have provided for the exclusion of any resulting gain from the individual shareholders' Oklahoma taxable income. Similarly, if S Corp had simply sold all of its assets directly to Purchaser, Section 2358(D) would have provided excludability from Oklahoma taxable income since all capital assets upon which gain is recognizable have been held longer than three years, and S Corp is not selling, either directly or indirectly, any real property to Purchaser. The question upon which we seek assurance arises due to the fact that all of the operating business assets of S Corp are being contributed to New LLC, and the Preferred Interest in the New LLC is then being sold to Purchaser.

Federal income tax law has always provided that, when capital assets are contributed to an entity that is taxed as a partnership (in this case, the New LLC) in exchange for an interest therein under Internal Revenue Code ("Code") Section 721, the holding period of the contributed property tacks and the partner/member maintains the same holding period and adjusted basis in the partnership or LLC interest as it had in the contributed property. This "tacking" of holding periods is codified in Code Section 1223.

For purposes of Oklahoma's capital gain deduction or exclusion rules, the Commission has previously issued private rulings confirming the applicability of the tacking rules. See, for example, the ruling issued by the Commission on April 6, 2006, and identified as LR 05-085. While we realize that prior letter rulings do not bind the Commission with regard to taxpayers other than the taxpayers to whom they are issued, they do verify the Commission's existing analysis of an issue. We believe such tacking of holding periods, under the facts outlined above, has been contemplated by Oklahoma law at all times since the capital gain deduction was added to Section 2358.

In addition, as we have discussed, Senate Bill 685 (which was recently passed by the legislature and was signed into law by Governor Henry June 4) explicitly provides that for all taxable years beginning after December 31, 2005 the deduction from a corporation's taxable income for qualifying gains receiving capital treatment utilizes a holding period which includes "any additional period when the property was held by another individual or entity, if such additional period is included in the taxpayer's holding period for the asset pursuant to the Internal Revenue

Code". Because the changes made by Senate Bill 685 were simply clarifications of existing law, as verified by the Commission's revenue impact study, and because the new law effectively governs all taxable years beginning after December 31, 2005, we believe it is clear that, on the facts summarized above, all capital gain recognized by S Corp on the sale of the Preferred Interest in the New LLC will qualify for the Oklahoma capital gain deduction or exclusion.

Please confirm that, on the facts summarized above, all capital gain recognized by S Corp upon the sale of the Preferred Interest in the New LLC will qualify for the Oklahoma deduction for "qualifying gains receiving capital treatment".

**OTC RESPONSE:**

Since federal income tax law provides that when capital assets are contributed to an entity that is taxed as a partnership (in this case, the New LLC) in exchange for an interest therein under Internal Revenue Code ("Code") Section 721, the holding period of the contributed property tacks and the partner/member maintains the same holding period and adjusted basis in the partnership or LLC interest as it had in the contributed property. This "tacking" of holding periods is codified in Code Section 1223. Therefore, the gain described in the facts above meets the holding period test for the Oklahoma capital gain exclusion found in 68 O.S. § 2358 (F).

As an additional note, the provisions of SB 685 become effective for tax year 2008 and subsequent tax years. The changes outlined in 685 are not pertinent to this letter ruling, since the transaction you describe would have met the holding period test, regardless of the passage of SB 685. SB 685 would apply to other transactions in which the holding period did not clearly tack.

This response applies only to the circumstances set out in your request of June 25, 2007. Pursuant to Commission Rule 710:1-3-73(e), this Letter Ruling may be generally relied upon **only** by the entity to whom it is issued, assuming that all pertinent facts have been accurately and completely stated, and that there has been no change in applicable law.

If I can be of further assistance, please feel free to call me at (405) 521-3133.

Sincerely,

FOR THE OKLAHOMA TAX COMMISSION

Michael C. Kauffman
Tax Policy Analyst