

Ideas & Insights

Oklahoma Capital Gains Exclusion

Why is this law important to you? Oklahoma income tax on the gain from the sale of property can be significant. State income tax on gain is levied at the same rate as on ordinary income. Thus, if you have more than \$10,001 of Oklahoma taxable income, you will be in the 5.65% state income tax bracket, and any gain from the sale of property in Oklahoma will be subject to Oklahoma income tax at that rate. Keep in mind that the maximum federal tax rate on long-term capital gains is currently 15% (excluding sales of collectibles and unrecaptured Section 1250 gains). Thus, the Oklahoma tax on the sale of property can be almost half as much as the federal tax.

What sales are subject to Oklahoma income tax? If you are a resident of Oklahoma, then virtually all gain from the sale of property you own, other than real estate located in another state, will be subject to Oklahoma income tax. Also, if you own an interest in a pass-through entity, such as an LLC, a partnership or an S Corporation, and that entity sells property for a gain, the gain will be passed through to you and will be subject to Oklahoma income tax. If you own an interest in an entity and sell your interest at a gain, then the entire amount of that gain (even that portion attributable to intangibles in connection with the sale of a business) will be subject to Oklahoma income tax.

How Does the Exclusion Work? For tax years beginning January 1, 2005 or after, both individual and corporate taxpayers may exclude “qualifying” capital gains from their Oklahoma taxable income. For tax years beginning January 1, 2007 or after, trusts and estates may also exclude “qualified” capital gains from their Oklahoma taxable income. Specifically, the exclusion allows taxpayers to subtract from their Oklahoma adjusted gross income, “qualifying gains receiving capital treatment” which were reported on their Oklahoma tax return and included in their federal taxable income. 68 O.S. §2358(D)-(F).

Following is a summary of the types of property eligible for qualifying capital gains, along with the required holding period for that property:

1. The sale of Oklahoma real property or Oklahoma tangible personal property (all personal property owned by an Oklahoma resident, wherever located, will be deemed to be Oklahoma tangible personal property). For individuals, corporations, estates or trusts, the required holding period is five years.
2. The sale of an ownership interest in an Oklahoma entity. For an individual, the required holding period is two years; for a corporation, estate or trust, the required holding period is three years.
3. The sale of Oklahoma real property, tangible personal property, or intangible personal property as part of the sale of all or substantially all of the assets of an Oklahoma entity. Such property must have been held either directly or indirectly

by the Oklahoma entity or owned by the owners of the Oklahoma entity for a holding period of two years (individuals) or three years (corporations, estates or trusts).

As a result of Senate Bill 685, the Oklahoma exclusion has been amended to make clear that the gain attributable to the sale of intangible assets associated with the sale of the assets of a business and the sale of a sole proprietorship will qualify for the exclusion. For example, if an Oklahoma entity or an individual engaged in a business sells all of the assets of that business, then any gain from the sale of intangible assets, such as goodwill of the business, will also qualify for the exclusion as long as the assets sold were held by the business for the required holding period.

Senate Bill 685 also clarifies that Oklahoma tax law will follow the federal tax law to allow for the “taking” of holding periods when property is transferred in an exchange which is not subject to tax. For example, in Oklahoma Tax Commission Letter Ruling 07-083, an S corporation contributed certain assets, meeting the “qualifying” capital gains required holding period, to a newly formed LLC. Because the transfer of these assets to the LLC were not subject to tax, the S corporation had a holding period in its LLC interest equal to the holding period which it had in any contributed assets. Immediately following the contribution of these assets by the S corporation of the LLC, the S corporation sold part of its interest in the LLC to a purchaser for cash. Because the S corporation had the required holding period in its interest in the LLC, the sale of its interest in the LLC was excluded from Oklahoma capital gains tax.

So how can you plan for taking maximum advantage of this exclusion? It appears that you can utilize any of your preexisting entities (corporations, LLCs or partnerships) to meet the required holding periods. The question is whether, or to what extent, you can avoid Oklahoma tax on the gain of the sale of an interest in an entity, which meets the holding period requirement, but which owns assets which do not meet the holding period requirement. For example, suppose you are an individual and own an interest in an LLC for the required holding period of over two years. The LLC then acquires real property today, and one year from now, you sell your interest in the LLC. Will the sale of your interest in the LLC qualify for capital gains exclusion? Or, will Oklahoma try to “look through” the LLC to determine the holding period of the real property? Although there is no direct answer to this question, it would appear that Oklahoma should not be able to look through an entity to tax the transaction based upon the holding period of the assets owned by the entity, unless there was some tax abuse involved.

If you don't currently own any interests in Oklahoma entities, you might form one or more entities today to start the holding period running for future sales. For example, if you are an Oklahoma resident contemplating the future sale of a piece of real property located in Oklahoma, under the current law you can avoid Oklahoma income tax on the gain from that transaction if you hold the real property for at least five years. However, if the real property is owned by an LLC in which you have only a two year holding period, you could sell the LLC and avoid gain on the sale. Consider the following scenarios:

1. You buy property outright today and hold it for two years before selling it. You will have Oklahoma income tax on the gain.
2. You form an LLC today which buys the target property and then hold the LLC for two years before selling it. You can avoid Oklahoma income tax on the gain.

In certain circumstances, a taxpayer might even be able to take this a step further. Consider the following example. You currently own outright a piece of property which you have held for two years and want to sell. You form an LLC today and contribute the property to the LLC. Under the tacking rules in I.R.C. § 1223, your holding period in the LLC should be two years because the holding period you had in the real estate “tacks” to your holding period in the LLC interest. Thus, it would appear that you should be able to sell your LLC interest tomorrow and still qualify for the exclusion.