

**IT 1994-01 - Taxation of S Corporations and Their Shareholders - July, 1994;
Revised April, 2006**

The purpose of this information release is to address inquiries concerning the department's policy and interpretation of recent legislative changes in connection with the taxation of S corporation income. This information release sets forth our answers to those questions. *This release was revised in April, 2006 to account for changes in the law that make question 5 no longer applicable to taxable years ending on and after June 30, 2005. It also adds updated contact information in question 39.*

This information release supersedes the department's April 21, 1986 release, also entitled "Taxation of S Corporations and Their Shareholders." We have changed the dates which appeared in the previous release and are now using more current dates. This release has substantive changes to questions #5, #8, #10 and #22. Newly-issued questions and answers ("Supplemental Questions and Answers") begin at question #33. Footnotes are at the end of the text.

GENERAL QUESTIONS

1. QUESTION:

WHAT IS AMENDED SUBSTITUTE SENATE BILL NO. 121, 116TH GENERAL ASSEMBLY?

ANSWER:

This legislation amended, among other things, Ohio tax law regarding the taxation of S corporations and their shareholders (see Subchapter S, Chapter 1, Subtitle A of the Internal Revenue Code). Effective October 17, 1985 the legislation repealed the portion of Ohio Revised Code section ("R.C.")5747.01(A) which had provided an exclusion for "any amounts of income included in [federal] adjusted gross income by reason of Subchapter S, Chapter 1, Subtitle A of the Internal Revenue Code, 26 U.S.C. 1371."

The bill also enacted R.C. 5733.09(B) which exempts S corporations from the R.C. Chapter 5733 corporation franchise tax.¹

2. QUESTION:

WHAT IS THE EFFECTIVE DATE OF THE LEGISLATION?

ANSWER:

Section 3 of the legislation states that the corporate franchise tax amendments are effective with the 1987 franchise tax year. Individual income tax law changes are effective for taxable years ending after December 31, 1985.

3. QUESTION:

WHAT IS THE PURPOSE OF THE LEGISLATION?

ANSWER:

The purpose of the law is to treat S corporations as nearly as possible as partnerships for income and franchise tax purposes so that income earned by an S corporation is taxed only in the hands of the shareholders.

INCOME TAXATION OF S CORPORATION RESIDENT SHAREHOLDERS²

4. QUESTION:

DO THE APPORTIONMENT/ALLOCATION PROVISIONS SET FORTH IN R.C. 5733.05(B), 5733.051, 5747.20, 5747.21, AND 5747.22 AFFECT THE TAX COMPUTATION FOR S CORPORATION SHAREHOLDERS WHO ARE OHIO RESIDENTS?

ANSWER:

No. Since R.C. 5733.09(B) exempts S corporations from the franchise tax, it follows that the franchise tax apportionment/allocation provisions (R.C. 5733.05(B) and 5733.051) are not applicable. Furthermore, under Chapter 5747 an individual's federal adjusted gross income is the basis for calculating Ohio income tax. The R.C. 5747.20, 5747.21, and 5747.22 apportionment/allocation provisions do not affect the tax computation for residents; those provisions apply only to nonresidents that claim the Ohio nonresident tax credit. Thus, an Ohio resident's entire distributive share from an S corporation is subject to Ohio income taxation.

Even if an S corporation does business in several states or even if an S corporation does no business in Ohio, 100% of the Ohio resident's distributive share from the S corporation is subject to Ohio individual income taxation. In this manner, the tax treatment for Ohio resident shareholders of S corporations parallels the Ohio tax treatment for Ohio residents who have invested in partnerships regardless of where the partnerships and S corporations are located and regardless of the extent of the multi-state activity of the partnerships and S corporations. However, Ohio residents may claim the resident credit set forth in R.C. 5747.05(B) for income subjected to

income tax in another state (see the following question and answer).

5. QUESTION:

MAY AN OHIO RESIDENT SHAREHOLDER OF AN S CORPORATION CLAIM THE R.C. 5747.05(B) RESIDENT CREDIT IN THOSE CIRCUMSTANCES WHERE THE S CORPORATION EITHER PAYS TO ANOTHER STATE CORPORATE INCOME TAX OR PAYS TO ANOTHER STATE CORPORATE FRANCHISE TAX BASED ON OR MEASURED BY NET INCOME?

ANSWER: *[NOTE: As a result of Am. Sub. H.B. 66 and Am. Sub. H.B. 530, both passed by the 126th General Assembly, this answer is not applicable for taxable years ending on or after June 30, 2005, to which R.C. 5747.05(B)(4) applies.]*

Yes. An Ohio resident shareholder of an S corporation may claim the resident credit for his/her distributive share of S corporation income that is subjected to corporate income tax or corporate franchise tax (based on or measured by net income) by another state even if the S corporation itself paid the tax.

In those situations where both the S corporation and the shareholder pay taxes on or measured by income to a state, the shareholder can claim the resident credit for both (i) his/her distributive share of income upon which the corporation paid the tax to another state and (ii) his/her own income upon which he/she paid tax to another state.

The credit is based on the lesser of either (i) the shareholder's pro-rata share of the portion of income actually subjected to an income tax in another state or (ii) the shareholder's pro-rata share of the amount of income tax liability paid to other states. In those situations where the S corporation paid the tax, in order for the resident shareholder to claim the credit, the department requires that the resident shareholder increase his/her Ohio adjusted gross income by his/her proportionate share of the tax paid by the S corporation.

Ohio residents cannot claim this credit for gross receipts taxes or other similar excise taxes (states such as Michigan and Indiana levy a gross receipts tax. Since those taxes are not based on income, Ohio residents cannot claim any credit for any such taxes which they, their businesses, or their S corporations pay).

6. QUESTION:

DO THE VARIOUS BUSINESS CREDITS SET FORTH IN OHIO LAW PASS THROUGH TO RESIDENT SHAREHOLDERS?

ANSWER:

Yes. S corporation business credits will pass through to the resident shareholders. However, Q & A #32 discusses a limitation with respect to the pass-through of certain credit carryforwards. Unless Ohio law expressly states otherwise, each shareholder's portion of the credits is based on his/her distributive share of income as set forth in Internal Revenue Code section 1366.

**INCOME TAXATION OF S CORPORATION NONRESIDENT
SHAREHOLDERS**

7. QUESTION:

ARE S CORPORATION NONRESIDENT SHAREHOLDERS
SUBJECT TO THE OHIO INDIVIDUAL INCOME TAX?

ANSWER:

Yes. For taxable years ending after December 31, 1985, any nonresident individual or nonresident estate whose federal taxable income includes a distributive share from an S corporation is subject to the Ohio individual income tax and must file if any of the following circumstances apply:

- The S corporation was incorporated in Ohio for any portion of the period to which the distributive share relates, or
- The S corporation owned or used a part or all of its capital or property in Ohio for any portion of the period to which the distributive share relates, or
- The S corporation did business in Ohio for any portion of the period to which the distributive share relates, or
- The S corporation held a certificate of compliance for any day within the period to which the distributive share relates.

However, Federal Public Law 86-272 may protect some nonresidents from the Ohio individual income tax if the S corporation's Ohio activities do not exceed the activities protected by Public Law 86-272.

8. QUESTION:

HOW DO S CORPORATION NONRESIDENT SHAREHOLDERS
CALCULATE THEIR OHIO TAX LIABILITY?

ANSWER:

Since the purpose of the legislation is to treat for income tax purposes an S corporation as a partnership, nonresident S shareholders must utilize R.C. 5747.22 and section 5747.05(A) to determine the amount of the nonresident credit for income neither earned nor received in this State.

Those two sections in conjunction with R.C. 5747.01 and 5747.02 result in a nonresident's out-of-state income being included in determining the marginal rate at which the nonresident pays the tax. The Ohio Income Tax Return (Ohio Form IT-1040) instructions discuss the calculation of a nonresident credit. In addition, readers may wish to refer to Hellerstein, "Some Reflections on the State Taxation of a Nonresident's Personal Income", 72 Michigan Law Review 1309, 1335 (1974).

The determination of whether an item is "business income" or "nonbusiness income" is made at the S corporation level. The Department's position is that all income is business income unless the taxpayer establishes otherwise. This presumption can be rebutted with a preponderance of the evidence to the contrary.⁴

9. QUESTION:

DO THE VARIOUS BUSINESS CREDITS SET FORTH IN OHIO LAW PASS THROUGH TO NONRESIDENT SHAREHOLDERS?

ANSWER:

Yes. S Corporation business credits will pass through to the nonresident shareholders. However, Q & A #32 discusses a limitation with respect to the pass through of certain credit carryforwards. Unless Ohio's law expressly states otherwise, each shareholder's portion of the credits is based on his/her distributive share of income as set forth in Internal Revenue Code Section 1366.

10. QUESTION:

ASSUME AN S CORPORATION DOING BUSINESS IN OHIO HAS TWO OR MORE NONRESIDENT SHAREHOLDERS WHO DERIVE NO TAXABLE INCOME FROM OHIO OTHER THAN A DISTRIBUTIVE SHARE OF THE S CORPORATION INCOME. MAY THE S CORPORATION FILE A SINGLE RETURN ON BEHALF OF THE NONRESIDENT SHAREHOLDERS?

ANSWER:⁵

Yes. Each year an S corporation may file a master income tax return, Ohio Form IT-1040M, on behalf of and as agent for its electing nonresident shareholders having no Ohio-sourced income other than their distributive share of income from

the S corporation.

CORPORATION FRANCHISE TAX - GENERAL QUESTIONS

11. QUESTION:

FOR PURPOSES OF THE OHIO FRANCHISE TAX WHAT IS A "TAX YEAR"?

ANSWER:

A tax year is the calendar year for which the franchise tax is paid and for which the franchise tax report is due.

12. QUESTION:

FOR PURPOSES OF THE OHIO FRANCHISE TAX WHAT IS A "TAXABLE YEAR"?

ANSWER:

The taxable year is the corporate franchise taxpayer's fiscal or calendar year which ends prior to January 1 of the tax year and on which the tax is based. For example, an Ohio franchise taxpayer with a calendar (taxable) year end of December 31 will file a 1995 franchise tax report based upon the taxable year ended December 31, 1994. The corporation pays the 1995 franchise tax for the privilege of doing business in Ohio during the 1995 calendar (tax) year.

An Ohio corporation with a fiscal (taxable) year end of January 31 will file its 1995 franchise tax report based upon the taxable year ending January 31, 1994. Filing of the franchise report and paying the 1995 franchise tax are for the privilege of doing business in Ohio during the 1995 calendar (tax) year.

13. QUESTION:

WHAT S CORPORATIONS ARE COVERED BY THE LEGISLATION?

ANSWER:

The legislation exempts all calendar year S corporations that are not C corporations at any time during the calendar year prior to the franchise tax year. The legislation exempts all fiscal year end S corporations that are not C corporations at any time during their fiscal year or years ending prior to the franchise tax year.

CORPORATION FILING REQUIREMENTS

14. QUESTION:

FOR THOSE OHIO TAX YEARS FOR WHICH THE S CORPORATION IS EXEMPT FROM THE FRANCHISE TAX, WHAT OHIO CORPORATE TAX FORM SHOULD THE S CORPORATION FILE?

ANSWER:

Ohio Revised Code section 5733.09(B) requires that an S corporation file a notice of the S election with the Tax Commissioner between the first day of January and the thirty-first day of March of each tax year for which the election is in effect. A corporation should use Ohio Tax Department Form FT-1120-S, Notice of S Corporation Status.

15. QUESTION:

MUST AN S CORPORATION FILE THE ANNUAL NOTICE, FORM FT-1120-S, EVERY YEAR?

ANSWER:

Yes. The corporation must file the annual notice, Form FT-1120-S, each and every tax year for which it claims exemption from the franchise tax imposed by the franchise tax laws set forth in Ohio Revised Code Chapter 5733.

16. QUESTION:

IS THE S CORPORATION ELECTION VOID FOR OHIO PURPOSES IF THE CORPORATION FAILS TO FILE THE FORM FT-1120-S ANNUAL NOTICE?

ANSWER:

No. Filing the annual notice is not a requirement in order to be treated as an S corporation for Ohio franchise and income tax purposes. A corporation which is an S corporation for federal income tax purposes is an S corporation for Ohio franchise and income tax purposes even if it fails to file the annual notice.

17. QUESTION:

WHAT IS THE PENALTY EITHER FOR FAILURE TO FILE THE ANNUAL NOTICE OR FOR FILING THE ANNUAL NOTICE LATE?

ANSWER:

R.C. 5733.20 sets forth the procedure whereby the Tax Commissioner can request that the Secretary of State cancel the articles of incorporation of any domestic corporation or the certificate of authority of any foreign corporation which fails or neglects to make reports required by Chapter 5733. In addition, R.C. 5733.21 and 5733.99 provide for penalties of not less than \$100 nor more than \$1,000 against individuals who exercise any corporate powers, privileges, or franchises after cancellation of the articles of incorporation or the certificate of authority for failure to make the reports required by Chapter 5733 of the Ohio Revised Code. In appropriate cases the Tax Commissioner will consider criminal charges for those who intentionally refuse to file the annual notice required by R.C. 5733.09(B). In addition, under R.C. 5733.28(A)(1) there is a \$50 per month penalty (not to exceed \$500) for failure to file the annual notice.⁶

18. QUESTION:

CAN AN OHIO CORPORATION CHOOSE TO BE AN S CORPORATION FOR FEDERAL TAX PURPOSES BUT CHOOSE TO BE A C CORPORATION FOR OHIO FRANCHISE TAX PURPOSES?

ANSWER:

No. The Ohio franchise tax law does not provide for such "dual status".

19. QUESTION:

CAN AN OHIO CORPORATION CHOOSE TO BE A C CORPORATION FOR FEDERAL INCOME TAX PURPOSES BUT CHOOSE TO BE AN S CORPORATION FOR OHIO INCOME TAX PURPOSES?

ANSWER:

No. The Ohio franchise tax law does not provide for a dual status.

RETROACTIVE ELECTIONS; PROSPECTIVE ELECTIONS

20. QUESTION:

ASSUME THE FOLLOWING FACTS:

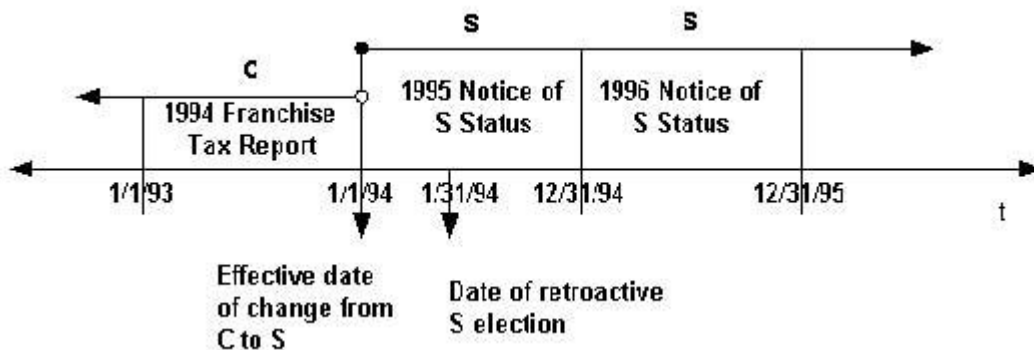
- ON JANUARY 31, 1994 A CALENDAR YEAR C CORPORATION MAKES A TIMELY ELECTION UNDER INTERNAL REVENUE CODE SECTION 1362(b)(1)(B) TO BE TREATED AS AN S CORPORATION RETROACTIVE TO JANUARY 1, 1994.
- THE CORPORATION MAINTAINS ITS S STATUS FOR ALL OF 1994.

WHAT ARE THE CONSEQUENCES UNDER THE FRANCHISE TAX LAWS SET FORTH IN OHIO REVISED CODE CHAPTER 5733?

ANSWER:

A corporation for which there is a valid retroactive election pursuant to Internal Revenue Code section 1362(b)(1)(B) will be treated for Ohio tax purposes as an S corporation for the entire taxable year if for federal income tax purposes the corporation is an S corporation for its entire taxable year. Given the facts set forth above, the S corporation would be exempt from the 1995 Ohio franchise tax imposed by Ohio Revised Code Chapter 5733. However, since the corporation was not an S corporation for its entire taxable year ending December 31, 1993, it is liable for the 1994 franchise tax. That is, a corporation's status on January 1 of the tax year is not determinative of whether it is subject to the franchise tax; rather, the corporation's status during the taxable year prior to January 1 of the tax year is determinative. See Sanders Health and Fitness, Inc. vs. Joanne Limbach, (June 21, 1991) BTA Case No. 88-E-559.

Below is our illustration of this fact pattern:



21. QUESTION:

ASSUME THE FOLLOWING FACTS:

- A FISCAL YEAR C CORPORATION HAS A NOVEMBER 30 YEAR END.
- IT HAS BEEN A C CORPORATION FROM THE DATE OF INCORPORATION THROUGH AND INCLUDING NOVEMBER 30, 1994.
- THE CORPORATION PROSPECTIVELY ELECTS (AND THE SHAREHOLDERS CONSENT TO) S STATUS EFFECTIVE WITH THE FISCAL YEAR BEGINNING DECEMBER 1, 1994.
- THE I.R.S. CONSENTS TO THE FISCAL YEAR END.

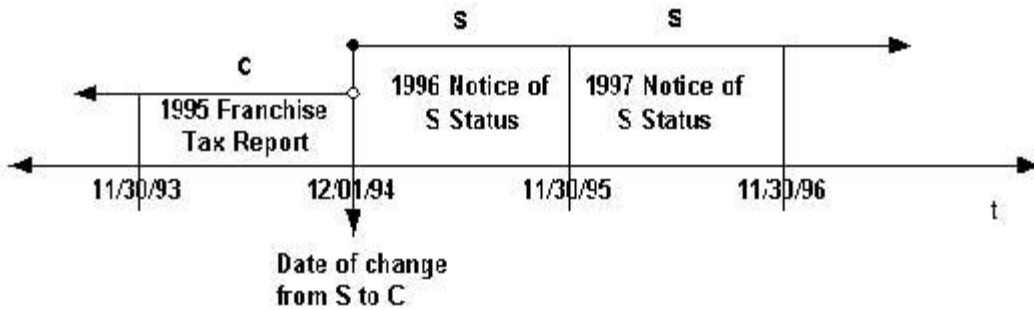
WHAT ARE THE TAX CONSEQUENCES UNDER THE FRANCHISE TAX LAWS SET FORTH IN OHIO REVISED CODE CHAPTER 5733?

ANSWER:

The 1995 franchise tax report will be based upon (i) the taxable income for the twelve month taxable (fiscal) year ended November 30, 1994 and (ii) the net worth at December 1, 1994 (the net worth "business done" factor for the 1995 report will be based upon the twelve month taxable (fiscal) year ended November 30, 1994).

If the corporation maintains its S status from December 1, 1994 through and including November 30, 1995, it will not be subject to the 1996 franchise tax because it meets the requirements set forth in Answer No. 13: the corporation was not a C corporation at any time during its fiscal year (ending November 30, 1995) prior to January 1 of the 1996 franchise tax year.

Below is our illustration of this fact-pattern:



22. QUESTION:

ASSUME THE FOLLOWING FACTS:

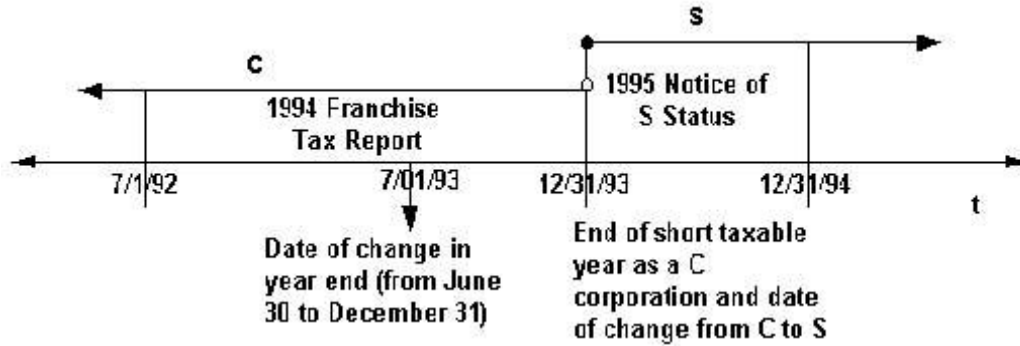
- A C CORPORATION HAS A JUNE 30 YEAR END.
- THE C CORPORATION REQUESTS AND THE IRS AGREES TO THE C CORPORATION'S CHANGING TO A CALENDAR YEAR TAXPAYER WITH A SHORT C TAXABLE YEAR ENDING DECEMBER 31, 1993.
- THE C CORPORATION THEN TIMELY ELECTS (AND THE SHAREHOLDERS CONSENT TO) THE S ELECTION TO BE EFFECTIVE ON JANUARY 1, 1994.

WHAT ARE THE CONSEQUENCES UNDER THE FRANCHISE TAX LAW SET FORTH IN OHIO REVISED CODE CHAPTER 5733?

ANSWER:⁷

Pursuant to Paragraph (C)(2) of Administrative Code Section (Rule) 5793-504, the 1994 franchise tax report will be based on the eighteen month period beginning July 1, 1992 and ending on December 31, 1993. If the corporation is an S corporation for the entire 1994 calendar year, the corporation will owe no franchise tax for the 1995 franchise tax year.

Below is our illustration of this fact pattern:



REVOCAION AND TERMINATION

23. QUESTION:

WHAT ARE THE OHIO FRANCHISE TAX CONSEQUENCES IF AN S CORPORATION BECOMES A C CORPORATION FOR SOME PERIOD OF TIME DURING ITS CALENDAR (OR FISCAL) YEAR ENDING PRIOR TO THE FRANCHISE TAX YEAR?

ANSWER:

Pursuant to Internal Revenue Code section 1362(e)(1)(B), the corporation has a "short taxable year" for which the corporation is a C corporation.

Because it was not an S corporation for its entire calendar (or fiscal) year ending prior to January 1 of the franchise tax year, the corporation will be liable for the Ohio franchise tax for that portion of the calendar (or fiscal) year beginning with the date of the termination/revocation of the S status. An S corporation which terminates its S status is not considered a "new taxpayer" as defined in Administrative Code Section (Rule) 5703-5-01. See the Questions and Answers that follow for more discussion regarding the calculation of the franchise tax.

24. QUESTION:

HOW SHOULD A CALENDAR YEAR S CORPORATION CALCULATE ITS FRANCHISE TAX FOR THE 1994 FRANCHISE TAX YEAR IF SOME TIME DURING 1993 EITHER (i) THE SHAREHOLDERS PROSPECTIVELY TERMINATE THE S ELECTION BY REVOCATION (EFFECTIVE IN 1993) PURSUANT TO INTERNAL REVENUE CODE SECTION 1362(d)(1)(D) OR (ii) THE CORPORATION CEASES TO BE AN S CORPORATION PURSUANT TO EITHER INTERNAL REVENUE CODE SECTION 1362(d)(2) OR SECTION 1362(d)(3)? ASSUME THE TERMINATING EVENT OCCURS ON DECEMBER 30, 1993.

ANSWER:

If any of these circumstances occur, the corporation will have been a C corporation for some portion of its taxable year ending prior to January 1 of the 1994 tax year. The corporation will owe the 1994 franchise tax based on (i) its taxable income from the date of the terminating event (in this example, December 30, 1993) through December 31, 1993 and (ii) its net worth at January 1, 1994 (the net worth "business done" factor for the 1994 report will be based upon the taxable year December 30, 1993 through December 31, 1993.

25. QUESTION:

ASSUME THE FOLLOWING FACTS:

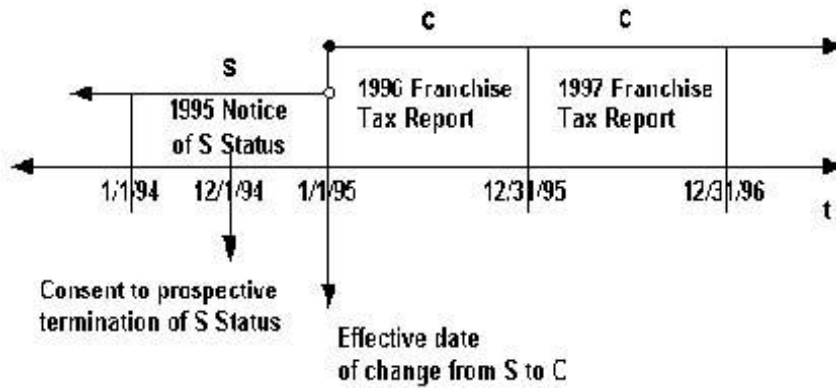
- AN S CORPORATION IS A CALENDAR YEAR ENTITY.
- THE CORPORATION HAS BEEN AN S CORPORATION SINCE THE DATE OF INCORPORATION.
- ON DECEMBER 1, 1994 THE SHAREHOLDERS CONSENT TO THE TERMINATION OF THE S STATUS AND SPECIFY THAT THE TERMINATION WILL BE EFFECTIVE JANUARY 1, 1995.

WHAT ARE THE CONSEQUENCES UNDER THE FRANCHISE TAX LAWS SET FORTH IN OHIO REVISED CODE CHAPTER 5733?

ANSWER:

Since the corporation was an S corporation for its entire taxable year ending prior to January 1 of the 1995 tax year, the corporation is exempt from the 1995 Ohio franchise tax (but not the 1996 franchise tax) imposed by the Ohio Revised Code Chapter 5733.

Below is our illustration of this fact pattern:



26. QUESTION:

ASSUME THE FOLLOWING FACTS:

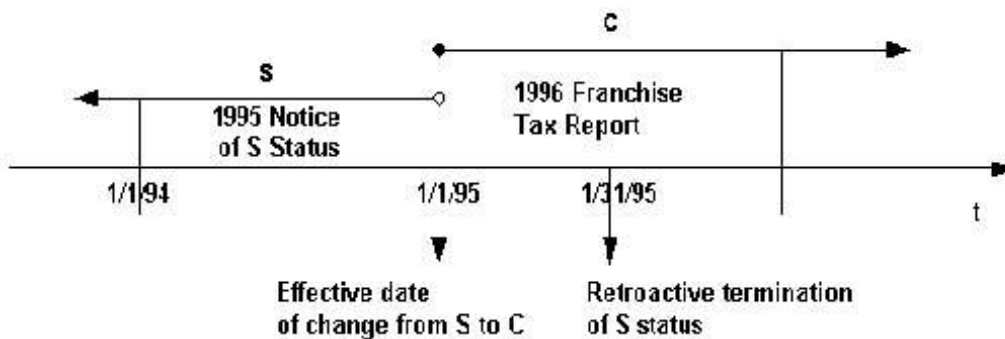
- AN S CORPORATION IS A CALENDAR YEAR ENTITY.
- THE CORPORATION HAS BEEN AN S CORPORATION SINCE THE DATE OF INCORPORATION.
- ON JANUARY 31, 1995 THE SHAREHOLDERS CONSENT TO THE TERMINATION OF THE S STATUS AND SPECIFY THAT THE TERMINATION WILL BE EFFECTIVE JANUARY 1, 1995.

WHAT ARE THE CONSEQUENCES UNDER THE FRANCHISE TAX LAWS SET FORTH IN OHIO REVISED CODE CHAPTER 5733?

ANSWER:

Since the corporation was an S corporation during its entire 1994 taxable year ending prior to January 1 of the 1995 tax year, the corporation is exempt from the 1995 franchise tax (but not the 1996 franchise tax) imposed by Ohio Revised Code Chapter 5733.

Below is our illustration of this fact pattern:



27. QUESTION:

ASSUME THE FOLLOWING FACTS:

- AN S CORPORATION HAS A NOVEMBER 30 FISCAL YEAR END.
- THE CORPORATION HAS BEEN AN S CORPORATION FROM THE DATE OF INCORPORATION THROUGH AND INCLUDING NOVEMBER 30, 1993.
- IN NOVEMBER, 1993 THE SHAREHOLDERS CONSENT TO THE TERMINATION OF THE S STATUS AND SPECIFY THAT THE TERMINATION WILL BE EFFECTIVE DECEMBER 1, 1993.

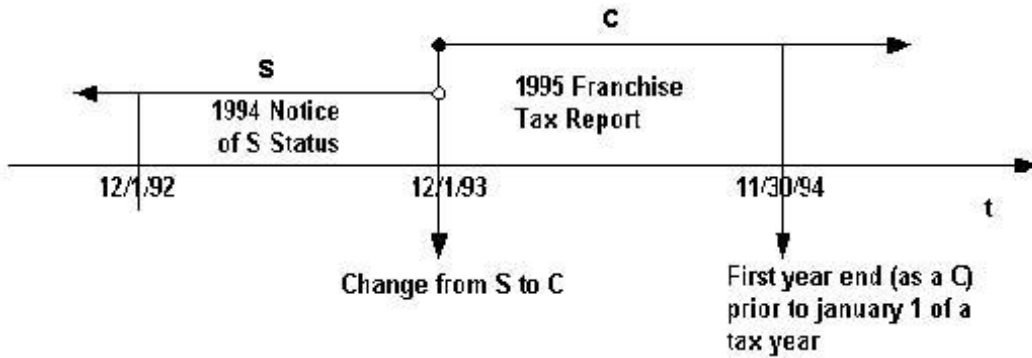
WHAT ARE THE TAX CONSEQUENCES UNDER THE FRANCHISE TAX LAWS SET FORTH IN OHIO REVISED CODE CHAPTER 5733?

ANSWER:

The corporation is not required to file a 1994 franchise tax report since it was not a C corporation during any part of its fiscal year (December 1, 1992 through November 30, 1993) which ended prior to January 1 of the 1994 franchise tax year. However, the corporation will be liable for the 1995 franchise tax. The 1995 report will be based on (i) the corporation's net income for the period December 1, 1993 through November 30, 1994 and (ii) the corporation's net worth at December 1, 1994 (the net worth "business done" factor for the 1995 report will be based upon the twelve month taxable year December 1, 1993 through November 30, 1994).

Note: Although the corporation is a C corporation for some period of time prior to January 1 of the 1994 tax year (in this case, December 1, 1993 through December 31, 1993), it will not owe any 1994 Ohio corporation franchise tax because (i) the corporation is not a "new taxpayer" as defined in Administrative Code Section (Rule) 5703-5-01(I) and (ii) its taxable year as a C corporation did not end prior to January 1 of the 1994 tax year. The corporation will be liable for the 1995 Ohio corporation franchise tax.

Below is our illustration of this fact pattern:



28. QUESTION:

ASSUME THE FOLLOWING FACTS:

- AN S CORPORATION HAS A JUNE 30 FISCAL YEAR END.
- IT HAS BEEN AN S CORPORATION SINCE THE DATE OF INCORPORATION.
- THE S STATUS TERMINATES ON SEPTEMBER 1, 1993, BUT THE CORPORATION DOES NOT CHANGE ITS FISCAL END (SO, THERE IS A "SHORT" C TAXABLE YEAR BEGINNING SEPTEMBER 1, 1993 AND ENDING JUNE 30, 1994).

WHAT ARE THE CONSEQUENCES UNDER THE FRANCHISE TAX LAWS SET FORTH IN OHIO REVISED CODE CHAPTER 5733?

ANSWER:

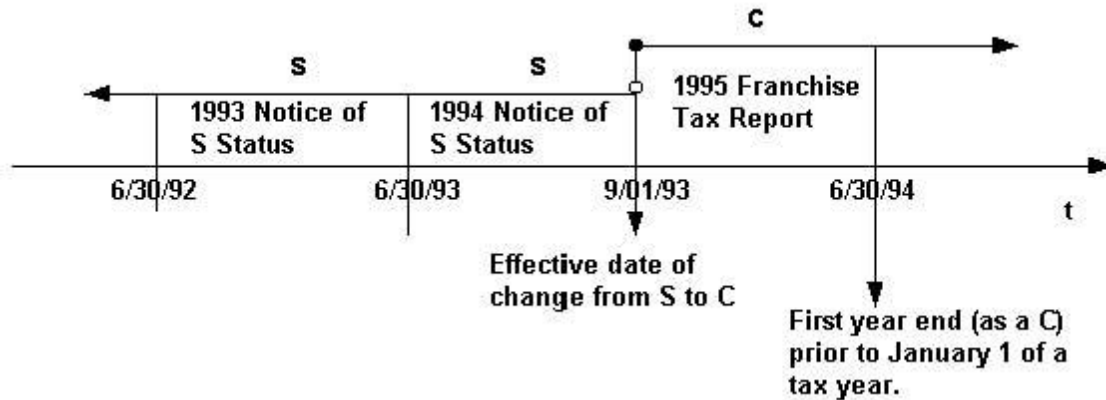
The corporation is not subject to the 1994 franchise tax because of the following:

- i. the corporation was not a C corporation for any part of its taxable (fiscal) year (July 1, 1992 through June 30, 1993) prior to January 1 of the 1994 franchise tax year, and
- ii. the corporation's "short" taxable year as a C corporation (September 1, 1993 through June 30, 1994) does not end prior to January 1 of the 1994 tax year (the corporation is not a "new taxpayer" as defined in Administrative Code Section (Rule) 5703-5-01).

Pursuant to Internal Revenue Code section 1362(e)(1)(B), the corporation has a short taxable year as a C corporation (beginning on the date of the terminating event, September 1, 1993, and ending June 30, 1994). Consequently, for Ohio franchise tax purposes, the corporation's 1995 franchise tax will be based on (i) the corporation's net income for the short taxable year (September 1, 1993 through June 30, 1994), and (ii) its net worth on July 1, 1994 (the net worth "business done" factor for the 1995 report will be based upon the ten month taxable year

September 1, 1993 through June 30, 1994).

Below is our illustration of this fact pattern:



29. QUESTION:

ASSUME THE FOLLOWING FACTS:

- AN S CORPORATION HAS A JUNE 30 FISCAL YEAR END.
- THE CORPORATION HAS BEEN AN S CORPORATION FROM THE DATE OF INCORPORATION.
- THE S STATUS TERMINATES ON JUNE 1, 1993 (THUS, THERE IS A SHORT C TAXABLE YEAR COMMENCING JUNE 1, 1993 AND ENDING JUNE 30, 1993).

WHAT ARE THE CONSEQUENCES UNDER THE FRANCHISE TAX LAWS SET FORTH IN OHIO REVISED CODE CHAPTER 5733?

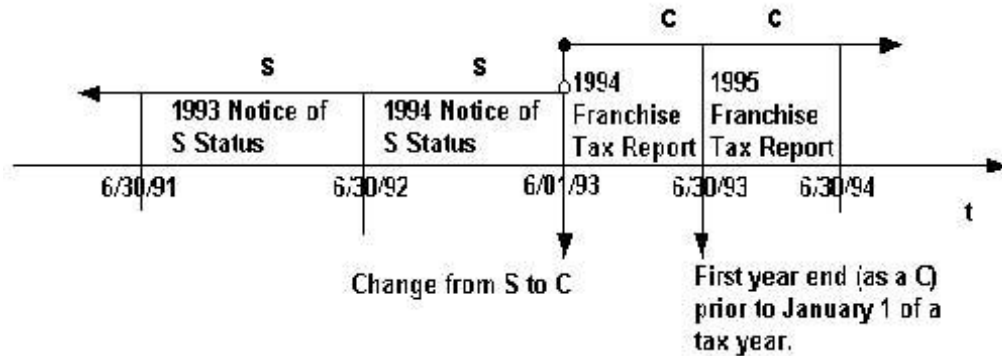
ANSWER:

The corporation is subject to the 1994 franchise tax because the corporation was a C corporation during some part of its fiscal year (June 1, 1993 - June 30, 1993) which ended prior to January 1 of the 1994 franchise tax year. The 1994 report will be based on (i) the corporation's net income for the period June 1, 1993 through June 30, 1993 and (ii) the corporation's net worth at July 1, 1993 (the net worth "business done" factor for the 1994 report will be based upon the short taxable year June 1, 1993 through June 30, 1993).

The 1995 franchise tax report will be based on (i) the corporation's net income for the twelve month period July 1, 1993 through June 30, 1994 and (ii) the corporation's net worth at July 1, 1994 (the net worth "business done" factor for the 1995 report will be based upon the twelve month taxable year July 1, 1993 through

June 30, 1994).

Below is our illustration of the fact pattern:



30. QUESTION:

ASSUME THE FOLLOWING FACTS:

- THERE IS AN INTERNAL REVENUE CODE SECTION 1362 REVOCATION OR TERMINATION OF A CORPORATION'S S STATUS.
- THE REVOCATION OR TERMINATION OCCURS OTHER THAN AT YEAR END.
- THE REVOCATION OR TERMINATION RESULTS IN A SHORT C TAXABLE YEAR.
- THE SHAREHOLDERS DO NOT ELECT TO HAVE ITEMS ASSIGNED TO EACH SHORT YEAR UNDER NORMAL ACCOUNTING RULES AS SET FORTH IN INTERNAL REVENUE CODE SECTION 1362(e)(3); INSTEAD, THEY CHOOSE TO UTILIZE THE "PRO-RATA ALLOCATION" METHOD SET FORTH IN INTERNAL REVENUE CODE SECTION 1362(e)(2).

WHAT ARE THE CONSEQUENCES UNDER THE FRANCHISE TAX LAWS SET FORTH IN OHIO REVISED CODE CHAPTER 5733?

ANSWER:

The Tax Commissioner will generally follow the method of calculating taxable income which the taxpayer chooses for federal income tax purposes.

31. QUESTION:

ASSUME THE FOLLOWING FACTS:

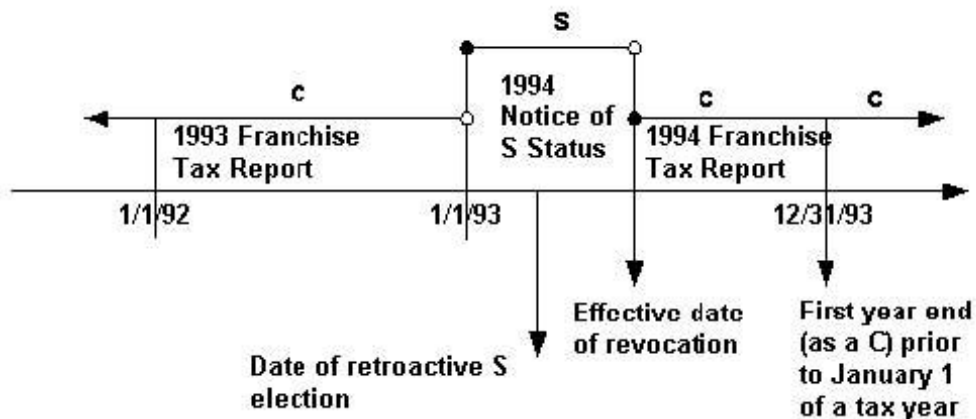
- IN LATE JANUARY, 1993 A CALENDAR YEAR C CORPORATION ELECTS (AND THE SHAREHOLDERS CONSENT TO) A TIMELY RETROACTIVE ELECTION TO BE AN S CORPORATION EFFECTIVE JANUARY 1, 1993 PURSUANT TO INTERNAL REVENUE CODE SECTION 1362(b)(1)(B).
- SUBSEQUENTLY IN THE SAME TAXABLE YEAR (1993) THERE IS EITHER A PROSPECTIVE REVOCATION OR TERMINATING EVENT PURSUANT TO INTERNAL REVENUE CODE SECTION 1362(d)(1)(D).

WHAT ARE THE CONSEQUENCES UNDER OHIO REVISED CODE CHAPTER 5733?

ANSWER:

The Internal Revenue Code contains no specific prohibition against a revocation being made in the first taxable year in which a corporation elects to be an S corporation. Consequently, a calendar year S corporation's net income from January 1, 1993 (the beginning of the year) to the date of revocation is exempt from the 1994 Ohio franchise tax imposed by ORC Chapter 5733. Because of the prospective S status revocation effective sometime later during its first taxable year (1993) and because as a C corporation it has a taxable year which ended prior to January 1 of the 1994 franchise tax year, the corporation will be liable for the 1994 franchise tax. The 1994 report will be based on (i) the corporation's net income for period commencing with the date of the revocation of the S status through December 31, 1993 and (ii) the corporation's net worth at January 1, 1994 (the net worth "business done" factor for the 1994 report will be based upon the taxable year beginning with the date of the revocation of the S status and ending December 31, 1993).

Below is our illustration of the fact pattern:



CORPORATE CARRYFORWARD ITEMS

32. QUESTION:

ASSUME THAT A C CORPORATION INCURS AN OHIO NET OPERATING LOSS CARRYFORWARD, AN OHIO INVESTMENT TAX CREDIT CARRYFORWARD, AN OHIO EXPORT TAX CREDIT CARRYFORWARD, AND/OR SIMILAR CARRYFORWARD AMOUNTS WHICH WERE NOT FULLY UTILIZED PRIOR TO THE CORPORATION'S BECOMING AN S CORPORATION. WILL THESE CARRYFORWARDS "PASS THROUGH" TO THE SHAREHOLDERS?

ANSWER:

No. The Tax Commissioner will be guided by Internal Revenue Code section 1371(b). As such, carryforwards arising from a franchise tax year for which the corporation was subject to the Ohio corporation franchise tax do not pass through to shareholders for tax years for which the corporation is exempt from tax.

Accordingly, unused Ohio net operating losses, unused investment tax credits, ACRS depreciation adjustment items and unused export sales credit carryforwards arising in a tax year prior to a tax year for which the S corporation is exempt from the franchise tax do not pass through to the shareholders.

However, nothing in the preceding paragraph shall prevent treating a tax year, for which an S corporation is exempt from tax, as a franchise tax year for purposes of determining the number of franchise tax years to which such unused amounts may be carried forward. Thus, the fifteen year Ohio net operating loss carryforward period, the three year investment tax credit carryforward period, and the export sales credit carryforward limitation period are not suspended for tax years during which the corporation is exempt from tax.

For example, assume that a calendar year corporation has an unused Ohio net operating loss carryforward arising from its 1986 franchise tax report (based on its taxable year ended December 31, 1985). Further assume that for federal income tax purposes the corporation is an S corporation from January 1, 1986 through December 31, 1999. In this situation, in order to take advantage of the net operating loss carryforward, the corporation must not be exempt from the 2001 franchise tax and must file a 2001 franchise tax report. However, if the corporation is still an S corporation on December 31, 2000, it will not file a 2001 franchise report, and the net operating loss carryforward will expire even though it has never been utilized.

**SUPPLEMENTAL QUESTIONS AND ANSWERS NOT APPEARING IN THE
APRIL 21, 1986 RELEASE**

33. QUESTION:

ASSUME THE FOLLOWING FACTS:

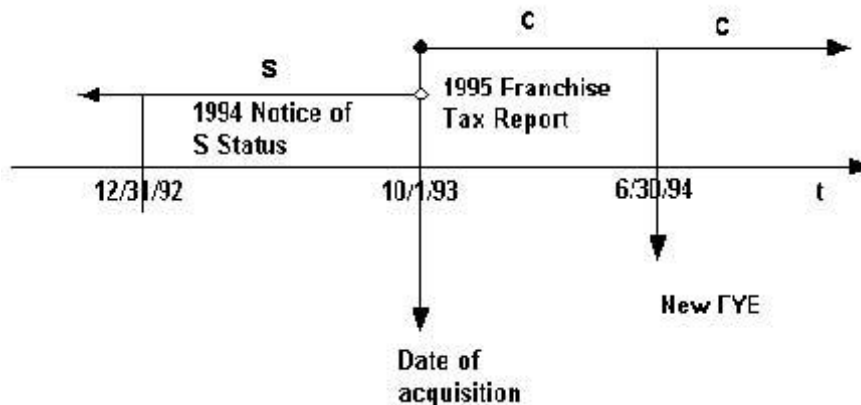
- AN S CORPORATION HAS A DECEMBER 31 YEAR END.
- ON OCTOBER 1, 1993 AN UNRELATED C CORPORATION HAVING A JUNE 30 FISCAL YEAR END PURCHASES ALL OF THE S CORPORATION'S OUTSTANDING STOCK (A TERMINATING EVENT).
- THE ACQUIRED CORPORATION CHANGES ITS ACCOUNTING PERIOD TO JUNE 30, ITS NEW PARENT'S FISCAL YEAR END (THUS, THE ACQUIRED CORPORATION WAS AN S CORPORATION FROM JANUARY 1, 1993 THROUGH SEPTEMBER 30, 1993, AND IT WAS A C CORPORATION FROM OCTOBER 1, 1993 FORWARD).

MUST THE ACQUIRED CORPORATION FILE A 1994 OHIO CORPORATION FRANCHISE TAX REPORT?

ANSWER:

No. The acquired corporation is not subject to the 1994 Ohio corporation franchise tax because (i) it is not a "new taxpayer" as defined in Rule 5703-5-01 and (ii) it did not have a C corporation taxable year ending prior to January 1 of the 1994 tax year, Ohio Administrative Code (Rule) 5703-5-04. The acquired corporation's 1995 Ohio corporation franchise tax will be based on (i) the corporation's net income for the period October 1, 1993 through-June 30, 1994 and (ii) the corporation's net worth at July 1, 1994 (the net worth "business done" factor for the 1995 report will be based upon the nine month taxable year beginning on October 1, 1993 and ending on June 30, 1994).

Below is our illustration of this fact pattern:



34. QUESTION:

ASSUME THE FOLLOWING FACTS:

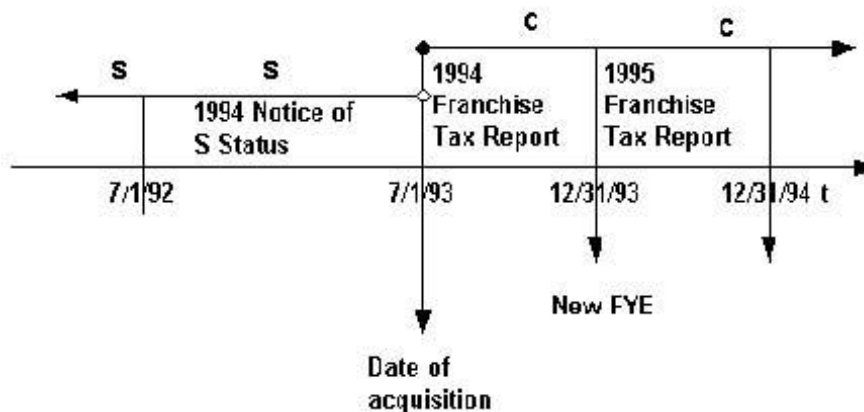
- AN S CORPORATION HAS A JUNE 30 FISCAL YEAR END.
- ON JULY 1, 1993 A CALENDAR YEAR C CORPORATION PURCHASES ALL OF THE OUTSTANDING STOCK OF THE S CORPORATION (A TERMINATING EVENT).
- THE NEWLY-ACQUIRED CORPORATION THEN CHANGES ITS ACCOUNTING PERIOD TO A CALENDAR YEAR END IN ORDER TO CONFORM TO ITS NEW PARENT'S CALENDAR YEAR END. THUS, THE ACQUIRED CORPORATION HAS A TWELVE MONTH S TAXABLE YEAR, (JULY 1, 1992 THROUGH JUNE 30, 1993) FOLLOWED BY A SHORT C TAXABLE YEAR (JULY 1, 1993 THROUGH DECEMBER 31, 1993).

MUST THE ACQUIRED CORPORATION FILE A 1994 OHIO CORPORATION FRANCHISE TAX REPORT?

ANSWER:

Yes. The acquired corporation is subject to the franchise tax for tax year 1994 and must file the 1994 Ohio corporation franchise tax report because it has a C corporation taxable year (July 1, 1993 through December 31, 1993) which ended prior to January 1 of the 1994 Ohio franchise tax year. Ohio Administrative Code (Rule) 5703-5-04.

Below is our illustration of this fact pattern:



35. QUESTION:

ASSUME THE FOLLOWING FACTS:

- AN S CORPORATION HAS A JUNE 30 FISCAL YEAR END.

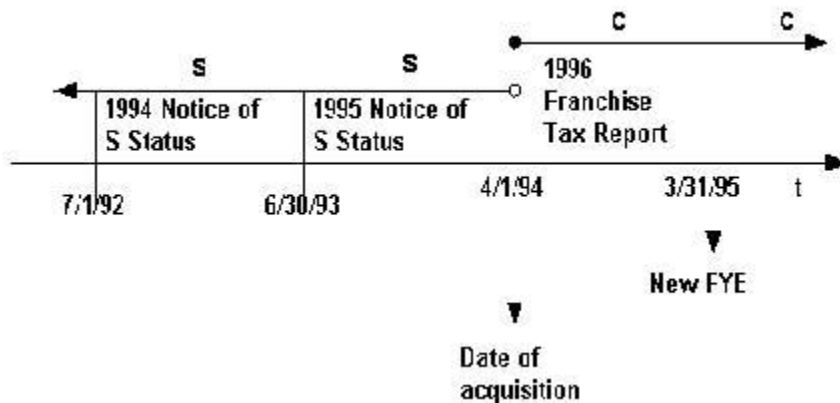
- ON APRIL 1, 1994 AN UNRELATED C CORPORATION HAVING A MARCH 31 FISCAL YEAR END PURCHASES ALL OF THE OUTSTANDING STOCK OF THE S CORPORATION (A TERMINATING EVENT).
- THE NEWLY-ACQUIRED CORPORATION THEN CHANGES ITS ACCOUNTING PERIOD TO MARCH 31 IN ORDER TO CONFORM TO ITS PARENT'S MARCH 31 FISCAL YEAR END. THUS, THE ACQUIRED CORPORATION HAS A TWELVE MONTH S TAXABLE YEAR (JULY 1, 1992 THROUGH JUNE 30, 1993) FOLLOWED BY A SHORT S TAXABLE YEAR (JULY 1, 1993 THROUGH MARCH 31, 1994), AND THEN FOLLOWED BY A TWELVE MONTH C TAXABLE YEAR (APRIL 1, 1994 THROUGH MARCH 31, 1995).

MUST THE ACQUIRED CORPORATION FILE A 1995 OHIO CORPORATION FRANCHISE TAX REPORT?

ANSWER:

No. The acquired corporation is not subject to the 1995 Ohio corporation franchise tax because (i) it is not a "new taxpayer" as defined in Ohio Administrative Code (Rule) 5703-5-01 and (ii) it did not have a C corporation taxable year ending prior to January 1 of the 1995 tax year, Ohio Administrative Code (Rule) 5703-5-04. The acquired corporation's 1996 Ohio corporation franchise tax will be based on (i) the corporation's net income for the period April 1, 1994 through March 31, 1995 and (ii) the corporation's net worth at April 1, 1995 (the net worth "business done" factor for the 1996 report will be based upon the twelve month taxable year beginning on April 1, 1994 and ending on March 31, 1995).

Below is our illustration of this fact pattern:



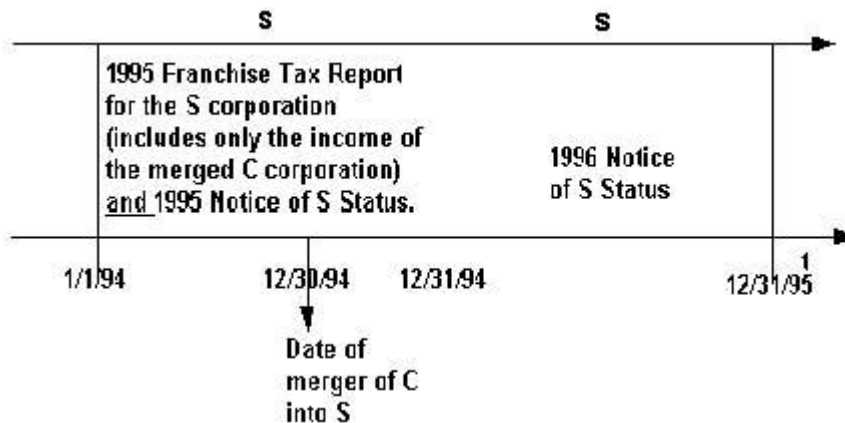
36. QUESTION:

WHAT ARE THE FRANCHISE TAX EFFECTS OF A MERGER OF A C CORPORATION INTO AN S CORPORATION WHERE PRIOR TO THE MERGER THE C CORPORATION AND THE S CORPORATION WERE BROTHER-SISTER CORPORATIONS OWNED BY THE SAME INDIVIDUAL OR FAMILY? DOES THE ORC SECTION 5733.053 TRANSFEROR STATUTE APPLY TO THE SURVIVING S CORPORATION? ASSUME (i) THE MERGER OCCURS ON DECEMBER 30, 1994 AND (ii) BOTH CORPORATIONS ARE CALENDAR YEAR CORPORATIONS.

ANSWER:

The department's position is that R.C. section 5733.053 requires that the S corporation file a 1995 Ohio corporation franchise tax report and pay the tax based upon the net income basis. The S corporation must include on its 1995 report the income earned by the merged C corporation during the period January 1, 1994 through December 30, 1994. That is, the C corporation is not subject to the tax, but the S corporation is subject to the tax and must include the C corporation's income. However, the S corporation will not be subject to the 1995 net worth basis franchise tax.

Below is our illustration of this fact pattern:



For further information see the Corporation Franchise Tax Information Release dated September 24, 1992.

37. QUESTION:

WHAT IS THE STATUTORY AUTHORITY FOR OHIO'S IMPOSING THE OHIO INCOME TAX ON NONRESIDENT SHAREHOLDERS OF S CORPORATIONS DOING BUSINESS IN OHIO?

ANSWER:

The position of the Ohio Department of Taxation is that R.C. section 5747.02 provides the statutory authority for Ohio to impose the Ohio income tax on nonresident shareholders of S corporations doing business Ohio. ORC section 5747.02, in part, imposes the income tax "on every individual and every estate... earning income in the state" (emphasis added).

For support of the department's position that it can tax nonresident shareholders of S corporations, see Kulick v. Department of Revenue, 290 Or. 507, 624 P.2d 93 (1981), appeal dismissed, 454 U.S. 803 (1981) and Isaacsan v. Iowa State Tax Commission, 183 N.W. 2d 693 (Iowa S. Ct., 1971).

38. QUESTION:

A FLORIDA S CORPORATION PERFORMS MANAGEMENT SERVICES FOR A RELATED OHIO S CORPORATION. IS THERE AUTHORITY FOR THE TAX COMMISSIONER TO REQUIRE THAT THE TWO CORPORATIONS COMBINE THEIR INCOMES FOR PURPOSES OF APPLYING THE ALLOCATION AND APPORTIONMENT PROVISIONS OF CHAPTER 5747?

ANSWER:

Yes. Although there are no Ohio cases addressing this issue, there is authority in other states' case law which will allow the department to utilize R.C. section 5747.21 (D)⁸ in order to require a combination.

Some explanation is in order. Nonresident individuals who have invested in S corporations doing business in Ohio are establishing Florida-based S corporations which may be inappropriately siphoning off profits from the Ohio S corporations. Often, combining the two S corporations more fairly reflects the extent of the companies' Ohio activity and, thus, the shareholder's income earned in Ohio.

ADDITIONAL INFORMATION

39. QUESTION:

IF I HAVE FURTHER QUESTIONS, WHOM DO I CONTACT?

ANSWER:

You can write to the following:

Ohio Department of Taxation
Business Tax Division
4485 Northland Ridge Blvd.
Columbus, Ohio 43229

Or call: (888) 405-4039

Or e-mail: [Ohio Department of Taxation - E-Mail Us](#)

Footnotes:

¹ ORC section 5733.09(B) reads as follows:

"(B) A corporation that has made an election under subchapter S, chapter one, subtitle A, of the Internal Revenue Code for its taxable year under such code is exempt from the tax imposed by this chapter that is based on that taxable year.

"A corporation that makes such an election shall file a notice of such election with the tax commissioner between the first day of January and the thirty-first day of March of each tax year that the election is in effect."

² See page 4 for "[Income Taxation of S Corporation Nonresident Shareholders](#)".

³ The answer in our April 21, 1986 release read as follows:

ANSWER:

Yes. An Ohio resident will be able to claim the resident credit for his/her portion of the S distributive share which was subjected to tax on income or measured by income in another state even if the S corporation paid tax in that other state.

In those situations, if any, where both the S corporation and the shareholder pay taxes based on or measured by income to the same state, the shareholder can claim the credit only for his/her own income which was subject to the tax. The shareholder will not be able to claim the credit for his/her distributive share of income upon which the corporation paid the tax to another state.

Page twelve of the 1985 Ohio Income Tax Return Instructions discusses the computation of the credit. The credit is not based on the amount of tax paid to another state; nor is the credit based on the amount of income that would be apportioned to another state based on ORC section 5733.05(B). The credit is based on the portion of income actually subjected to income tax in another state. As such, Ohio residents can not claim this credit for gross receipts taxes or other similar excise taxes. For example, states such as Michigan and Indiana levy a gross receipts tax. Since that tax is not measured by income, Ohio residents can not

claim any credit for gross receipts taxes paid by them, by their businesses, or by their S corporations.

⁴The last two sentences of this paragraph did not appear in our April 21, 1986 release.

⁵The answer in our April 21, 1986 release read as follows:

ANSWER:

No. Each shareholder of an S corporation must file his/her own individual income tax return (Form IT-1040) and claim the appropriate deductions and credits, including the investment tax credit and the nonresident credit.

⁶This sentence did not appear in our April 21, 1986 release.

⁷The answer in our April 21, 1986 release read as follows:

ANSWER:

The Department of Taxation will disregard the short C taxable year prior to the inception of the S status. In the examples set forth above, the 1994 franchise tax report would be based on the twelve months ended June 30, 1993.

If the corporation were in S status for the entire 1994 calendar year, the corporation would owe no franchise tax for the 1995 franchise tax year.

⁸ORC section 5747.21(D) permits the tax commissioner to employ "... any other method to effectuate an equitable allocation of business in this State."