IT 12-10
Tax Type: Individual Income Tax
Tax Issue: Properly Determined AGI for Subchapter S Shareholders

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
SPRINGFIELD, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	
v.	**Docket # XXXX**
JOHN DOE, et. al.	
Taxpayers	

RECOMMENDATION FOR DISPOSITION

Appearances: Matthew S. Crain, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Jack Black and John Brown of ABC Law Firm for JOHN DOE, Bob & Mary White, Susie Red, Patrick Purple, and Polly Purple

Synopsis:

The Department of Revenue ("Department") issued Notices of Deficiency ("NODs") to JOHN DOE, Bob & Mary White, Susie Red, Patrick Purple, and Polly Purple ("taxpayers") alleging that the taxpayers owe Illinois income tax, plus interest and penalties. The taxpayers timely protested the NODs. The parties filed a Stipulation of Facts with attached exhibits and supporting briefs, and they requested that the matter be decided based on the written submissions. The taxpayers have raised the following issues: (1) whether section 203(a)(2)(J) of the Illinois Income Tax Act (35 ILCS 5/101 *et seq.*) allows shareholders of an S corporation that operates in an Illinois Enterprise Zone a "dividend" subtraction for the shareholders' proportionate share of the corporation's income (*i.e.*, the full amount of corporate income included in adjusted gross income ("AGI")); (2) in the alternative, whether the funds that were actually paid to the shareholders during the years at issue should be subtracted from the taxpayers' AGI pursuant to the Enterprise Zone Dividend Subtraction in section 203(a)(2)(J); and (3) whether the penalties should be abated due to reasonable cause. After reviewing the record, it is recommended that this matter be resolved in favor of the Department.

FINDINGS OF FACT:

1. ABC Company (the "Corporation") is an Anystate corporation that is authorized to transact business in the State of Illinois. (Stip. #1)
2. The Corporation's principal place of business is Anywhere, Illinois. (Stip. #2)
3. The Corporation's principal place of business is located within Illinois Enterprise Zone #XX, located in Anywhere, Illinois. (Stip. #3)
4. The Corporation is a Small Business Corporation (an "S Corporation") within the meaning of §1361(a)(1) of the Internal Revenue Code. (Stip. #4)
5. For the years at issue in this proceeding, the following individuals were shareholders of the Corporation (hereinafter sometimes collectively referred to as the "Shareholders"):

   a. JOHN DOE;
   b. Bob White;
   c. Mary White;
   d. Susie Red;
   e. Patrick Purple; and
   f. Polly Purple. (Stip. #5)

6. A Schedule K-1-P was issued to Bob White by the Corporation for tax year 2007. (Stip. #6; Ex. A)

7. A Schedule K-1-P was issued to Mary White by the Corporation for tax year 2007. (Stip. #7; Ex. B)

8. A Schedule K-1-P was issued to Patrick Purple by the Corporation for tax year 2007. (Stip. #8; Ex. C)

9. A Schedule K-1-P was issued to Polly Purple by the Corporation for tax year 2007. (Stip. #9; Ex. D)

10. A Schedule K-1-P was issued to Susie Red by the Corporation for tax year 2007. (Stip. #10; Ex. E)

11. A Schedule K-1-P was issued to JOHN DOE by the Corporation for tax year 2007. (Stip. #11; Ex. F)

12. A Schedule K-1-P was issued to Bob White by the Corporation for tax year 2008. (Stip. #12; Ex. G)

13. A Schedule K-1-P was issued to Mary White by the Corporation for tax year 2008. (Stip. #13; Ex. H)

14. A Schedule K-1-P was issued to Susie Red by the Corporation for tax year 2008. (Stip. #14; Ex. I)

15. In 2007, the Corporation distributed to Bob White $144,642.00.[1] (Stip. #15)

16. In 2007, the Corporation distributed to Mary White $47,052.00. (Stip. #16)

17. In 2007, the Corporation distributed to Patrick Purple $133,314.00. (Stip. #17)

18. In 2007, the Corporation distributed to Polly Purple $133,314.00. (Stip. #18)

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[1] The actual text of this stipulation (and stipulations 16 through 23) states that these distributions were "dividend" distributions. The parties may bind themselves by stipulations, but they cannot bind this tribunal "by stipulating to a question of law or the legal effect of facts." American Pharmaseal v. TEC Systems, 162 Ill. App. 3d 351, 356 (2nd Dist. 1987) (quoting Domagalski v. Industrial Commission, 97 Ill. 2d 228, 235 (1983)). As the following discussion indicates, the actual distributions by an S corporation are not necessarily "dividends" within the meaning of federal and Illinois income tax law.

19. In 2007, the Corporation distributed to Susie Red $133,314.00. (Stip. #19)

20. In 2007, the Corporation distributed to JOHN DOE $47,052.00. (Stip. #20)

21. In 2008, the Corporation distributed to Bob White $82,679.00. (Stip. #21)

22. In 2008, the Corporation distributed to Mary White $26,896.00. (Stip. #22)

23. In 2008, the Corporation distributed to Susie Red $76,205.00. (Stip. #23)

24. Each of the Shareholders included their proportionate share of the Corporation's income in their Federal Adjusted Gross Income and Illinois Total Income, in accordance with the amounts reported in their Schedules K-1-P. (Stip. #24)

25. The taxpayers' certified public account ("CPA") has been preparing Illinois business and individual income tax returns for over 30 years. He has prepared or overseen the preparation of the Corporation's Illinois income tax returns for over 20 years. (Ex. J)

26. Based on the CPA's advice, the Shareholders claimed the Enterprise Zone Dividend Subtraction on Schedule 1299-C of their Illinois individual income tax returns in the following amounts:

Shareholder	Year	Amount
Bob and Mary White	2007	$259,075.00
Susie Red	2007	$180,181.00
Patrick Purple	2007	$180,182.00
Polly Purple	2007	$180,181.00
JOHN DOE	2007	$63,592.00
Bob and Mary White	2008	$26,824.00
Susie Red	2008	$18,654.00 (Stip. #27)

27. The parties waive their right to an administrative hearing and consent to the entry of a ruling based on the facts set forth herein and based on briefs to be submitted. (Stip. #33)

CONCLUSIONS OF LAW:

Section 201(a) of the Illinois Income Tax Act ("Act" or "IITA") imposes a tax on the privilege of earning or receiving income in or as a resident of the State of Illinois. 35 ILCS 5/201(a). The tax is measured by net income, which is calculated by starting with the taxpayer's federal adjusted gross income. 35 ILCS 5/201(a); 203. A taxpayer's net income for a taxable year is "that portion of his base income for such year which is allocable to this State … less the standard exemption allowed by Section 204 and the deduction allowed by Section 207." 35 ILCS 5/202.

Section 203 of the Act defines base income and provides, in relevant part, as follows:

> **Sec. 203. Base income defined.**
>
> **(a) Individuals.**
>
> **(1) In general.** In the case of an individual, base income means an amount equal to the taxpayer's adjusted gross income for the taxable year as modified by paragraph (2).
>
> **(2) Modifications.** The adjusted gross income referred to in paragraph (1) shall be modified by adding thereto the sum of the following amounts:
>
> . . .
>
> and by deducting from the total so obtained the sum of the following amounts:
>
> . . .
>
> **(J)** An amount equal to those dividends included in such total which were paid by a corporation which conducts business operations in an Enterprise Zone or zones created under the Illinois Enterprise Zone Act or a River Edge Redevelopment Zone or zones created under the River Edge Redevelopment Zone Act, and conducts substantially all of its operations in an Enterprise Zone or zones or a River Edge

> Redevelopment Zone or zones. This subparagraph (J) is exempt from the provisions of Section 250; … **35 ILCS 5/203(a)(2)(J).**

The parties agree that ABC Company qualifies as an Enterprise Zone corporation under this provision. The only dispute is whether either the shareholders' proportionate share of the Corporation's income or the actual distributions from the Corporation are "dividends" within the meaning of this section.

The Department's regulation concerning the Enterprise Zone Dividend Subtraction in section 203(a)(2)(J) states, in relevant part, as follows:

> **Section 100.2480 Enterprise Zone Dividend Subtraction**
>
> **(a)** Taxpayers are entitled to subtract from taxable income (adjusted gross income, in the case of an individual) an amount equal to dividends paid by a corporation which conducts business operations in an Enterprise Zone or zones created under the Illinois Enterprise Zone Act, and conducts all or substantially all of its operations in the Enterprise Zone or zones (IITA Sections 203(a)(2)(J), 203(b)(2)(K), 203(c)(2)(M) and 203(d)(2)(K)).
>
> . . .
>
> **(d)** Limitations.
>
> **(1)** This Section allows taxpayers to subtract distributions from a corporation only to the extent:
>
> **(A)** such distributions are characterized as dividends;
>
> **(B)** such dividends are included in federal taxable income (in the case of an individual, adjusted gross income) of the taxpayer; and
>
> **(C)** the taxpayer has not subtracted such dividends from federal taxable income (in the case of an individual, adjusted gross income) under any other provision of Section 203 of the IITA.
>
> **(2)** Example: Taxpayer, an S corporation shareholder, receives a distribution from an S corporation which conducts substantially all of its business in an Enterprise Zone. Although the S corporation satisfies the 95% test, Taxpayer is not entitled to this subtraction modification since a distribution by an S corporation is generally

> not characterized as a dividend. See Section 1368 of the Internal Revenue Code. **86 Ill. Admin. Code §100.2480 (a), (d).**

The Department argues that the shareholders' "distributive shares of income" from the S corporation do not qualify for the Enterprise Zone "dividend" subtraction because, as the Department's regulation indicates, the distributions are not dividends. The Department contends that under section 1366 of the Code, the income of an S corporation is not distributed but "flows through to its shareholders." The Department, therefore, believes that the proportionate share of the corporation's income that was included in the shareholders' adjusted gross income is not a dividend that can be subtracted from their adjusted gross income.

The taxpayers argue that the Department's regulation misinterprets federal tax law by concluding that S corporation "distributions" are not dividends. The taxpayers state that the plain language of section 203(a)(2)(J) does not distinguish between C corporations and S corporations; it includes all corporations operating in an Illinois Enterprise Zone. The taxpayers contend that under federal tax law, distributions of corporate earnings to shareholders of all corporations are dividends, and the only distinction between S corporation and C corporation dividends is whether such dividends are separately taxable to the shareholder.

For C corporations, the only portion of the corporation's income that is included in the shareholder's AGI is the dividends paid by the corporation. By contrast, each shareholder in an S corporation is required to include their entire proportionate share of the corporation's income in their AGI. The taxpayers believe that under the Department's interpretation of section 203(a)(2)(J), shareholders in an S corporation would not receive a tax benefit from their investment in an S corporation operating in an Enterprise Zone.

The taxpayers contend that the Department's interpretation of section 203(a)(2)(J) is contrary to the legislative intent of the Enterprise Zone Subtraction. According to the taxpayers, the purpose of the subtraction is to encourage investment in businesses operating in an Enterprise Zone, and the legislature intended to give a tax break to "every person who would gain any dividend from an enterprise located within the enterprise zone." (Ex. M, p. 259) Because corporate income is included in an S corporation shareholder's AGI at the time it is earned rather than when the dividends are paid, the taxpayers contend that their argument of subtracting their proportionate share of the corporation's income from AGI in determining base income is consistent with the legislative intent of excluding corporate earnings from the shareholders' base income.

In the alternative, if section 203(a)(2)(J) does not allow a subtraction for the full amount of corporate income included in an S corporation shareholder's AGI, then the taxpayers argue that the subtraction should be available for the "dividend distributions" that were actually paid to each taxpayer during the years in question. The plain language of section 203(a)(2)(J) states that AGI shall be modified by subtracting an amount equal to the dividends that were included in AGI that were paid by a corporation that conducts business in an Enterprise Zone. The taxpayers contend that because each shareholder's AGI included their entire share of the corporate income, the distributions that were actually paid in this case should be subtracted from AGI.

The taxpayers believe that the Department's distinction between "dividends" and "distributions" is an inaccurate interpretation of federal tax law. Section 316 of the Code defines "dividend" as "any distribution of property made by a corporation to its shareholders … out of its earnings and profits …" 26 U.S.C. §316. This definition applies to both C corporations and S corporations. See 26 U.S.C. §1371.[2]

The taxpayers claim that the only distinction between the distributions of earnings from C corporations and S corporations is not whether they are "dividends" but whether they are taxable for federal income tax purposes. Section 301(c) of the Code requires dividends from C corporations to be included in gross income. The taxpayers contend that for S corporations, section 1368(c) states that a distribution of corporate "earnings and profits" is not taxable to the extent that it does not exceed the corporation's Accumulated Adjustments Account ("AAA").[3]

The taxpayers believe that the relationship between Code sections 301 and 1368 can be summarized by stating that all corporate distributions out of earnings and profits are dividends (pursuant to the definition in section 316), but not all dividends are independently taxable to the shareholder. C corporation dividends are separately taxable, but S corporation dividends are not if they do not exceed the corporation's AAA. According to the taxpayers, all distributions out of an S corporation's earnings and profits fall within the definition of "dividend" under the Code (sections 316 and 1371), but S corporation dividends are simply not separately taxable to the shareholder to the extent that they do not exceed the S corporation's AAA.

[2] This section states that "subchapter C shall apply to an S corporation and its shareholders" except to the extent that it is inconsistent with the provisions of subchapter S. Because there is no definition of the term "dividend" in subchapter S of the Code, the taxpayers assert that the definition of "dividend" under section 316 of the Code applies to distributions of earnings from both C corporations and S corporations.

[3] An S corporation's AAA will be discussed subsequently in greater detail.

The taxpayers have correctly stated the definition of "dividend," which is essentially a distribution out of a corporation's "earnings and profits." See 26 U.S.C. §316. With respect to an S corporation, however, not all of the S corporation's distributions are from its "earnings and profits." As the following discussion indicates, the critical inquiry in determining whether a distribution from an S corporation is a "dividend" is first determining whether the S corporation has accumulated "earnings and profits."

Section 203(a)(2)(J) of the IITA allows a deduction from the taxpayers' AGI for an "amount equal to those dividends included in such total which were paid by a corporation which conducts business operations in an Enterprise Zone …" 35 ILCS 5/203(a)(2)(J). The cardinal rule of statutory construction is to ascertain and give effect to the true intention of the legislature. Solich v. George & Anna Portes Cancer Prevention Center of Chicago, Inc., 158 Ill. 2d 76, 81 (1994). The statute's plain language is the best indicator of the legislature's intent. Lulay v. Lulay, 193 Ill. 2d 455, 466 (2000). When the language is clear, it will be given effect without resort to other aids for construction. Petersen v. Wallach, 198 Ill. 2d 439, 445 (2002). It is only when the statutory language is ambiguous that it is appropriate to resort to extrinsic aids, such as legislative history. Kunkel v. Walton, 179 Ill. 2d 519, 534 (1997).

The statutory language in section 203(a)(2)(J) is not ambiguous because the definition of the word "dividend" is clear. As the taxpayers have indicated, section 316 of the Code defines "dividend" as "any distribution of property made by a corporation to its shareholders … out of its earnings and profits …" 26 U.S.C. §316. Because the statutory language is clear, it is not necessary to resort to the legislative history of section

203(a)(2)(J). Under section 102 of the IITA, if the taxpayer's income was "dividend" income for federal income tax purposes, then the same characterization would apply for Illinois income tax purposes. 35 ILCS 5/102.

For federal income tax purposes, S corporations may or may not have "earnings and profits." Only distributions from "earnings and profits" are considered to be dividends. 26 U.S.C. §316. For the following reasons, the taxpayers have not clearly established that either their proportionate share of the Corporation's income or the distributions that they actually received during the years 2007 and 2008 were from the Corporation's "earnings and profits." Therefore, the taxpayers have not clearly established that any of the amounts were "dividends" for purposes of section 203(a)(2)(J).

Section 1368 of the Internal Revenue Code concerns distributions to shareholders of S corporations and provides, in relevant part, as follows:

> **1368. Distributions**
>
> **(a) General rule.**--A distribution of property made by an S corporation with respect to its stock to which (but for this subsection) section 301(c) would apply shall be treated in the manner provided in subsection (b) or (c), whichever applies.
>
> **(b) S corporation having no earnings and profits.**--In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits--
>
> > **(1) Amount applied against basis.**--The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.
> >
> > **(2) Amount in excess of basis.**--If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

(c) S corporation having earnings and profits.--In the case of a distribution described in subsection (a) by an S corporation which has accumulated earnings and profits--

(1) Accumulated adjustments account.--That portion of the distribution which does not exceed the accumulated adjustments account shall be treated in the manner provided by subsection (b).

(2) Dividend.--That portion of the distribution which remains after the application of paragraph (1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation.

(3) Treatment of remainder.--Any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (b).

Except to the extent provided in regulations, if the distributions during the taxable year exceed the amount in the accumulated adjustments account at the close of the taxable year, for purposes of this subsection, the balance of such account shall be allocated among such distributions in proportion to their respective sizes.

(d) Certain adjustments taken into account.--Subsections (b) and (c) shall be applied by taking into account (to the extent proper)--

(1) the adjustments to the basis of the shareholder's stock described in section 1367, and

(2) the adjustments to the accumulated adjustments account which are required by subsection (e)(1).

In the case of any distribution made during any taxable year, the adjusted basis of the stock shall be determined with regard to the adjustments provided in paragraph (1) of section 1367(a) for the taxable year.

(e) Definitions and special rules.--For purposes of this section--

(1) Accumulated adjustments account.--

(A) In general.--Except as otherwise provided in this paragraph, the term “accumulated adjustments account” means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under section 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under this title and the phrase "(but not below zero)" shall be disregarded in section 1367(a)(2)) and no adjustment shall be made for Federal taxes attributable to any taxable year in which the corporation was a C corporation.

(B) Amount of adjustment in the case of redemptions.--In the case of any redemption which is treated as an exchange under section 302(a) or 303(a), the adjustment in the accumulated adjustments account shall be an amount which bears the same ratio to the balance in such account as the number of shares redeemed in such redemption bears to the number of shares of stock in the corporation immediately before such redemption.

(C) Net loss for year disregarded.--

(i) In general.--In applying this section to distributions made during any taxable year, the amount in the accumulated adjustments account as of the close of such taxable year shall be determined without regard to any net negative adjustment for such taxable year.

(ii) Net negative adjustment.--For purposes of clause (i), the term "net negative adjustment" means, with respect to any taxable year, the excess (if any) of--

(I) the reductions in the account for the taxable year (other than for distributions), over

(II) the increases in such account for such taxable year.

(2) S period.--The term "S period" means the most recent continuous period during which the corporation has been an S corporation. Such period shall not include any taxable year beginning before January 1, 1983.

(3) Election to distribute earnings first.--

(A) In general.--An S corporation may, with the consent of all of its affected shareholders, elect to have paragraph (1) of subsection (c) not apply to all distributions made during the taxable year for which the election is made.

(B) Affected shareholder.--For purposes of subparagraph (A), the term "affected shareholder" means any shareholder to whom a distribution is made by the S corporation during the taxable year. **26 U.S.C. §1368**.

As subsections (b) and (c) of section 1368 indicate, the tax treatment of distributions from an S corporation depends on whether the S corporation has accumulated earnings and profits ("E & P"). Because an S corporation is taxed differently than a C corporation, sometimes an S corporation will not have accumulated E & P.

An S corporation does not pay corporate-level income taxes. Broadaway v. Commissioner of Internal Revenue, 111 F. 3d 593, 594 (8th Cir. 1997). An S corporation is like a partnership in that it is a "pass through entity;" in other words, with certain exceptions, the shareholders must report gain or loss irrespective of any distributions that are made to them. *Id*. at 594-595; Williams v. Commissioner of Internal Revenue, 110 T.C. 27, 29 (1998). The S corporation's income is taxed directly to its shareholders based on their ownership of the corporation's stock, whether or not the funds are actually distributed to the shareholders. Broadaway, at 594-595; Williams, at 29-30.

The current tax treatment of S corporations under Subchapter S of the Code "obviated the conceptual need for corporate earnings and profits, except to the extent that an S corporation may possess accumulated earnings from prior years in which it was a subchapter C corporation." Williams, at 30 (citing 26 U.S.C. §1371(c)). A C corporation must maintain an E & P account. Once a company switches, however, from Subchapter C to Subchapter S treatment, the company is required to track its income using a so-called accumulated adjustments account ("AAA") rather than the earnings and profits account used when the company was a C corporation. Broadaway, at 596 (citing 26 U.S.C. §1368(e)(1)(A)).

An S corporation monitors its undistributed corporate income (income that has been taxed to the shareholders but not yet distributed) using the AAA from which distributions to shareholders are generally tax-free.[4] Broadaway, at 595 (citing 26 U.S.C. §1368(c)(1)). This is done instead of maintaining an E & P account. Broadaway, at 595. An S corporation may have an accumulated E & P account, but only if it is derived from one or more of the following sources: (1) its prior existence as a C corporation; (2) earnings prior to 1983, when E & P concepts were still applicable to S corporations; or (3) the acquisition of another C corporation with an E & P account balance. Broadaway, at 595, f.n. 9. Therefore, an S corporation that (1) was organized after 1983; (2) was not previously a C corporation; and (3) did not acquire another C corporation, would not have an accumulated E & P account.

If an S corporation does not have an accumulated E & P account, then a distribution from that S corporation would not be a "dividend." See 26 U.S.C. §316, §1368(b), (c)(2). Because most S corporations generally do not have an accumulated E & P account, the Department's regulation concerning the Enterprise Zone Dividend Subtraction accurately states that "a distribution by an S corporation is generally not characterized as a dividend." 86 Ill. Admin. Code §100.2480(d)(2). In order for a distribution by an S corporation to be characterized as a "dividend," it must be a distribution that is treated as a dividend pursuant to section 1368(c)(2), *i.e.*, it must (1) be from an S corporation that has accumulated E & P; (2) exceed the S corporation's AAA; and (3) not exceed the accumulated E & P of the S corporation. 26 U.S.C. §1368(c)(2).

The provision of the Code that addresses adjustments to the E & P of an S corporation confirms the limited use of the E & P account for an S corporation. Section

[4] The AAA is adjusted to reflect the net income of the corporation. Broadaway, at 595, f.n. 7. "The account is adjusted upward by the amount of the corporation's income and is decreased by the amount of any losses and by return-of-capital distributions to shareholders." *Id*. (citing 26 U.S.C. §1368(e)(1)(A)).

1371 of the Code concerns the coordination of subchapter C with subchapter S and provides, in relevant part, as follows:

> **1371. Coordination with subchapter C**
>
> **(a) Application of subchapter C rules.**--Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.
>
> . . .
>
> **(c) Earnings and profits.--**
>
> **(1) In general.**--Except as provided in paragraphs (2) and (3) and subsection (d)(3), no adjustment shall be made to the earnings and profits of an S corporation.
>
> **(2) Adjustments for redemptions, liquidations, reorganizations, divisives, etc.**--In the case of any transaction involving the application of subchapter C to any S corporation, proper adjustment to any accumulated earnings and profits of the corporation shall be made.
>
> **(3) Adjustments in case of distributions treated as dividends under section 1368(c)(2).**--Paragraph (1) shall not apply with respect to that portion of a distribution which is treated as a dividend under section 1368(c)(2).
>
> **(d) Coordination with investment credit recapture.--**
>
> . . .
>
> **(3) Adjustment to earnings and profits for amount of recapture.**--Paragraph (1) of subsection (c) shall not apply to any increase in tax under section 49(b) or 50(a) for which the S corporation is liable. . . .
> **26 U.S.C. §1371.**

Section 1371 "effectively suspends activity" related to the E & P account of an S corporation, and "the account balance carried over to an S corporation from its previous existence as a C corporation remains unchanged from year to year unless one of a limited number of specific events occur that warrant adjustment to the account." Broadaway, at 596. The carried-over E & P account "can be decreased under the Code only to reflect

(1) dividend distributions to shareholders to the extent made out of accumulated earnings and profits; (2) distributions resulting from redemptions, liquidations, reorganizations, or divisives; and (3) tax paid by an S corporation as a result of recapture of investment credit taken when the corporation was a C corporation." *Id*. (citations omitted). In addition, the E & P account can be increased if the S corporation acquires another corporation with an E & P account balance. *Id*.

In the present case, the record does not indicate whether the Corporation has an accumulated E & P account. If the Corporation *does not* have an accumulated E & P account, then under section 1368(b) the distribution would not be included in the gross income of the shareholder (*i.e.*, a nontaxable return of capital) to the extent that the distribution does not exceed the adjusted basis of the shareholder's stock. 26 U.S.C. §1368(b)(1); Broadaway, at 595, f.n. 6. Distributions that exceed the adjusted basis are treated as gains from the sale or exchange of property (*i.e.*, a capital gain). 26 U.S.C. §1368(b)(2); Broadaway, at 595, f.n. 6.

If the Corporation *does* have an accumulated E & P account, then the distributions are deemed to come first from the Corporation's AAA; these distributions are tax-free (*i.e.*, a nontaxable return of capital) to the extent of the corporation's AAA and to the extent of the shareholder's basis in the Corporation's stock. 26 U.S.C. §1368(b)(1), (c)(1); Williams, at 30. If the distribution exceeds the basis of the stock, then it is a gain from the sale or exchange of property. 26 U.S.C. §1368(b)(2), (c)(1). It is only after the AAA is depleted that the remaining distribution is treated as a *dividend* to the extent that it does not exceed the accumulated E & P. 26 U.S.C. §1368(c)(2); Williams, at 30-31. This dividend distribution that exceeds the AAA balance but does not exceed the accumulated E & P balance is treated in the same manner as subchapter C dividend distributions (*i.e.*, the dividend distribution is taxable as ordinary income). Williams, at 30-31. After both the AAA and the accumulated E & P are depleted, the distribution is not included in gross income to the extent that it does not exceed the remaining adjusted basis of the stock. If the distribution exceeds the basis of the stock, then the excess is treated as a gain from the sale or exchange of property. 26 U.S.C. §1368(c)(3), (b).

In the present case, as stated previously, the taxpayers have argued that for S corporations, section 1368 of the Code does not change the definition of "dividend" but instead creates an exception to the general taxability of dividends. The taxpayers' argument is stated as follows:

> §1368 does not create a separate class of 'non-dividend distributions' for S corporations. Instead, §1368 simply establishes that S corporation dividends, which would otherwise be taxable under IRC §301(c), are not separately taxable to the shareholder if they do not exceed the corporation's AAA. In other words, the relationship between IRC §§301 and 1368 can be summarized by stating that all corporate distributions out of earnings and profits are dividends (according to the definition in §316), but not all dividends are independently taxable to the shareholder. Specifically, C corporation dividends are separately taxable to the shareholder, but S corporation dividends are not if they do not exceed the corporation's AAA. **Taxpayers' brief, p. 9.**

Based on the previous discussion, the taxpayers' arguments regarding section 1368 are mistaken because that section *does* create a separate class of "non-dividend distributions" for S corporations. The distributions by an S corporation are only "dividends" to the extent that they meet the requirements of section 1368(c)(2), *i.e.*, they must (1) be from accumulated E & P; (2) exceed the S corporation's AAA; and (3) not exceed the accumulated E & P of the S corporation. 26 U.S.C. §1368(c)(2). The taxpayers' arguments assume that all of an S corporation's distributions are from its "earnings and profits," but as previously discussed, an S corporation only has an "earnings and profits" account if it is derived from a limited number of sources. See Broadaway, at 595, f.n. 9. The taxpayers have not shown that the Corporation in this case had an accumulated E & P account. Because the tax treatment of the distributions by the Corporation depends on whether the Corporation had accumulated E & P during the years at issue, without that information it cannot be determined whether the distributions were actually dividends.

A copy of the Corporation's federal income tax returns for the years 2007 and 2008 would have been helpful to determine whether any of the distributions from the S corporation were actually dividends. On federal Form 1120S for the year 2008, line 17c on Schedule K states "Dividend distributions paid from accumulated earnings and profits." The instructions for this line state as follows:

> Enter total dividends paid to shareholders from accumulated earnings and profits. Report these dividends to shareholders on Form 1099-DIV. Do not report them on Schedule K-1. **Instructions for Form 1120S, Schedule K, line 17c, p. 33.**[5]

The taxpayers not only did not provide a copy of the Corporation's Form 1120S, Schedule K, they have not provided a copy of their individual 1040 returns to show any dividend income that they received from the S corporation that would have been reported on Form 1099-DIV. The taxpayers have not shown that any of the distributions that they received were actually from the S corporation's accumulated earnings and profits (*i.e.*, that they were actually dividends). The taxpayers have failed to meet their burden of proving their entitlement to the subtraction, and therefore, their request for the Enterprise Zone Dividend Subtraction must be denied.

Penalties

[5] The same information is provided on the same form and instructions for the year 2007.

The taxpayers have also argued that in the event that the dividend subtraction is not allowed, the penalties should be abated. The penalties may be abated if the taxpayers establish "reasonable cause" for the failure to pay the tax at the required time. See 35 ILCS 735/3-8. The Department's regulation concerning reasonable cause provides, in part, as follows:

> The determination of whether a taxpayer acted with reasonable cause shall be made on a case by case basis taking into account all pertinent facts and circumstances. The most important factor to be considered in making a determination to abate a penalty will be the extent to which the taxpayer made a good faith effort to determine his proper tax liability and to file and pay his proper liability in a timely fashion. **86 Ill. Admin. Code §700.400(b).**

The regulation states that a taxpayer is considered to have made a good faith effort to determine the liability and file and pay the taxes if "he exercised ordinary business care and prudence in doing so." 86 Ill. Admin. Code §700.400(c). The regulation continues as follows:

> A determination of whether a taxpayer exercised ordinary business care and prudence is dependent upon the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education. Accordingly, reliance on the advice of a professional does not necessarily establish that a taxpayer exercised ordinary business care and prudence, nor does reliance on incorrect facts such as an erroneous information return. ***Id***.

The regulation further states that one of the relevant factors used by the Department in determining the existence of reasonable cause is the length of time between the reason cited and the actual violation. 86 Ill. Admin. Code §700.400(f)(3).

The taxpayers provided an affidavit from their CPA in which he stated that he contacted the Department by telephone on February 19, 1992 to request guidance regarding whether the Enterprise Zone Dividend Subtraction applied to shareholders of an S corporation. The CPA contends that a Department representative told him that an S corporation shareholder could claim the subtraction on Form 1299-C in an amount equal to the shareholder's distributive share of corporate income included in his or her federal AGI. The CPA stated in the affidavit that based on the telephone conversation and his "own independent research" (which was not further explained), he advised each shareholder that they were entitled to claim the dividend subtraction. (Ex. J) Since 1992, the taxpayers have been subtracting their distributive share of the Corporation's income from their federal AGI for purposes of determining their Illinois base income. (Taxpayers' brief, p. 2) The taxpayers contend that because they relied on the advice of their CPA, they are entitled to an abatement of the penalties.

The taxpayers have not presented sufficient evidence to support an abatement of the penalties. Their CPA did not provide oral testimony and was, therefore, not subject to cross-examination. The record does not include any information concerning the CPA's "independent research" or exactly what the CPA told the taxpayers regarding this issue. The CPA did not indicate who he spoke with at the Department or the questions that were asked of the Department's representative. Nevertheless, the alleged oral misinformation from the Department's representative is not a basis for abating the penalty. The Taxpayers' Bill of Rights Act, which has been in effect since 1990, requires the abatement of penalties only upon the erroneous *written* advice given by the Department. See 20 ILCS 2520/4(c).

The Department has procedures available for taxpayers to obtain written advice, known as Private Letter Rulings, regarding tax inquiries. See 2 Ill. Admin. Code §1200.110. The Department's regulation concerning the Enterprise Zone Dividend Subtraction, which indicates that a distribution by an S corporation is generally not characterized as a dividend, initially became effective on January 9, 1998. See 86 Ill. Admin. Code §100.2480(d)(2). It is reasonable to assume that the taxpayers' CPA was aware of this regulation when it became effective. Despite the publication of the Department's regulation, nothing in the record indicates that the CPA did anything after January 9, 1998 to determine the proper tax treatment of distributions by the S corporation.

Furthermore, none of the taxpayers provided oral testimony, which would have been subject to cross-examination, concerning exactly what their CPA told them about the subtraction. The taxpayers provided one affidavit from one of the taxpayers (Ex. K) that simply indicates that the taxpayer relied on the advice of the CPA. The parties agreed that the other taxpayers would provide similar testimony. (Stip. #30) The taxpayers did not, however, give any details concerning their conversations with their CPA. Nothing indicates whether the CPA and the taxpayers discussed the Department's regulation concerning the Enterprise Zone Dividend Subtraction.

The record falls short of evidence that would warrant the abatement of the penalties. Relying on the advice of a professional does not, *per se*, establish that a taxpayer acted with reasonable cause. 86 Ill. Admin. Code §700.400(c). The record lacks details concerning the "independent research" that the CPA performed and the discussions that the CPA had with the taxpayers and the Department. A significant amount of time passed (15 years) between the alleged basis of the CPA's advice and the violations that occurred in this case. The record does not indicate whether the CPA did anything after the Department's regulation was published in January of 1998 to determine the proper tax treatment of S corporation distributions, and nothing indicates whether the regulation was discussed with the taxpayers. Furthermore, the CPA did not take advantage of the Department's procedures that are available for obtaining written advice (a Private Letter Ruling) from the Department. See 2 Ill. Admin. Code §1200.110. Taking into account all these facts and circumstances, it is not possible to conclude that the taxpayers' reliance on the advice of their CPA was reasonable. The taxpayers have simply failed to meet their burden of proving the existence of reasonable cause, and the abatement of the penalties is not warranted.

Recommendation:

For the foregoing reasons, it is recommended that the taxpayers' request for the Enterprise Zone Dividend Subtraction for the years 2007 and 2008 be denied. It is further recommended that the penalties be upheld.

Linda Olivero
Administrative Law Judge

Enter: December 27, 2012