

Ohio: State Supreme Court allows non-resident's tax credit of nearly \$200,000



David M. Kall | Wednesday, February 15, 2017

In the case [Giddens v. Testa](#), the Ohio Supreme Court reversed a Board of Tax Appeals (Board) decision that disallowed a non-resident tax credit related to a distribution from a corporation that did some of its business in Ohio, for the tax year 2008. The tax commissioner's theory was that the distribution constituted business income, and was therefore apportionable in part to Ohio, based on the proportion of the corporation's business in that state. The Board affirmed the assessment, the taxpayers appealed, and the high court reversed the Board, concluding that the taxpayers properly treated the income at issue as nonbusiness income allocable solely to their state of domicile, Missouri.

Background

The Court provided the following facts as background. The plaintiffs/appellants, Ernest and Louann Giddens, lived in Missouri, but paid Ohio income tax by virtue of their ownership of shares in a corporation that does business in Ohio. For the tax year at issue, 2008, that company was an S corporation. The S corporation, Redneck, Inc. is a wholesale supplier of equipment for trailer parks, including running gear, axles, springs, hitches, and jacks, had just two shareholders, the Giddens.

In 2008, the year of the dividend distribution, Redneck was a pass-through Subchapter S corporation. For tax purposes, this designation differs significantly from a C corporation because earnings generated through the S corporation flow through to shareholders and are taxed as personal income to the shareholders. Accordingly, income that Redneck earned in the ordinary course of business during 2008 was reported on the Giddens' joint return in 2008.

However, in 2008 Redneck also distributed \$74,099,830 to Ernest and Louann, its two shareholders, through their grantor trusts (which are disregarded under Ohio law). This distribution was of earnings and profits recorded when Redneck was a C corporation, which was before the couple elected pass-through treatment for Redneck, on September 1, 2004.

Ernest and Louann treated the \$74 million distribution as a dividend, and as nonresidents of Ohio, allocated the dividend entirely outside of Ohio (to Missouri), by claiming a full nonresident credit to offset all Ohio income tax associated with the dividend. Upon audit, the tax commissioner treated the dividend as business income rather than as nonbusiness income, and applied Redneck's apportionment factors to the dividend. Thus, 3.9 percent of the dividend was treated as Ohio income. The total amount of tax deficiency assessed was \$182,809.89, most of which was attributable to the apportionment of the dividend.

The tax commissioner relied on a statute, R.C. 5747.231, as well as the 1999 Ohio Supreme Court case *Agley v. Tracy*, which held 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." As a result, on appeal, the Board held that because the S election was in place in 2008, the 2008 dividend was to be treated as business income. The question before the Ohio Supreme Court then was how to apply the statutory provisions relating to the income taxation of dividends and business income to the Giddens' 2008

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distribution.

The Court's analysis

The Court first looked to statutory law providing the general rule that the income of Ohio residents is taxable wherever earned or received. Non-Ohio resident taxpayers may take a credit that allows a nonresident who must file an Ohio return to take a credit for all Ohio income tax that is associated with any income that was not earned or received in the state.

Here, the Giddens' joint return for 2008 reflected a nonresident credit that subtracted all Ohio tax pertaining to the Redneck dividend. They construed an Ohio statute to provide that a nonresident's dividends and distributions should not be allocated to Ohio unless the taxpayer's domicile was in Ohio at the time such income was paid or accrued. They argued, then, that their dividend should not be allocable to Ohio because they were domiciled in Missouri.

The tax commissioner asserted that because Redneck was an S corporation when the dividend was distributed, the character of the dividend as apportionable business income taxable in Ohio, or as nonbusiness income allocable entirely to Missouri, should have been based upon the Redneck's business activities rather than the Giddens personal out-of-state residence. Again, the Tax Commissioner relied upon R.C. 5747.231 and a line of Ohio Supreme Court cases including *Agley v. Tracy* for this legal proposition.

Relevant to the analysis is C-Corp versus S-Corp tax treatment. The Court explained that under C-Corp treatment, a corporation pays income tax on its earnings, and later, if retained earnings are paid out as a dividend, the shareholder must pay tax on the dividend. However, under S-Corp treatment, income generally is not taxed at the corporate level. Instead, it, along with deductions, losses and credits recognized at the corporate level, are passed through to the S corporation shareholders, who are taxed on their proportionate share of the income even if the corporation does not make distributions. S corporations can usually distribute S corporation earnings tax free, but the taxation of S corporation distributions can differ if it has accumulated earnings and profits. Quoting the *Agley v. Tracy* case, the Court recognized that ultimately, the business or nonbusiness character is to be determined as if the item were realized from the source from which the corporation realized the item.

However, the Court disagreed with application of R.C. 5747.231 and the *Agley* principle to the Giddens' situation, because the Giddens, through their trusts, received a dividend from Redneck that was traceable to earnings that accrued before the S election in 2004. The Giddens, and the Court, drew a distinction between distributive-share income that is taxed on a pass-through basis, and a dividend paid out of accumulated earnings and profits that is subjected to income taxation. The latter is not business income, but is taxed solely by virtue of its having been distributed by the corporation.

The Court characterized as "crucial" the nature of the event that triggered the income-tax liability, the declaration of the dividend, as opposed to the Giddens' liability as S-corporation shareholders when they report their distributive share of the corporation's current income on their individual income tax return. In that circumstance, the event that triggers the tax liability is the accrual of income to the corporation by virtue of its business activity.

The Court made further reference to the *Agley v. Tracy* case, to declare that it made a misstatement there, when it used the term "item distributed" even though no actual distribution of corporate earnings was at issue because the income was a distributive share. Observed the Court, "[w]e 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." With that correction, the Court states, the tax commissioner's argument "evaporate[d]" because the income at issue for the Giddens taxpayers was not their distributive share of Redneck's current income, it was the dividend paid out of earnings that accrued to the corporation. On this rationale, the Court reversed the \$182,809.89 assessment.



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