



Brent Watson, CPA, is the principal for SALTA LLC in Tulsa, Okla. An OSCPA member for 11 years, he has served on the OSCPA's Taxation and Continuing Professional Education Committees and now serves on the Oil & Gas Committee. His 31 years of practice in state and local taxes have focused on sales and use tax, but have also included property tax and state incentive programs. His expertise is concentrated in the manufacturing, oil and gas, multi-state contracting and retailing industries.

2020 vision for Oklahoma tax reform

By Brent Watson, CPA

Governor Stitt's intention to make Oklahoma a "Top Ten" state is widely known. A key part of making any state a top state in which to live is having good tax laws that provide an adequate tax base while avoiding unnecessary or unfair burdens on businesses and citizens. Keenly aware of this, Governor Stitt, along with Oklahoma Secretary of Commerce Sean Kouplen, are working with The Tax Foundation and the State Chamber of Commerce to develop a legislative package that improves Oklahoma's tax laws. OSCPA members can work through the OSCPA's Governmental Affairs Committee to have input in this process.

Perhaps the most well know summary of what makes good tax law was written by Adam Smith in his book, "The Wealth of Nations" (1776). Smith argued taxation should follow the four principles of fairness, certainty, convenience and efficiency. Fairness, in that taxation should be compatible with taxpayers' conditions, including their ability to pay in line with personal and family needs. Certainty means taxpayers are clearly informed about why and how taxes are levied. Convenience relates to the ease of compliance for the taxpayers: how simple is the process for collecting or paying taxes? Finally, efficiency touches on the collection of taxes. Basically put, the administration of tax collection should not negatively affect the allocation and use of resources in the economy, and certainly shouldn't cost more than the taxes themselves.

Many of Oklahoma's tax laws have not been updated since the '80s—when a 10-megabyte computer cost \$3,500 and no one knew what the internet was. Some of the reforms suggested are needed because the business and economic environments have vastly changed since then.

This article focuses on some suggested reforms, many of which are already under consideration:

1 Sales tax audit practices: Currently, in audits of purchases, the Oklahoma Tax Commission (OTC) will not apply credits to

audits for taxes overpaid to vendors. Instead, taxpayers are forced to file a separate claim for a refund with the OTC or obtain a refund from the vendor. This an inefficient practice. It forces taxpayers to spend resources to build the refund claim and then forces the OTC to process the claim. Additionally, this is unfair to taxpayers because: (1) the failure to net overpayments against underpayments exaggerates underpayments, which inflates charges for penalties and interest; and (2) because the statute of limitations (SOL) for refunds is currently limited to two years, many credits are lost while the SOL for assessments is three years.

Suggested reform: Audit procedure laws should be amended to require that audits afford equal treatment to include both overpayments and underpayments in the net assessment of the audit. Perhaps Oklahoma can model the practice set forth in the Texas statutes. For Texas audits, credits for overpaid taxes, whether paid to vendors or accrued as consumer's use tax, are credited to the taxpayer in the audit. Further, if the audit utilizes sampling technology and if the credit is one of the sampled items, the credit is projected the same as a debit for underpaid taxes. (If the taxpayer claiming the credit does not hold a tax permit, the taxpayer is required to obtain an assignment of rights for taxes paid to a vendor from that vendor assigning the rights to the refunded tax to the customer/taxpayer.)

2 SOL for sales tax: The 2016 legislature enacted a law to limit the SOL for refunds of sales tax to two years, while the SOL for underpayments is three years. This is facially unfair to businesses.

Suggested reform: 68 O.S. § 227 should be amended to restore the SOL to three years as it was previously, thereby equalizing treatment of credits and assessments and making the SOL for sales tax the same as it is for income taxes. No other state has such an unfair arrangement.

3 Interest: The interest rate of 15% charged on underpayments is the second highest in the nation and was implemented in the 1980s when inflation approached 20% annually. This is, in effect, a very heavy-handed additional penalty that can be used to induce taxpayers to accept tax assessments to settle audits. Equally unfair, no interest is paid for overpaid taxes, except that income tax refunds do accrue interest if not paid generally within 90 days.

Suggested reform: Reduce the interest rate for underpaid taxes to a reasonable rate. A fairer rate would be based on using the prime rate on the first business day in January of each year plus 2%. This is similar to laws in other states. Implement an interest rate for overpaid tax to be equal to the prime rate. (For comparison, Texas' rate for both under and overpayments is prime + 1%). Interest should be payable on all overpayment claims that are not paid within the existing timeframes for income tax and for sales tax refunds not paid within 120 days of the filing of the claim with the OTC, with interest based on the date the overpayment occurred, just as it is for underpayments.

4 Sales taxes – taxation of casual sales: Oklahoma sales tax is levied on all sales of tangible personal property not otherwise exempt. No exemption is provided regarding occasional, isolated or casual sales, except for certain transfers of property in corporate and partnership organizations, re-organizations and liquidations. This imposes burdens on businesses that sell or purchase assets and it creates special problems for sellers of oil and gas leases. These properties are sold as units, meaning the sales price covers the sale of surface equipment, minerals to be extracted and downhole equipment, some of which is tangible personal property. In 1988, the OTC suggested to a taxpayer in a letter (not an official letter ruling) that the taxpayer could report tax using a 21% allocation of the total purchase price as the value of personal property, but no legal authority exists for this or any other safe harbor allocation. Commonly, appraisals done for such purposes have fallen in the 5% to 15% range.

Suggested reform: A general occasional sale exemption would be desirable to eliminate this unfriendly tax that surprises and punishes taxpayers, mainly businesses. Steps should be taken to minimize the burden and confusion this causes. Some suggested steps include:

- a. Implement an exemption for the sales of non-inventory business assets that would apply to the first \$100,000 of assets sold annually.
- b. Provide a safe harbor pertaining to the sale of oil and gas leases giving the seller the option of valuing the tangible personal property included in the sale of developed oil and gas leases as either 10% of the value of developed properties or the determination of the fair market value based on an appraisal.

5 Refund claim processing: Recently, the OTC's evaluation of refund claims often has not begun for more than a year after filing, with some claims not paid in excess of 18 months after the claim was filed. Additionally, the OTC pays no interest for overpaid taxes and does not acknowledge receipt of the claim.

Suggested reform: Audit procedure laws should be amended to require the OTC begin processing refund claims within 120 days of the claim filing, the OTC should be required to notify the taxpayer/applicant acknowledging receipt of the claim and interest should be credited to the claimant as suggested in the section regarding interest reform.

6 Property taxes – de-minimis exclusion: No de-minimis filing threshold for property taxes is provided, meaning all businesses having any assets are required to file tax returns. This results in unnecessary administrative burdens on businesses as well as tax assessors and collectors. For example, a taxpayer having assets with a fair market value of \$5,000, given an effective tax rate of 1%, would have a tax of \$50. The time required for the taxpayer to file a rendition and pay the tax bill, for the assessor and the collector to maintain records, assign values to properties, bill and collect the tax exceeds the total tax

to be collected on properties with such low valuation. Many states provide a de-minimis filing exemption that saves both businesses and county governments from wasting resources on such filings.

Suggested reform: Provide a de-minimis exemption to eliminate unprofitable, burdensome filing requirements. Such de-minimis filing thresholds could allow a taxpayer to not file a return if the value of their assets meet one of two tests: (1) less than \$20,000 in original cost or (2) \$10,000 in fair market value. Some states require taxpayers who are exempt because of de-minimis valuation to file an affidavit or a form that states no rendition is filed because of a value below the de-minimis filing threshold.

7 Sales tax collection allowance: The 2017 legislature repealed the collection allowance provided to vendors for timely collection and remittance of taxes. The allowance was not even close to the cost of compliance imposed on businesses, but at least it was somewhat of a reimbursement of those costs.

Suggested reform: Amend 68 O.S. Sec. 1367 and 68 O.S. Sec. 1410 to reinstate collection allowances for taxpayers collecting and remitting sales taxes. Before July 1, 2017, the vendor's compensation for recordkeeping and prompt payment was 1% of the tax due and up to \$2,500 per month per sales tax permit. Collecting sales taxes has been shown to cost businesses an average of 3% of the value of the tax, but that amount is much higher for small businesses.

8 Sales & use tax account simplification: Currently, taxpayers may need as many as three types of accounts for sales and use taxes: (1) sales tax, (2) vendor's use tax or (3) consumer use tax. Only a few states make such differentiations, especially between sales tax and vendor's use tax (both on sales—first intra-state, the latter for inter-state sellers). This complication causes additional costs to both taxpayers and the OTC for handling multiple returns and accounts. There is little or no benefit from having these multiple accounts and returns.

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various tax types—especially sales/vendors use taxes (taxes on sales) and consumer’s use tax (tax on purchases).

9 Sales tax prepayments: Currently, taxpayers owing an average of \$2,500 or more per month in total sales taxes for the previous fiscal year must remit pre-payments of the tax due for the first 15 days of each month by the 20th of that month. This is burdensome and the method of calculating the pre-payments is confusing.

Suggested reform: While it would be simpler to eliminate the requirement to make pre-payments totally, this is probably not a politically viable option. However, the burden can be eased by raising the threshold for requirement to file prepayments from \$2,500 to \$10,000 per month and changing the formula for determining the prepayment that must be made.

The current formula requires the calculation be updated each month: at least 50% of the tax liability incurred during the immediately preceding calendar year for the same month or at least 90% of the tax liability for that 15-day period. A simpler method would base the prepayment annually based on half of 75% of the average monthly tax for the preceding year. The taxpayer could choose this annual method or, if lower, 90% of the tax liability for that 15-day period. Businesses having very large infrequent sales, (i.e., a one-time sale of a \$500,000 piece of equipment), should be allowed to apply for exemption from prepayment requirements since their tax would usually be zero.

10 Property taxes – homestead exemption adjustment: The deduction provided in 68 O.S. Section 2889 allows a \$1,000 exemption of assessed valuation per homestead. This exemption has not been increased since 1988 and does not provide significant relief from property taxes.

Suggested reform: Increase the exemption by \$250 annually over four years until it is doubled.

11 Sales tax – exemption for groceries: Oklahoma is one of only eight states that does not fully exempt groceries (35 states), or provide a reduced rate of tax on them (seven states). Of the states that do tax groceries, Oklahoma has the highest average state and local rate of sales tax imposed on them (8.85 percent). This is a regressive tax that is especially burdensome to families.

Suggested reform: An exemption from state level sales tax should be phased in as budgetary conditions allow for it. It could be dropped 1% per year until it is eliminated, much as Arkansas has done.

12 Personal income taxes – elimination of the marriage penalty and bracket simplification: Individuals are subject to graduated tax rates on Oklahoma taxable income, and the rate schedule (except for the top rate) has not been adjusted significantly since 1971. A slight marriage penalty is built into the 4% bracket. The applicable rates for individuals or married filing jointly respectively are:

- 0.5% for the first \$1,000 or \$2,000
- 1% on the next \$1,500 or \$3,000;
- 2% on the next \$1,250 or \$2,500;
- 3% on the next \$1,150 or \$2,300;
- 4% on the next \$2,300 or \$2,400; and
- 5% on the rest.

Suggested reform: Either reduce the income tax rate schedule to one flat rate of 5%, coupled with increasing the personal exemption from \$1,000 to \$2,500, or change the rate structure to something simpler and more meaningful such as taxing the first \$10,000 (single) or \$20,000 (married filing joint), at 2.5%, with the remainder taxed at a flat rate of 5%.

Many citizens are excited about prospect of making Oklahoma a Top Ten state, including being more economically competitive with other states, as well as being a fairer place to live, raise a family and do business. These suggested reforms are a start at moving our state in that direction by making state tax laws less complicated. Many of these suggested changes have little or no revenue impact, while providing savings and simplification that will save both taxpayers and the OTC time dealing with inefficient and wasteful laws. 