TULSA CHAPTER OSCPA

**Odd Items for Oklahoma**

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## A. INDIAN RESERVATION STATUS FOR ABOUT 2/3 OF OKLAHOMA

**Generates an employment credit of $4,000 per qualified employee annually (Form 8845) and faster depreciation.** Worthwhile to point out a few items here:

1. **The IRS Has a Precise Map Available**—Map describes the qualified areas.

2. **The 1993 Base for Form 8845 Credit**--Has been a problem for many companies. Difficulty in determining the1993 base is not a very good reason to by-pass claiming the credit. If you can obtain a valid statistical sample, you should be able to develop a reasonable 1993 base.

3. **Compensation Limit (Currently $45,000)**--Under IRC Section 45A, this is described as an "annual rate." So if someone was employed for only six months and made $25,000 during that period, that would take them above the $45,000 annual rate, so they would not qualify. With regard to overtime, we have argued with the IRS on this point, and still believe that overtime does not count toward the $45,000 wage limit since it is not part of the "annual rate."

4. **Benefits Extended Through 2016 By 2015 Tax Bill**

## B. PROVISIONS OF OKLAHOMA LAW

1. **Capital Gain Deduction**—This has been a confusing mess since its initial enactment in 2004. We have the CDR saga, which dealt with the Oklahoma Supreme Court rendering an opinion that CDR did not satisfy the definition of an "Oklahoma company" for purposes of the Oklahoma capital gain deduction. The case ended with the Oklahoma Tax Commission (OTC) settling with CDR, despite having a 5-4 win in the Oklahoma Supreme Court (Docket No. 109.886, 4/22/14). Although this action was criticized by some observers, it was a very prudent move on the part of the OTC, since CDR had a very impressive brief ready to file with the U.S. Supreme Court. The basic problem for the OTC is a 9-0 decision in 1996 by the U.S. Supreme Court, Fulton Corp. v. Faulkner, (116 S.Ct. 848) where the Court held that a tax break related to North Carolina's

intangible tax for ownership of stock of corporations paying North Carolina's income tax violated the Commerce Clause. Oklahoma's capital gain benefit for entities headquartered in Oklahoma does not appear to align with the Fulton decision.

The attorney for CDR, Thomas Ferguson, has other cases in progress which will result in larger refunds than the CDR case. Consequently, taxpayers who sold shares of non-Oklahoma companies should consider filing refund claims. Note that the statute of limitations for 2014 Oklahoma Form 511 runs out April 15, 2018. Unlike federal law, Oklahoma law does not take extensions into account.

There are several reasons why refund claims are worth considering for taxpayers whose stock sales would qualify for the Oklahoma capital gain deduction except for the company headquarters being outside Oklahoma:

a. Ferguson has a strong case.
b. It is likely the U.S. Supreme Court will not look favorably on an Oklahoma decision that is at odds with the Fulton case.
c. The CDR decision was only 5-4 for the OTC and the appeals court decision it reversed was 3-0 for CDR.
d. There is a more recent Supreme Court decision, Comptroller of Maryland v. Wynne (135 S.Ct. 1787, 2015)
e. The five-member CDR majority cannot be pleased with the published criticism of their CDR decision and may be less pleased with the OTC settlement with CDR.

2. **Sales Tax Issue When Buying or Selling Business**--Oklahoma has a fairly unique rule for sales tax applicable to the sale of a business. First, unlike other states, Oklahoma has no blanket exemption for occasional and isolated sales such as the sale of a business. Second, in order to qualify for the manufacturer exemption, the buyer needs to file for a manufacturer exemption prior to closing. It is possible to get a temporary certificate. The date of application is accepted as cutoff date by the OTC.

3. **Avoiding the Franchise Tax**--See attached article from 2002.

4. **Form 506—Oklahoma Manufacturer's Tax Credit**--This is 5% of your manufacturing property additions or $2,500 for each new manufacturing job, claimed on Form 506. Double credit for "Enterprise Zone" areas. Oklahoma Department of Commerce (www.commerce.ok.gov) has a website with maps based on census tracts. Best to actually check with them because maps are sometimes unclear and areas are subject to change (405-815-5120).

   a. The credit is subject to a limitation for years 2016, 2017 and 2018, the limitation is yet to be determined, but should be something close to 60% of the credit otherwise available. Note that the credit is doubled if you are in an enterprise zone, so it will usually pay you to check with the Oklahoma Department of Commerce to see if your location is in the "enterprise zone." There are some maps available, but they are hard to read and sometimes not up-to-date. A simple email to the Department of

Commerce will get you a response that tells you whether or not your location is in the enterprise zone. A manufacturer qualifies for the credit by filing a registration form with the OTC. In the past, the OTC has frequently disallowed manufacturing status based on some arbitrary decisions. If you have a manufacturing operation, it would be worthwhile to make a careful submission, and to follow up with a protest if manufacturer status is denied.

b. The OTC has done some flip flopping with regard to lessors who lease manufacturing property to a qualified Oklahoma manufacturer. The current interpretation apparently is that the lessor does not qualify for the credit because the lessor is in the business of leasing rather than manufacturing. For other purposes under the Internal Revenue Code, the lessee's business is taken into consideration in classifying the property for depreciation purposes, so that the OTC's position is somewhat dubious. An interpretation from some years earlier was that the lessor could claim the credit so long as the property would qualify in the hands of the lessee. This would apply for example if the lessee was taking an investment credit rather than a jobs credit and was not claiming a quality jobs payment. It is fairly common for a manufacturer to lease real estate from a related party. Note that the manufacturing facility does qualify for the credit based on the square footage utilized for manufacturing versus office or storage.

c. If the manufacturer is a partnership, it may be possible for the partnership to allocate the (Form 506) tax credit amongst partners so as to maximize the benefit. This is particularly true if there are of out-of-state partners who might derive no benefit whatsoever by utilizing the Form 506 credit to reduce their Oklahoma income tax. Oklahoma has a unique taxation scheme with regard to out-of-state income. Other states provide a credit for tax on out-of-state income whereas Oklahoma provides an exclusion with a salary exception.

5. **Out-of-State Income and Delaware Holding Companies**

a. Probably the strangest feature of Oklahoma income tax is that, unlike other states, out-of-state income is excluded. Other states allow a proportionate credit for state tax paid on out-of-state income, but all of the income is included in your tax return. If you have income from a rental property in a non-tax state like Florida or Texas, you nevertheless pay your income tax on the Florida/Texas income.

b. Delaware Holding Companies—See Item attached on Delaware Holding Companies.

6. **Apportionment**

a. Oklahoma uses a standard three-factor apportionment formula based on 1/3 wages, 1/3 property and 1/3 sales, with a throwback provision for sales which are not subject to income tax in a destination state. So there is then a question of whether sales destined for another country should be "thrown back" and treated as Oklahoma sales. The form refers to sales not subject to tax in another state or country, but the statute itself at Section 2358 A.5.c.(1) says "...the taxpayer is not doing business in the state of the destination of the shipment."

b. Wage Factor—Most states determine wages where the employee is based. So an employee based in Arkansas would have Arkansas wages even if he spent time in Oklahoma developing sales. Oklahoma's payroll factor is based on time spent in Oklahoma under Rule 710:50-17-71(3)(E).

# QUESTIONNAIRE

TO CURRENT OR FORMER EMPLOYEES OF ______________________________

In order to determine our income taxes, we are required to determine whether you **or** your spouse were an enrolled member of an Indian Tribe for each year you were our employee. This information does not affect your personal tax situation. If you do not respond to this questionnaire, we will assume that you or your spouse were not enrolled members of an Indian Tribe.

Were you or your spouse an enrolled member of an Indian Tribe during the following years? Please circle YES or NO for **each year that you were employed by us**.

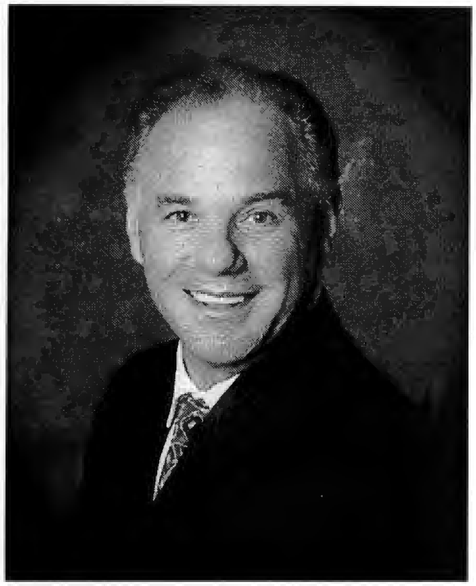
| | | | | | |
|---|---|---|---|---|---|
| 2006: | YES | NO | 2012: | YES | NO |
| 2007: | YES | NO | 2013: | YES | NO |
| 2008: | YES | NO | 2014: | YES | NO |
| 2009: | YES | NO | 2015: | YES | NO |
| 2010: | YES | NO | 2016: | YES | NO |
| 2011: | YES | NO | | | |

______________________________ ____________
Signature Date

______________________________
Social Security Number

______________________________
Tribe

______________________________
Tribal Enrollment Number



# Avoiding Oklahoma Franchise Tax

## By Rick Kells, CPA, JD, LLM

*Richard "Rick" Kells was a partner with the law firm of Hartzog Conger Cason & Neville, P.C. He was past president of the Oklahoma City Tax Lawyers Group, past chairman of the OBA Tax Section and past Chairman of the Oklahoma Society of CPAs' Taxation Committee. Kells served on the Board of Directors for the OSCPA. He was a fellow of the American College of Trust and Estate Counsel and was listed in The Best Lawyers in America in Tax Law and Trusts & Estates Law. The OSCPA Taxation Committee created the Rick Kells Outstanding Tax Professional Award (http://www.oscpa.com/Content/60958.aspx) in his honor. This article appeared in the May/June 2002 issue of* **CPA*FOCUS*.**

Any corporation conducting business in Oklahoma, whether a C corporation or a S corporation, is subject to Oklahoma franchise tax. Limited liability companies (LLCs) are not subject to Oklahoma franchise tax. Therefore, when creating a new entity for a business, it is usually preferable to organize as a LLC rather than a corporation. A LLC can, if it wishes, elect to be taxed for Federal income tax purposes as an association taxable as a corporation. Further, a new LLC electing corporate treatment can, if it qualifies, elect S corporation status. If the corporate election is not made, the LLC will be taxed as a partnership for Federal income tax purposes - or if a one-member LLC - as a disregarded entity. Regardless of how a LLC is taxed for Federal income tax purposes, it is not subject to Oklahoma franchise tax.

Effective Nov. 1, 2001, Oklahoma law permits a corporation to convert to a LLC by simply filing Articles of Conversion with the Secretary of State. Articles of Organization for the LLC must also be filed. If the LLC wants to continue to be taxed as a corporation it would simply make such an election by filing Form 8832 with the IRS. The conversion from a corporation to a LLC electing corporate treatment should be non-taxable as a mere change in form under Section 368(a)(1)(F). Therefore, if a S corporation converts to a LLC and elects corporate treatment by filing Form 8832, it will continue to be taxed as a S corporation and no new S election is necessary.

Before Nov. 1, 2001, such conversion of a corporation was usually accomplished by creating a new LLC, immediately merging the corporation into the LLC and electing corporate tax treatment. This was accorded the same tax treatment as outlined above. The new law allows for a one-step conversion, rather than the prior two-step process of creation of a LLC and merger.

An operating agreement for the LLC should be entered into by the owners before the conversion. If S corporation status is desired, it must be carefully drafted to avoid more than one class of stock. The conversion should not affect the validity of existing contracts. Further, for income tax purposes, the LLC would use the same tax identification number. Rev. Rul. 95-37. On its next tax return, it would simply reflect the change in name to a LLC.

With a parent and a subsidiary, both the parent and the subsidiary could file Articles of Conversion and Articles of Organization. If the subsidiary did not make the election to be taxed as a corporation and was wholly owned, it would be considered a disregarded entity or division of the parent. In that case, the subsidiary's conversion to a LLC would be considered a liquidation of the subsidiary which is usually tax free under IRC Section 332. Another advantage of using non-electing LLCs as subsidiaries is to avoid the complexities of the Federal consolidated return rules.

The Federal income tax treatment will apply automatically for Oklahoma income tax purposes, but not for Oklahoma sales tax purposes. However, sales tax exemptions are available that should apply to a conversion.

Current tax reform proposals call for repeal of the franchise tax. Since the franchise tax is paid in advance through June 30, corporations which are considering a conversion to a LLC may want to wait until May or June. If, at that time, it appears the franchise tax will not be repealed, a conversion can be made before July 1, 2002.

## DELAWARE HOLDING COMPANIES

The Delaware Holding Company (DHC) is an old device. Also referred to as a passive investment company (PIC). The tax haven state doesn't have to be Delaware, it could be Nevada or elsewhere. Although commonly used to shelter income from a securities portfolio, much more can be involved. Example: Corporation about to sell stock for large gain, fully taxable in the selling corporation's home state. Selling corporation sets up Delaware or Nevada holding company and transfers the stock to the holding company. Stock is then sold by the Delaware or Nevada holding company and is exempt from tax in Delaware or Nevada.

Problems:

A. Selling state may look at step transaction theory to argue that gain does not belong to holding company but to shareholder. It will be important to be able to show that the transfer of assets to the holding company and their subsequent sale are independent transactions which should not be combined ("stepped") into one transaction for tax purposes.

B. Notwithstanding the legal location of the holding company, a taxing state may argue that business and investment decisions are made by personnel in the taxing state where books and records are kept and most of the corporation's activities are performed. This gives the corporation a domicile in the taxing state.

1. Oklahoma was successful with this argument in Chestnut Securities Co. v. Oklahoma Tax Commission, 125 F.2d 571 (CA-10, 1942), and Texas was successful in Lawrence Industries, Inc. v. Sharp, 890 S.W. 2d 886 (1994). Both of these cases are good examples of how not to utilize a DHC.

2. Geoffrey, Inc. v. S. Carolina Tax Commission (S. Carolina Supreme Court, Case No. 23886, 7-6-93). Delaware subsidiary of Toys-R-Us licensing Toys-R-Us trademarks and trade names in S.C. was held subject to S.C. income tax.

3. Aaron Rents, Inc. v. Collins, Fulton Co., GA Super. Ct., Case No. D-96025 (6-25-94). Delaware subsidiary held trademarks and service marks and got royalties of 2% of gross sales. Taxpayer convinced Georgia lower court of good business purposes and holding company structure was upheld. Georgia Department of Revenue attacked Georgia subsidiary deductions.

4. Koch v. Commissioner of Revenue, 416 Mass. 540 (1993) held for taxpayer, a Massachusetts resident who transferred Koch stock to a number of Delaware S corporations just prior to redemption. The Mass. Supreme Court held that the taxpayer had "effectively transferred his shares to his Delaware S corporations before closing on the sale to Koch Industries, Inc. of its stock..." Massachusetts law at the time of the transaction was similar to Oklahoma.

If enough money is involved, consider utilizing an officer in Delaware or Nevada. Sophisticated institutions such as Wilmington Trust will provide such services.

For Oklahoma purposes, an out-of-state partnership or S corporation may provide similar results. Oklahoma's relatively unique way of taxing resident individuals on income from out-of-state partnerships and S corporations means that the DHC gimmick (as used by Mr. Koch) may work for individuals as well as corporations.

# Business Personal Property Tax Freeport Exemption for Inventory

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**By James W. Heatherington, CPA, and Joe Boydston**

There is a property tax exemption for inventory acquired from outside Oklahoma and either resold outside Oklahoma or incorporated into a product sold outside Oklahoma. The exemption has a rather unique aspect. Rather than being included in Oklahoma statutes like other tax exemptions, it is actually part of the Oklahoma Constitution (Article X, Sec. 6A).

The wording of the exemption presents interesting questions. The section first explains that property moving in interstate commerce is exempt, and that "Goods, wares and merchandise ... shall be deemed to move in interstate commerce and not subject to taxation in the State if not detained more than nine months where such goods, wares and merchandise are so held for assembly, storage, manufacturing, processing or fabricating purpose ..."

The Oklahoma Tax Commission has developed a form for computing the exemption, the Freeport Exemption Declaration (Form 901-F). The form, which has been in use for many years, contains five separate sections. The first section (lines 1 - 6) computes a cost of goods sold, and the second section (lines 7 – 11) computes an average inventory and an inventory turnover period. This determines whether your inventory is around for more than nine months, in which case no exemption would be allowable. Because no business can afford to have an inventory turn that long, the nine-month test as interpreted by the form should have no effect except in very unusual circumstances (taxpayers likely headed for bankruptcy).

For taxpayers who have slow-moving inventory, there may be an argument available. The idea is to segregate the slow-moving inventory to show that a portion of the inventory is not in Oklahoma for nine months and thus qualifies for the Freeport exemption.

Section three of the form (lines 12 – 15) is a computation of purchases and identifies "inventory purchased from Oklahoma vendors" to determine the percentage of purchases which would not be exempt from property tax. Section four (lines 16 – 19) identifies sales sold and shipped out-of-state. Note that this is not the same as out-of-state sales for income tax apportionment purposes. For Oklahoma income tax purposes, a sale is only considered to be an out-of-state sale if the seller is "doing business" in the destination state. For property tax exemption purposes, an out-of-state destination is the only requirement. Section five of the form (lines 20 – 22) multiplies the average inventory by the lesser of the out-of-state purchase percentage to determine the amount of exempt inventory.

The form is a logical attempt to provide a compliance mechanism for some rather difficult language. However, line 14 of the form, "Inventory purchased from Oklahoma vendors," may represent a departure from the constitutional language, so as to deny taxpayers an exemption to which they should be entitled. Many Oklahoma businesses purchase inventory materials from Oklahoma vendors which may be exempt under the constitutional language. If an Oklahoma manufacturer with an inventory turn of four months purchases materials from an Oklahoma wholesaler who has an inventory turn of four months and who purchases all of his goods from outside Oklahoma, then such items would seem to meet the nine-month period required by the constitution for a property tax exemption.

For taxpayers subject to the purchase limitation rather than the sales limitation, who purchase materials from an Oklahoma vendor that are obtained by the Oklahoma vendor from out-of-state, it will probably be worthwhile to obtain a statement from the vendor concerning his inventory turnover (line 11 of the Freeport Exemption Declaration). It is very likely that the manufacturer's inventory turnover and the wholesaler's inventory turnover together will be much less than the nine-month period stated in the Oklahoma Constitution.

It is entirely possible that the tax assessor would insist on following the language of the form, so that the above would be to no avail. It is more likely that the issue would not be raised at all. €

**CHARITABLE STUFF-IRC SECTION 501(c)(3)**

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Tulsa Chapter OSCPA

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## A. MANAGEMENT ISSUES

1. Low pay, volunteer Board and problematic internal controls

2. Typical—CPA prepares Form 990, Forms 941 and W-2s are handled internally

3. IRS Penalty structure—reasonable cause (Ogden vs. Oklahoma City)

4. Annual Oklahoma Registration form for Secretary of State

5. Note new extension procedure: one 6 month period instead of two 3 month periods

## B. GETTING EXEMPTION, FORM 1023

1. Lots of help on IRS website and IRS Publication 557. Also shorter Publication 4220.

2. Consider affiliation with a church or other established charity instead of giving yourself a large and endless headache

## C. PRIVATE FOUNDATIONS

1. Silly to do this unless you have a large amount of money and a real intention to spend it for eleemosynary purposes.

2. Donations more limited—30% of AGI instead of 50%, and 20% for capital gain property Limited to cost for other than publicly traded securities

3. Annual Form 990 PF is a public document and there are annual taxes to pay.

4. Lots of penalties levied directly on "disqualified persons" otherwise known as "DIPs" who fail to observe the rules for PFs.

## D. UBIT—IRS PUBLICATION 598 & FORM 990-T

For most charities, main item is income from donations of partnership interests.
Note gain on sale is also UBIT.
Partnership investments (including PTPs) generate UBIT.

## E. CONTRIBUTIONS

1. IRS Publications 526,1771 & 561

2. Form 8283

   a. Need actual appraisal at $5,000 threshold for "similar" items

   b. "Qualified Appraisal"

   c. Donative intent

   d. *Darden* TC Memo 2012-140
      Lots of defective acknowledgement letters from charities, failing to state "no goods or services were provided by the donee in consideration, in whole or in part, for the above gifts." Also, the letter must be "contemporaneous."

## F. USE OF CONTRIBUTIONS FROM A TRADITIONAL IRA FOR FOLKS AGE 70 ½

1. No deduction, but no AGI either

2. Particular benefit where AGI is a factor or for a non-itemizer

   a. Medical deduction and misc. itemized deductions

   b. Taxability of Social Security

   c. May affect rental loss threshold

   d. Effect on Medicare premium

   e. High incomers—Phase out of deductions/exemptions and effect on 3.8% tax on unearned income