State Law & State Taxation Corner

The Ohio Supreme Court Holds That the State May Not Apportion a Nonresident Shareholder's Dividend Distribution from an S Corporation's Accumulated Earnings and Profits

By John A. Biek

Introduction

The Ohio Supreme Court has again reaffirmed the important distinction, for state income tax purposes, between (1) a distributive share of the net income from a passthrough entity's business operations—which typically is apportioned with the passthrough entity's apportionment factors and then flows through *pro rata* to the state income tax returns of the owners of the passthrough entity—and (2) income or gain that such an owner realizes in connection with the owner's equity interest in the passthrough entity (as opposed to a flow-through of the passthrough entity's net income). This latter category of income or gain is usually sourced entirely to the owner's state of residence or domicile.

The Ohio Supreme Court held last year in *Corrigan v. Testa* that the "investee apportionment" provision in the Ohio personal income tax laws, Ohio Revised Code Section 5747.212, unconstitutionally apportioned the capital gain that Patton Corrigan, a nonresident member of an Ohio-based limited liability company, realized from selling part of his ownership interest in the LLC, utilizing the LLC's Ohio apportionment factors.[1] The Ohio Supreme Court explained in its *Corrigan* opinion that the capital gain at issue in the case did not represent income from the business operations of the LLC, which would have been subject to formulary apportionment by Ohio. Rather, the capital gain resulted from Corrigan's sale of his intangible ownership interest in the LLC, which Corrigan had held and sold in Connecticut. The Ohio Supreme Court held that, by apportioning this nonresident's capital gain from the sale of the intangible interest, the Ohio Tax Commissioner was taxing income arising outside its borders.[2]

At the end of last year, the Ohio Supreme Court applied a similar rationale in *Giddens v. Testa*, holding that a distribution that an S corporation made to its two nonresident shareholders out of accumulated earnings and profits (E & P) of

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the corporation dating back to its days as a C corporation constituted a nonbusiness dividend allocable to the shareholders' state of residence (*i.e.*, Missouri).[3] The Ohio Tax Commissioner took the position in the *Giddens* case that because the corporation currently was an S corporation, all of its shareholder distributions, including the distribution made out of its accumulated E & P, must be viewed as distributive shares of the S corporation's income from its business operations and subject to formulary apportionment by Ohio. As it did in the *Corrigan* case, the Ohio Supreme Court criticized the Ohio Tax Commissioner for confusing an apportionable distributive share of a passthrough entity's income from business operations with income or gain that an owner of the passthrough entity realized with respect to the owner's equity interest in the passthrough entity (as opposed to his *pro rata* share of the passthrough entity's business income).

Federal Taxation of S Corporations and Their Shareholders

To understand the tax issue in the *Giddens* case, a brief review of the federal Subchapter S rules may be helpful.

With certain limited exceptions (*e.g.*, for built-in gains), an S corporation is not subject to federal income tax on the taxable net income from its business operations.[4] Instead, each shareholder's *pro rata* share, *whether or not distributed*, of the separately stated and nonseparately computed items of the S corporation's taxable income, loss, deduction or credit automatically flows through to the shareholder, who then includes those items in his or her federal income tax return.[5] The separately stated items of S corporation income, loss, deduction or credit flowing through to the shareholder include, among other things, capital gains or losses, charitable contributions, tax payments, tax credits, tax-exempt income and portfolio income or loss of the S corporation.[6] The nonseparately computed income or loss of the S corporation represents the rest of its net income or loss.[7] The character of each of the items included in the shareholder's distributive share of income, loss, deduction or credit of the S corporation is determined as if such items were realized by the shareholder directly from the source from which the S corporation realized them.[8]

The aggregate amount of these distributive shares of the S corporation's income and loss, which have been taxed to the shareholders, is then included in the "accumulated adjustments account" (referred to as the AAA) of the S corporation, awaiting distribution to the shareholders.[9] When the S corporation makes distributions to the shareholders of this undistributed income of the S corporation, the balance of the AAA is reduced accordingly.[10]

An S corporation also can have "accumulated earnings and profits" dating back to tax years when the corporation was a C corporation or inherited from a C corporation that, for example, merged into the S corporation. Significantly, the post-1982 business operations of a corporation with an S election in effect do not give rise to current E & P.[11] This accumulated E & P will already have been taxed to the C corporation during the tax years in which the corporation accrued the E & P. Consistent with the Subchapter C rules of the Code, S corporation shareholders generally receive taxable dividend income when the S corporation makes distributions out of its accumulated E & P to the shareholders.[12]

The adjusted basis of the shareholder's stock in the S corporation rises and falls to account for the taxation of the shareholder on distributive shares and distributions of the S corporation's net income. Specifically, the adjusted basis of the shareholder's stock is *increased* by the amount of the shareholder's distributive share of the S corporation's net income on which the shareholder has paid tax.[13] Meanwhile, the adjusted basis of the shareholder's stock is *decreased* (but not below zero) by the amount of the shareholder's distributive share of loss or deductions of the S corporation, as well as by the amount of any tax-free distributions of cash or property that the S corporation makes to the shareholder from the AAA.[14]

The federal tax treatment of the shareholder on the distributions that he or she receives from the S corporation will depend on whether the S corporation has accumulated E & P from C corporation tax years. If the S corporation does *not* have any accumulated E & P, the distributions will be applied, first, against the adjusted basis of the shareholder's stock in the S corporation—and the shareholder will not have to pay federal income tax a second time on that already taxed income of the S corporation.[15] To the extent that the amount of the shareholder distribution exceeds the adjusted basis in the stockholder's stock, this excess amount of the distribution will give rise to capital gain that must be reported on the shareholder's tax return.[16]

Subchapter S of the Code provides a three-tier set of rules for taxing shareholders on distributions they receive from S corporations *with accumulated E & P*. The shareholder distributions are considered to have been made, first, from the AAA of the S corporation, with those distributions being tax-free to the shareholder to the extent that the shareholder has adjusted basis in his or her stock in the S corporation. Distributions from the

AAA in excess of the adjusted basis of the shareholder's stock give rise to capital gain treatment that is reportable on the shareholder's tax return.[17] Once the AAA has been exhausted, the shareholder distributions are considered to have been made out of the accumulated E & P of the S corporation, and, consistent with the Subchapter C tax rules, those distributions are reportable as a taxable dividend on the shareholder's tax return.[18] To the extent the S corporation distributions exceed *both* the balance of the AAA and the amount of its accumulated E & P, such excess distributions are tax-free to the shareholder to the extent there is still adjusted basis in the shareholder's stock, and a capital gain reportable on the shareholder's tax return if the adjusted basis of the stock has been reduced to zero.[19]

The *Giddens* Case

Ernest and Louann Giddens owned (through their respective revocable grantor trusts) all of the stock of Redneck, Inc., a wholesale supplier of running gear, axles, springs, hitches, jacks and related equipment used in trailer parks.[20] Mr. and Mrs. Giddens were residents of Missouri. Redneck did business in a number of states, including Ohio, as a C corporation until September 1, 2004, and thereafter as an S corporation.[21]

As shareholders of an S corporation doing business in Ohio, the Giddenses filed Ohio personal income tax returns that included their distributive shares of Redneck's Ohio apportioned business income or loss. In 2008, Redneck also declared and distributed a $74,099,830 dividend to the Giddenses that was paid out of the accumulated E & P of Redneck dating back to tax years when it was a C corporation.[22] Although the opinions in the *Giddens* case do not mention this fact, it appears that the 2008 Schedule K-1s that Redneck issued to the Giddenses reported this $74 million distribution as a dividend in box 5a or 5b of the K-1 instead of including the distribution in the "ordinary business income" of Redneck reported in box 1 of the K-1. Following the Ohio personal income tax rules for dividends, the Giddenses allocated this $74 million dividend payment entirely to their state of residence, Missouri, and claimed a nonresident credit on their 2008 Ohio personal income tax return for the amount of Ohio personal income tax that had been computed on this dividend payment on that Ohio tax return.[23]

On audit, the Ohio Tax Commissioner reclassified the $74 million distribution from Redneck's accumulated E & P as an S corporation distributive share of the business operating income of Redneck and apportioned the distribution to Ohio utilizing Redneck's 3.9-percent Ohio apportionment factor. Largely as a result of this audit adjustment, the Tax Commissioner issued a $182,810 deficiency to the Giddenses.[24]

The Giddenses appealed their tax assessment, and on October 20, 2014, the Ohio Board of Tax Appeals ("the BTA") issued a brief opinion affirming all aspects of the tax assessment.[25] With regard to the $74 million distribution from Redneck's accumulated E & P, the BTA reasoned that:

> At the time of the issuance of the dividends and interest in question from Redneck, Inc., Redneck was operating as an S corporation. "Section 1366(b), Title 26, U.S. Code indicates that the character of the item distributed to a shareholder is to be determined as if the item were realized from the source from which the corporation realized the item. Thus, business income generated by an S corporation retains its status as business income as it passes through to the shareholders. As business income, it is apportioned under R.C. 5747.21 for taxation in Ohio." *Agley v. Tracy* (1999), 87 Ohio St. 3d 265, 268. …
>
> Herein, appellants contend that the dividend and interest received by appellants should be characterized as nonbusiness income, pursuant to R.C. 5747.01(C). However, that dividend and interest income must be characterized for the appellants as it existed upon its generation by Redneck, "arising … in the regular course of … business," *i.e.*, business income.[26]

The Giddenses appealed this adverse decision of the BTA to the Ohio Supreme Court.

> *The federal tax treatment of the shareholder on the distributions that he or she receives from the S corporation will depend on whether the S corporation has accumulated E & P from C corporation tax years.*

To take full advantage of its graduated personal income tax rates, the Ohio personal income tax laws require a nonresident individual taxpayer, first, to compute an Ohio personal income tax amount on all of the taxpayer's items of income, wherever earned, and, then, to offset that preliminary tax amount with the nonresident credit

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provided for in Ohio Revised Code Section 5747.05. The nonresident credit is equal to the "tax otherwise due under Section 5747.02 of the Revised Code on such portion of the combined adjusted gross income and business income of any nonresident taxpayer that is not allocable or apportionable to the state pursuant to Sections 5747.20 to 5747.23 of the Revised Code."[27]

Ohio Revised Code Section 5747.22(B) provides that:

> With respect to a pass-through entity, one or more of the pass-through entity investors of which are liable for the tax imposed by section 5747.02 of the Revised Code, *the business income and deductions of the pass-through entity shall be apportioned to this state in the hands of the pass-through entity* investors pursuant to section 5747.21 of the Revised Code. *The business income and deductions as thus apportioned to this state then shall be allocated to the pass-through entity investors in proportion to their right to share in that business income.*[28]

This is the familiar rule that the net income from the passthrough entity's business operations is apportioned with the passthrough entity's Ohio apportionment factors, and the amount of Ohio apportioned business income then flows through *pro rata* to the passthrough investors to be taxed on their Ohio tax returns.

The lesson of the Giddens *case should have wide application to the income taxes of states throughout the United States.*

Meanwhile, the Ohio allocation rules for items of nonbusiness income set forth in Ohio Revised Code Section 5747.20 provide in relevant part that:

> Any item of income or deduction which has been taken into account in the computation of adjusted gross income for the taxable year by a nonresident and which is not otherwise specifically allocated or apportioned pursuant to sections 5747.20 to 5747.23 of the Revised Code, *including, without limitation, interest, dividends and distributions*, items of income taken into account under the provisions of sections 401 to 425 of the Internal Revenue Code, and benefit payments received by a beneficiary of a supplemental unemployment trust which is referred to in section 501(c)(17) of the Internal Revenue Code, *shall not be allocated to this state unless the taxpayer's domicile was in this state at the time such income was paid or accrued*.[29]

The Giddenses contended that because Redneck had declared and paid the $74 million distribution out of its accumulated E & P dating back to its tax years as a C corporation, and that distribution was taxed federally as a dividend to the Giddenses under the Subchapter S rules discussed earlier, the $74 million distribution should also be treated as a "dividend" for Ohio tax purposes within the meaning of Section 5747.20(B)(6). Because the Giddenses were nonresidents of Ohio during the 2008 tax year that they received this dividend payment, they were entitled to allocate the dividend payment *outside Ohio* pursuant to Ohio Revised Code Section 5747.20(B)(6) and claim a nonresident tax credit on their 2008 Ohio personal income tax return for the amount of Ohio income tax they had computed on the dividend payment.[30]

The Ohio Tax Commissioner acknowledged that, for Ohio personal income tax purposes, dividends and distributions paid to a nonresident taxpayer generally are treated as nonbusiness income allocable outside Ohio pursuant to Section 5747.20(B)(6).[31] However, the Tax Commissioner argued that because Redneck was an S corporation during the 2008 tax year when it declared and paid the $74 million dividend to the Giddens, albeit out of the accumulated E & P dating back to Redneck's years as a C corporation, this dividend payment should be treated as if it were a distributive share of the business income of an S corporation, and apportioned to Ohio with Redneck's apportionment factors, pursuant to Section 5747.22(B).[32] As legal authority for this position, the Tax Commissioner pointed to the statement in the Ohio Supreme Court's 2001 opinion in *Agley v. Tracy* that "the character of the item distributed to a shareholder [of an S corporation] is to be determined as if the item were realized from the source from which the corporation realized the item."[33] Relying on this statement, the Tax Commissioner argued that because the $74 million distribution was traceable back to income generated in Redneck's business operations, admittedly income on which Redneck had already paid federal (and state) income tax, as a C corporation, this distribution retained that business income character in the hands of the shareholders of the company.[34]

The Ohio Supreme Court rejected the Tax Commissioner's argument, however, noting that the Tax Commissioner was taking the quoted statement from the *Agley* opinion out of context. In *Agley*, the nonresident shareholders of an S corporation argued that their distributive shares of the

S corporation's net income were analogous to a corporate dividend or distribution that would normally be treated as nonbusiness income allocable to the shareholder's state of residence under the Ohio personal income tax laws. It was in this context that the Ohio Supreme Court had stated in its *Agley* opinion that "the character of the item distributed to a shareholder [of an S corporation] is to be determined as if the item were realized from the source from which the corporation realized the item."[35] Indeed, this statement alluded to Code Sec. 1366(b), which is part of the federal income tax rules applicable to distributive shares of an S corporation's separately computed and nonseparately computed income or loss flowing through to the shareholders of the S corporation. Therefore, the Ohio Supreme Court was making the noncontroversial statement in its *Agley* opinion that, for Ohio income tax purposes, a distributive share of the net income that an S corporation *earned from its business operations as an S corporation* retains that business income character when it flows through to the shareholders of the S corporation. The Ohio Supreme Court acknowledged, though, that it could have used more precise terminology in its *Agley* opinion:

> We should have said that the character of the S corporation shareholder's *distributive share* of the corporation's own income is to be determined as if that income had been realized by the shareholder from the source from which the corporation realized the income.[36]

Turning to the $74 million distribution at issue in the *Giddens* case, the Ohio Supreme Court provided a brief summary of the federal income tax rules for S corporation distributive shares and distributions to shareholders. The Supreme Court noted that, as discussed earlier, *distributive shares of the S corporation's net income* are taxed to the shareholders and added to the S corporation's AAA until the S corporation makes (typically tax-free) distributions of that S corporation's net income to the shareholders.[37]

The Ohio Supreme Court went on to explain that, under the Subchapter S rules:

> a distribution of earnings and profits that accrued to a C corporation that later became an S corporation is subject to the rule that "[a]ny amount distributed in excess of the [AAA] *will generally be treated as a dividend to the extent of the corporation's accumulated E & P" from its C corporation days*.[38]

This was an accurate statement of Code Sec. 1368(c)(2). The Ohio Supreme Court concluded, "That is what occurred here. The Giddenses through their trusts received a dividend from Redneck traceable to earnings that accrued before the S election in 2004. That dividend was taxable as a dividend at the federal and potentially state level."[39]

Applying these federal tax rules, the Ohio Supreme Court held that the $74 million distribution that Redneck paid to the Giddenses in 2008 as a dividend out of accumulated E & P from Redneck's days as a C corporation constituted a nonbusiness dividend that was allocable to the state of residence of the Giddenses (Missouri) pursuant to Ohio Revised Code Section 5747.20(B)(6). Accordingly, the Ohio Supreme Court reversed the BTA and the Ohio Tax Commissioner, concluding that the Giddenses had correctly claimed the nonresident tax credit on their 2008 Ohio personal income tax return in the amount of the Ohio tax computed on their $74 million dividend payment.

Analysis of the *Giddens* Case

The Ohio Supreme Court reached the correct holding in its *Giddens* opinion. The $74 million distribution that Redneck declared and paid to the Giddenses out of its accumulated E & P was clearly treated as a taxable dividend payment to the Giddens under the federal S corporation rules, specifically Code Sec. 1368(c)(2). The parties appeared to agree in the *Giddens* case that the $74 million distribution was a dividend for federal tax purposes and that seems to be how Redneck reported this distribution on the 2008 Schedule K-1s it issued to the Giddenses. The fact that Redneck was an S corporation in 2008 when it made the $74 million distribution out of accumulated E & P to its shareholders clearly did not support the Ohio Tax Commissioner's reclassification of that distribution as a distributive share of S corporation business income because the treatment of the distribution as a taxable dividend was provided for in Code Sec. 1368(c)(2).

The Ohio Tax Commissioner either did not understand the federal income tax rules for S corporation distributions or he thought that the *Agley* case provided him with authority to treat any and all distributions by an S corporation to its shareholders as a distributive share of the net income of the S corporation's business operations. The Tax Commissioner was badly misreading the *Agley* opinion. As the Ohio Supreme Court correctly concluded, a distributive share of the S corporation's net income from its business operations is apportionable business income in the hands of the S corporation, and the distributive share of the Ohio business income of the S corporation retains that business income character when the distributive share flows through to the shareholder. However, the $74 million distribution at issue

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in the *Giddens* case did not in any way represent net income from Redneck's current business operations as an S corporation. Rather, this distribution had been paid out of the accumulated E & P from Redneck's days as a C corporation, on which Redneck had paid federal and state income taxes at the corporate level. As a result, that distribution was a taxable shareholder dividend for Ohio income tax purposes that was allocated to the Giddenses state of residence (Missouri) on their 2008 Ohio personal income tax return.

The lesson of the *Giddens* case should have wide application to the income taxes of states throughout the United States. Hopefully, those states pay attention to that lesson even if it means that the state cannot apportion a nonresident shareholder's receipt of a distribution of accumulated E & P of the S corporation.

ENDNOTES

1 *Corrigan v. Testa*, 2016 Ohio LEXIS 1163 (Ohio May 4, 2016).
2 For a fuller discussion of the *Corrigan* case, *see* John A. Biek, State Law & State Taxation Corner, *Ohio "Investee Apportionment" Statute Is Ruled Unconstitutional as Applied to Typical Nonresident Investors*, J. Passthrough Entities, Sept.–Oct. 2016, at 49.
3 *Giddens v. Testa*, 2016 Ohio LEXIS 3065 (Ohio Dec. 28, 2016).
4 Code Sec. 1363(a).
5 Code Sec. 1366; Reg. §1.1366-1.
6 Reg. §1.1366-1(a)(2).
7 Code Sec. 1366(c); Reg. §1.1366-1(a)(3).
8 Code Sec. 1366(b).
9 Code Sec. 1368(e).
10 Reg. §1.1368-2(a)(3)(iii).
11 Code Sec. 1371(c)(1) states that, except as provided in Code Sec. 1371(c)(2) and (3) and (d)(1), "no adjustment shall be made to the earnings and profits of an S corporation," implying that E & P must be attributable to the business operations of a C corporation. *See also* PS-264-82, 1992-2 CB 760, 762 ("Under the provisions of the Subchapter S Revision Act of 1982, an S corporation does not generate earnings and profits for taxable years beginning after 1982.").
12 Reg. §1.1368-3, ex. 3(iii) and ex. 6(iii).
13 Code Sec. 1367(a)(1).
14 Code Sec. 1367(a)(2).
15 Code Sec. 1368(b)(1).
16 Code Sec. 1368(b)(2).
17 Code Sec. 1368(c)(1).
18 Code Sec. 1368(c)(2).
19 Code Sec. 1368(c)(3).
20 *Giddens*, slip op. at 3.
21 *Id.*, at 4.
22 *Id.*
23 *Id.*
24 *Id.*
25 *Giddens v. Testa*, Ohio BTA 2012-359 (Oct. 20, 2014).
26 *Id.*, slip op. at 2–3.
27 Ohio Rev. Code §5747.05(A).
28 Ohio Rev. Code §5747.22(B) (emphasis added).
29 Ohio Rev. Code §5747.20(B)(6) (emphasis added).
30 *Giddens v. Testa*, 2016 Ohio LEXIS 3065, slip op. at 5.
31 *Id.*
32 *Id.*
33 *Agley v. Tracy*, 87 Ohio St. 3d 265, 268 (2001).
34 *Giddens*, slip op. at 5.
35 *Agley*, 87 Ohio St. 3d at 268.
36 *Giddens*, 2016 Ohio LEXIS 1163, slip op. at 6 (emphasis in original).
37 *Id.* (quoting from BNA Tax Mgt. Portfolio 731-3d, *S Corporations: Corporate Tax Issues*, Section II.C.1.).
38 *Giddens*, 2016 Ohio LEXIS 1163, slip op. at 6 (emphasis added) (quoting from BNA Tax Mgt. Portfolio 731-3d, *S Corporations: Corporate Tax Issues*, Section II.B.3).
39 *Giddens*, 2016 Ohio LEXIS 1163, slip op. at 6.

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