January 2006

State Tax Return

Volume 13 Number 2

Ohio Franchise Tax Annual Accounting Period: What A Difference Three Days Make (A Little More Than $2.4 Million)

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Ohio's corporate franchise tax calculated under the net worth method is based on the "value of the issued and outstanding shares of stock" of the company, to be determined each year on the date that marks "the beginning of the corporation's annual accounting period that includes the first day of January of the tax year." (That's hardly ordinary English, but since when did we expect the tax code to be written for English majors?) Still, it's pretty easy to apply this language: If a company's annual accounting period runs July 1 to June 30, its 2006 franchise tax is based on the accounting books as of July 1, 2005 (since January 1, 2006 falls in the period between July 1, 2005 and June 30, 2006). For a company sailing the seas of the American economy on a fairly even keel, this isn't a big deal.

But what if your company was in and out of a Chapter 11 reorganization during the relevant accounting period? Aye, the seas there are a touch stormier, matey.

And so it was with Federated Department Stores' 1993 Ohio franchise tax return. Federated kept its books on a February-to-January basis, so "the beginning of the corporation's annual accounting period" was February 1, 1992 – the critical date for ascertaining Federated's franchise-tax liability. The interesting fact here was this: On February 1, 1992, Federated was getting ready to emerge (but had not quite emerged) from Chapter 11 bankruptcy protection. That was going to (and did) happen on February 4, 1992.

Those three days made all the difference in the world. As with most companies emerging from Chapter 11, the "new" Federated adopted "fresh-start" reporting, which meant that the negative-equity portion of the "old" Federated had been wiped away, and the financial records of "new" Federated, reflecting its new assets and liabilities, took its place. Thus, on February 1, 1992, "old" Federated had a taxable net worth of negative $334,536,641. (I've noticed that accountants like to write negative numbers as "($334,536,641)," in parentheses, like it's supposed to be whispered.) But on February 4, 1992, "new" Federated had a taxable net worth of *positive* $430,069,566. The difference between the two, in 1993-franchise-tax terms, was the difference between $50 in taxes owed and $2,430,539.87 in taxes owed.

Ohio's Board of Tax Appeals (the BTA) said Federated was right to report a negative net worth on its 1993 franchise tax report, and the Ohio Supreme Court, by a 6-1 vote, affirmed that decision. *Federated Department Stores, Inc. v. Wilkins* (Dec. 7, 2005). The court affirmed the BTA's decision despite the Ohio Tax Commissioner's claims that Federated's 1991 Annual Report and its SEC From 10-K had stated that the company adopted fresh-start reporting on February 1, 1992. Even were that true, the court said, the accounting standards that govern fresh-start reporting make clear that such reporting cannot be instituted until the company actually emerges from bankruptcy and the new plan takes effect – an event that, as noted, occurred on February 4, 1992, not February 1.

And that made all the difference in the world.

Congratulations to our colleague Chuck Steines for his role in Federated's victory in this case. ■

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