NEW OKLAHOMA CAPITAL GAIN DEDUCTION DECISION

TAXPAYERS PREVAIL IN TACKING ARGUMENT AS TO

THREE YEAR OKLAHOMA HEADQUARTERS REQUIREMENT

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September 1, 2016

Oklahoma taxpayers win surprising victory in an Oklahoma capital gain deduction case where they argued that the "tacking" of Oklahoma headquarters periods of two entities should be allowed. In the following paragraphs we provide details on this new decision from the Oklahoma Tax Commission ("OTC") and its impact on other Oklahoma taxpayers. This three year Oklahoma headquarter "tacking" issue was addressed in the May/June 2016 issue of CPAFOCUS, pg. 26, where Edd Painter and James W. Heatherington provided Oklahoma taxpayers and taxpayer representatives a timely update on one of the biggest Oklahoma tax traps in their article "*Oklahoma Capital Gain: Another Trap for the Unwary*?" In the final two paragraphs, they address whether "tacking" applies in the context of the three year Oklahoma headquarters requirement associated with the capital gain deduction under 68 O.S. §§ 2358 D and F. The articles states "[T]he OTC has not provided a clear statement as to its policy on this matter." Despite the lack of a clear OTC order, ruling, rule or other statement, the Compliance Division ("Division") of the OTC has issued many income tax assessments and rejected even more refund claims where the taxpayers have asserted a "tacking" argument to satisfy the Oklahoma headquarters requirement. One of these cases finally made it through Oklahoma's administrative tax protest process and the taxpayers prevailed. While the decision has not been released to the public, the taxpayers' representatives have shared a redacted version of the OTC's decision addressing the "tacking" issue in the context of a merger transaction.

On August 16, 2016, the OTC adopted the proposed findings and conclusions issued by an OTC administrative law judge ("ALJ") in favor of taxpayers in an Oklahoma income tax capital gains deduction case. OTC Order #2016-08-16-25. ("2016 Order") The issue in the case was whether the merger of two companies ("LLC" and "Holdings") was a mere change in form of the legal organization of the same company, and if so, whether the taxpayers were entitled to "tack" the headquarters periods of LLC and Holdings in order to meet the three year Oklahoma headquarters requirement.

In this case, LLC was formed on May 21, 2007 and maintained its primary headquarters in Oklahoma throughout its existence. Holdings was formed on August 15, 2011 and maintained its primary headquarters in Oklahoma throughout its existence. On December 11, 2011, LLC merged into Holdings, with Holdings surviving. The only asset of LLC before and of Holdings after the merger was the stock of an operating company. Pursuant to the merger, the taxpayers

exchanged their LLC units for Holdings stock. On June 19 and December 20, 2012, the taxpayers sold the stock of Holdings which gave rise to the capital gains in question. The taxpayers claimed the Oklahoma capital gains deduction and argued that they satisfied the three year Oklahoma headquarters requirement by "tacking" the headquarters periods of LLC (May 21, 2007 to December 11, 2011) and Holdings (August 15, 2011 to the date of the sales). The Division disallowed the deduction; reasoning that the Oklahoma capital gains deduction did not allow "tacking" of the headquarters periods and that the headquarters period of Holdings alone must be three years.

The taxpayers argued that LLC and Holdings were the same entity, and the merger was effectuated merely to change the form of the entity. The Division responded that while the statutory language deduction does not prohibit a change in form of an entity, the form of the merger must control and only the surviving entity's period of existence could be used. The Division also argued that while the Oklahoma legislature expressly allowed for "tacking" in determining the holding period of an asset sold, it did not include similar language when it could have if it intended to allow "tacking" for the purpose of meeting the three year Oklahoma headquarters requirement. In response, the taxpayers cited to *TPQ*[1], showing that the Oklahoma Supreme Court "looked through" the form of a transaction to its substance in order to effectuate the legislative intent behind a tax credit.

The ALJ noted that the goal of any inquiry into the meaning of a statute is to give effect to the intent of the legislature and if the language is plain and unambiguous, it will not be subject to judicial construction. Without expressly stating it in the opinion, the ALJ appears to have concluded the statute was ambiguous and warranted statutory construction. In order to find the intent of the legislature, the ALJ cited to passages from the Oklahoma Supreme Court's ruling in *CDR*[2], which stated that the Oklahoma capital gains deduction "was passed by the Legislature to promote significant business investment in Oklahoma's economy." Based on this, the ALJ concluded that the Division's interpretation defeated the purpose of the deduction and was at odds with the *TPQ* decision because it exalted form over substance. The ALJ found that the substance of the merger was that Holdings was a "mere continuation" of LLC, and that allowing the taxpayers to "tack" the headquarters periods of LLC and Holdings to satisfy the three year headquarters rule promoted the legislative intent of attracting business and promoting economic development of Oklahoma. Upon OTC Commissioners' adoption of the ALJ's findings and issuance of the 2016 Order, this case is now completed. The State cannot appealed an OTC order.

Given the sparse legal analysis, there are many unanswered questions about the application of the 2016 Order to other factual situations where a taxpayer continues his or her business operations but there is some change in the form of the business entity. Such transactions would arguably include the formation of a holding company, a family LLC or a change in the form of the business entity from a limited partnership to an LLC or a corporation to an LLC. In such situations, it seems reasonable to conclude that the new entity is a continuation of the old one and "tacking" for the purpose of the three year Oklahoma headquarters requirement should be allowed. Certainly allowing such common business and estate planning

[1] *TPQ Inv. Corp. v. State ex rel. Oklahoma Tax Comm'n*, 1998 OK 13, 954 P.2d 139.

[2] *CDR Systems Corp. v. Oklahoma Tax Comm'n*, 2004 OK 31, 339 P.3d 848.

transactions promotes the legislative intent of attracting and retaining businesses and promoting Oklahoma economic development.

The 2016 Order could immediately impact taxpayers with similar or identical fact patterns who have stayed their cases before the OTC ALJs or have pending protective refund claims. Taxpayers who did not claim the capital gain deductions on such transactions can also file refund claims if the Oklahoma income taxes were paid in the last three years. Even taxpayers who participated in the 2015 Oklahoma Voluntary Compliance Initiative may be able to make a refund claim for income taxes paid.