



WILLIAM J. SCOTT
ATTORNEY GENERAL
STATE OF ILLINOIS
500 SOUTH SECOND STREET
SPRINGFIELD

October 16, 1973

File No. S-635

TAXATION:
Personal Property Tax

Honorable William H. Knuppel
State's Attorney
Mason County
P. O. Box 11
Havana, Illinois

I have your recent letter wherein you state:

"I have been contacted by the Mason County Collector regarding the refund of personal property taxes in accordance with the decision of the Supreme Court of the United States in Lehnhausen vs. Lake Shore Auto Parts Company. Specifically, I would like your opinion on the question of whether a corporation who elects under Sub-Chapter 'S' of the Internal Revenue Code to be taxed as an individual would also receive treatment as an individual under the Lake Shore Auto Parts case. In other words, would such a corporation be entitled to a refund of personal property taxes for the year 1971 and would their personal property be subject to taxation in subsequent years in which they elect to be treated as an individual for Federal Income Tax purposes."

As you know, certain small business corporations may elect to have no corporate income tax imposed on them and to transfer the tax to the shareholders of the corporations pursuant to subchapter S of the Internal Revenue Code of 1954, sections 1371 through 1378 of Title 26 U.S.C.A. The pertinent provisions are sections 1373 (b) and 1377 (a).

Section 1373 (b) provides:

"Each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year. For purposes of this chapter, the amount so included shall be treated as an amount distributed as a dividend on the last day of the taxable year of the corporation."

Section 1377 (a) provides:

"The accumulated earnings and profits of an electing small business corporation as of the close of its taxable year shall be reduced to the extent that its undistributed taxable income for such year is required to

be included in the gross income of the shareholders of such corporation under section 1373(b)."

Your specific question is whether a corporation which elects not to be taxed on its corporate income, but instead to pass through its income to its shareholders for purpose of taxation, is subject to the personal property tax for the year 1971 and subsequent years. In order to answer your question it is first necessary to briefly review some recent history of the personal property tax. In 1970 the people of Illinois amended its constitution by adding article IX-A which became effective January 1, 1971. It provided as follows:

"Notwithstanding any other provision of this Constitution, the taxation of personal property tax by valuation is prohibited as to individuals."

The first case to interpret this constitutional question was Lake Shore Auto Parts Co. et al. v. Korzen et al. and consolidated cases, 49 Ill. 2d 137. In these cases the Illinois Supreme Court held that article IX-A which was added to the Illinois Constitution of 1970 violated the equal protection clause of the fourteenth amendment to the federal Constitution.

In this decision the court, in interpreting the language of article IX-A said at page 148:

"We conclude that the meaning of article IX-A is that ad valorem taxation of personal property owned by a natural person or by two or more natural persons as joint tenants or tenants in common is prohibited."

The decision of the Illinois Supreme Court was appealed to the United States Supreme Court in Lehnhausen v. Lake Shore Auto Parts Co. et al., 93 Sup. Ct. 1001.

In these cases the United States Supreme Court reversed the Illinois Supreme Court and held that article IX-A did not violate the equal protection clause of the fourteenth amendment. Nowhere, however, in the decision of the U. S. Supreme Court is there anything which indicates that the court differed from the opinion of the Illinois Supreme Court that the term "individuals" means a natural person or two or more persons as joint tenants in common. Furthermore, the Illinois Supreme Court rendered a supplemental opinion in vacation after the March, 1973 term in Lake Shore Auto Parts Co. et al. v. Korzen, et al., 54 Ill. 2d

237 and reiterated its opinion that the term "individuals" as used in article IX-A means a natural person or two or more natural persons as joint tenants or tenants in common. The fact that a qualified corporation is permitted to take advantage of the election in subchapter S does not convert the corporation into an individual. (Wilhelm v. United States, 257 Fed. Supp. 16 and Byrne v. Comm. of Internal Revenue, 361 Fed. 2d 939.) Certainly it does not become a natural person. In Byrne v. Comm. of Internal Revenue, supra, at page 942 the U. S. Court of Appeals said:

"We recognize that the purpose of the statute here under consideration is to permit 'business to select the form of business organization desired, without the necessity of taking into account major differences in tax consequence.' S. Rep. No. 1983, 85th Cong., 2d Sess., p. 87 (1958-3 Cum. Bull. 922, 1008); U. S. Code Congressional and Administrative News 1958, p. 4876. We agree with the observation of the Tax Court that the statute is designed 'to permit a qualified corporation and its shareholders to avoid the double tax normally paid when a corporation distributes its earnings and profits as dividends' and this is accomplished in a specified manner which does not involve ignoring the corporate entity. * * * *"

Honorable William H. Knuppel - 6

Because of the foregoing, I am of the opinion that even though a qualified corporation elects under subchapter S not to be taxed on its corporate income but instead to pass it through to its shareholders for taxation, it does not become an individual. The fact that the Internal Revenue Code permits it to be taxed in a certain manner does not change its corporate identity. It remains a corporation and, therefore, subject to the personal property tax for the year 1971 and subsequent years.

Very truly yours,

A T T O R N E Y G E N E R A L