

## Oklahoma Civil Court of Appeals Issues Revised Opinion on Constitutionality of Capital Gains Deduction for In-State vs. Out-of-State Companies

June 27, 2013

### Overview

The Oklahoma Court of Civil Appeals recently withdrew its original opinion and released a revised opinion for *CDR Systems Corporation v. Oklahoma Tax Commission*.<sup>1</sup> In the initial holding on January 17, 2013, the Court of Civil Appeals held that the state's corporate capital gains deduction under Okla. Stat. tit. 68, §2358(D) was unconstitutional because it facially discriminated against non-resident taxpayers in violation of the Commerce Clause of the United States Constitution. In the revised opinion issued on June 12, 2013, the Court vacated its original decision, and remanded it with directions.<sup>2</sup> The Court specifically elaborated on the unconstitutional nature of sections of the statute under the Commerce Clause – upholding the capital gains deduction but invalidating the discriminatory distinctions made between Oklahoma and non-Oklahoma entities. The Court also discussed the retroactive effect of its holding.

In this Tax Alert we summarize the Court of Appeals' decision.

### Background

CDR Systems Corporation ("CDR"), an S corporation for federal income tax purposes, was incorporated in California, headquartered in Florida, and did business in Oklahoma and other states. CDR had an Oklahoma manufacturing facility. In 2008, CDR entered into a stock sale agreement with Buyer.<sup>3</sup> At Buyer's election, the transaction was treated as an asset sale for federal income tax purposes. CDR had owned the underlying assets for more than three but less than five years before the sale and had included the gains it received as capital gains in its 2008 federal income tax return. In 2009 CDR amended its Oklahoma return to claim the Oklahoma capital gains deduction under Okla. Stat. tit. 68, §2358(D) for the gain it received in the transaction with Buyer. As applicable to the tax year before the court, that section allows a corporate deduction for capital gains from sales of real and tangible personal property located in Oklahoma and held for at least five years.<sup>4</sup> The statute also provides deductions applicable to sales of stock of an "Oklahoma company" and to sales of all or substantially all of the Oklahoma property of an "Oklahoma company," provided such stock or property is held for at least three years.<sup>5</sup> An "Oklahoma company" is defined as "an entity whose primary headquarters have been located in Oklahoma for at least three . . . uninterrupted years prior to the date of a transaction from which the capital gains arise."<sup>6</sup> Thus, the statute provides capital gain deductions applicable to stock or certain property held for at least three years by Oklahoma-headquartered companies. In contrast, for a capital gain deduction to apply to certain property sold by non-Oklahoma companies, a five-year holding period is required.

The Compliance Division of the OTC denied CDR's capital gains deduction. CDR appealed the matter to the Court of Appeals on the grounds that the statute unconstitutionally discriminates against non-resident taxpayers by allowing the shorter, three-year holding period only for stock or certain property of an Oklahoma-headquartered company.

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<sup>1</sup> *CDR Systems Corporation v. Oklahoma Tax Commission*, Court of Civil Appeals of the State of Oklahoma, Case # 109886 (Jan. 17, 2013).

<sup>2</sup> *CDR Systems Corporation v. Oklahoma Tax Commission*, Court of Civil Appeals of the State of Oklahoma, Substitute Opinion, Vacated with Remanded Directions. Case # 109886 (June 12, 2013).

<sup>3</sup> The court opinion refers to CDR, the entity itself, as having "entered into a stock purchase agreement." *CDR Systems Corporation*, (1/17/2013) slip op. at ¶ 5.

<sup>4</sup> Okla. Stat. tit. 68, §2358(D)(2)(a)(1).

<sup>5</sup> Okla. Stat. tit. 68, §2358(D)(2)(a)(2), (3).

<sup>6</sup> Okla. Stat. tit. 68, §2358(D)(2)(c).

## Oklahoma Court of Appeals Ruling

In its action before the Court of Appeals, CDR asserted that the capital gains deduction statute unconstitutionally discriminates against non-resident taxpayers in violation of the U. S. Constitution.<sup>7</sup> The Court held that the statute is facially discriminatory under the Commerce Clause.<sup>8</sup>

The Court determined that portions of Okla. Stat. tit. 68, §2358(D) were inherently discriminatory because they imparted favorable treatment upon Oklahoma companies and disparate treatment on companies outside of Oklahoma: "The capital gains deduction set forth in §2358(D) discriminates between corporate transactions based on interstate considerations -- in this case, whether the corporate taxpayer is an "Oklahoma company" -- which is facially discriminatory under the Commerce Clause."<sup>9</sup> The net effect of the statute was a desire to provide preferential treatment to Oklahoma companies and not to out-of-state companies for similar taxable transactions.<sup>10</sup> Because this different treatment of in-state companies vs. out-of-state companies is discriminatory and contrary to the intent of the Commerce Clause, the Court found it to be unconstitutional.<sup>11</sup>

Then Court did not, however, hold Okla. Stat. tit. 68 § 2358 (D) - and the capital gains deduction provided therein - to be unconstitutional in its entirety; rather, only those discriminatory distinctions between "Oklahoma" and non-Oklahoma entities regarding sales of real or personal property located in Oklahoma. In particular, any holding period requirement exceeding three years and any reference in restricting the application of the capital gains deduction only to "Oklahoma" companies, limited liability companies, or partnerships were held to be unenforceable by the Court.<sup>12</sup> Essentially, the same tax benefit afforded to an Oklahoma company should be allowed to an out-of-state company when there is a similar taxable transaction. Those sections of §2358(D) not discriminatory in nature are still applicable.

Lastly, the opinion addressed whether the Court's holding would apply retroactively or only prospectively. Because the case centered on a Constitutional matter, the holding "must be given full retroactive effect in all cases" as long as they are not time-barred, "regardless of whether they predate or postdate the announcement of this rule." Accordingly, the Court's decision applied retroactively and CDR is entitled to the relief it seeks.

## Conclusion

The Court reversed the OTC's decision, holding that Okla. Stat. tit. 68, §2358(D) is inconsistent with the Commerce Clause of the U.S. Constitution and thus unconstitutional.<sup>13</sup> Furthermore, the Court declared that its decision would apply retroactively.

## Amended Returns

Taxpayers similarly situated as CDR should consider filing amended returns to claim refunds. Soon after the initial Court of Appeals decision, the OTC released guidance as to how to claim a refund related to a capital gain claim. See (<http://www.tax.ok.gov/devdocs/CapGainsRef.html>) which provides as follows:

Taxpayer and/or Taxpayer's Preparer must file:

1. The fully completed Oklahoma amended income tax return(s) with "Oklahoma Capital Gain Claim for Refund" written at the top of page one of the return(s); and
2. The fully completed Oklahoma Form 561 Capital Gain Deduction, and
3. The appropriate Federal Schedule D with Federal Form 8949, if applicable, and
4. Federal Form 4797 OR Federal Form 6252 OR Schedule K-1, if applicable.

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<sup>7</sup> *CDR Systems Corporation*, (1/17/2013) slip op. at ¶ 10.

<sup>8</sup> *Id.* at ¶18.

<sup>9</sup> *CDR Systems Corporation*, (6/12/2013) slip op. at ¶ 18.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.* at ¶ 26.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.* at ¶ 29.

Transmit the return(s) and supporting documentation to the OTC in one of the following ways:

Mail to:	Fax to:
Oklahoma Tax Commission	(405) 522-1783
PO Box 258814	
Oklahoma City, OK 73126	

The statute of limitations for filing an amended return generally runs three years from the original due date of a return (not including extensions).<sup>14</sup> Corporate taxpayers with a fiscal year end should consider whether their 2009 tax year is still open under Oklahoma's statute of limitations.<sup>15</sup>

## Contacts

If you have questions regarding this court decision, the OTC's recent guidance, or other Oklahoma tax matters, please contact either of the following Deloitte Tax professionals.

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<sup>14</sup> Okla. Stat. tit. 68 §§ 227(a), (b), 2385.16.

<sup>15</sup> Federal waivers of the statute of limitations or changes resulting from federal audits may also affect the Oklahoma statute of limitations. Okla. Stat. tit. 68 §§ 227, 223, 2375.H.