Final Analysis

Mark Flanders *Legislative Service Commission*

Sub. S.B. 108

123rd General Assembly
(As Passed by the General Assembly)

Sens. **Latta, Oelslager, Watts, Blessing, Mumper, White, Nein, Wachtmann, Cupp, Hottinger, Carnes, Armbruster, Spada, Johnson, Drake, Ray, Gardner, Schafrath, Horn, DiDonato, Kearns**

Reps. **Coughlin, Wilson, Perry, Boyd, Ogg, Barrett, Sullivan, Corbin, Mead, Amstutz, Womer Benjamin, Mottley, Krebs, Damschroder, Evans, Hoops, Metzger, Netzley, Peterson, O'Brien, Stapleton, Carey, Kilbane, Widener, Aslanides, Grendell, Tiberi, Willamowski, Myers, A. Core, Callender, Flannery, Trakas, Mettler, Olman, Terwilleger, Buehrer, Jolivette, Calvert, Jacobson, Jordan, Winkler, Harris, Redfern, Robinson, Austria, Williams, Brading, Hollister, Gooding, D. Miller, DePiero, Hartnett, Distel, Sulzer, Buchy, Vesper, Stevens, Metelsky, Pringle, Clancy, Roberts, Schuler, Van Vyven, Householder, Jerse, Cates, Barnes, Roman, Young, Patton, Gardner, Verich, Britton, Allen, Salerno**

Effective dates: *

ACT SUMMARY

- Increases the estate tax credit from $500 to $6,600 (for 2001) and to $13,900 (for 2002 and thereafter), effectively exempting the first $200,000 (for 2001) and $338,000 (for 2002 and thereafter) of most estates from taxation.

- Increases the share of estate taxes to be paid to townships and municipal corporations from 64% to 70% (in 2001) and to 80% (in 2002).

- Permits estates of decedents dying after 2000 to deduct the value of family-owned businesses (including farms) when computing Ohio estate tax to the extent that the business is passed to other family members, as is allowed under the federal estate tax.

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* *The Legislative Service Commission had not received formal notification of the effective date at the time this analysis was prepared.*

- Provides for the recapture of some or all of the tax savings on a family-owned business when an heir ceases to own the business for at least ten years, or if the heir does not remain materially involved in its operation, as under federal law.

- Specifies that under certain conditions the trustee of a trust qualifying for the estate tax marital deduction has a duty to annually distribute to the surviving spouse any income from an IRA of which the trust is the beneficiary.

- Creates a joint House-Senate committee to propose the elimination, by 2006, of the basic estate tax, retaining only the two "pick-up" taxes.

CONTENT AND OPERATION

The Ohio estate tax

Overview

(Chapter 5731.)

The Ohio estate tax consists of four separate levies: the "basic" levy on Ohio residents' estates, a levy on the portion of a nonresident's estate that is located in Ohio, and two "pick-up" taxes equal to the maximum credits that the federal government gives for estate taxes paid to a state. One of the pick-up taxes is levied on Ohio residents' estates and the other is levied on generation-skipping transfers (of property to a person that is two or more generations below the transferor, such as from a grandparent to a grandchild).

The basic tax on Ohio residents' estates is levied on the value of the taxable estate, which generally is the value of all property in which the decedent had an interest on the date of death, minus certain deductions. The tax is levied at graduated rates, through six tax brackets, ranging from 2% for taxable estates of $40,000 or less, to $23,600 plus 7% of the excess over $500,000 for estates of more than $500,000.

Increase estate tax credit

(secs. 5731.02 and 5731.21)

Under prior law, each estate received a tax credit of $500 or the amount of taxes due, whichever was less. In effect, this credit excluded estates valued at $25,000 or less from bearing any tax liability. Accordingly, an estate tax return did not have to be filed if the taxable value of the estate was $25,000 or less. The act increases the estate tax credit in two steps: to $6,600 for estates of persons dying during 2001, and to $13,900 for estates of persons dying in 2002 or thereafter. These credits have the effect of exempting from tax the first $200,000 of the taxable estate of persons dying in 2001, and $338,000 of the taxable estate of persons dying in 2002 and thereafter. Estates valued at or below these exemption amounts do not have to file estate tax returns under the act.

The tax rate schedule is unchanged, but the first and second brackets are effectively eliminated for 2001 because of the higher credit, and the first three brackets and the lower one-fifth of the fourth bracket are eliminated for 2002 and thereafter. Thus, the tax rate on the value of the taxable estate above the exemption amount begins at 5% for 2001 and 6% for 2002 and thereafter. The tax rate on the value of the taxable estate above $500,000 remains at 7%.

The effect of the act is to reduce taxes on all estates that are not subject to the state's "pick-up" tax--specifically, taxes are reduced for estates with a taxable value (after deductions) of less than about $3.15 million (in 2002 and thereafter). Estates valued at more than that amount will pay less basic tax under the act, but the pick-up tax operates in such a way as to increase by exactly the amount of the basic tax savings, so there will generally be no net tax savings for such an estate under the act. These estates will continue to owe the maximum federal credit amount.

Change in distribution formula for estate tax revenue

(sec. 5731.48)

Under prior law, municipal corporations and townships in which the estate tax originated received 64% of the gross amount of estate taxes levied and paid, and the state received the remainder of the estate tax revenues, less fees and costs charged by sheriffs and county auditors for administering the tax, discussed below. The tax "originates" in a township or municipal corporation if the property in the estate (whether real, tangible personal, or intangible personal) is attributed to that subdivision under statutory rules. Generally, real property and tangible personal property located in Ohio are attributed to the subdivision where the property is located. Tangible personal property located outside Ohio and intangible property of a resident are attributed to the subdivision where the decedent was domiciled at the time of death. And intangible property of a nonresident is attributed to the subdivision where the financial institution's place of business is located (in the case of deposits) or where the property (other than deposits) is in possession or custody.

The act increases the percentage of estate taxes distributed to the township or municipal corporation where the tax originates. Of the revenue from the estates of persons dying during 2001, 70% is to be paid to the subdivisions and 30% is to be paid to the state (after deducting fees and expenses--see below). Of the revenue from estates of persons dying in 2002 or thereafter, 80% is to be paid to the subdivisions where the tax originates and 20% is to be paid to the state (again, after deducting fees and expenses).

Payment of fees and expenses for administration of the estate tax

(sec. 5731.47)

The sheriff or other officers and the county auditor receive fees and expenses for services performed under the estate tax law. Under continuing law, these fees and expenses are charged against the state's share of undivided inheritance taxes in the county treasury.

The act provides that if such fees and expenses exceed the amount of the state's share, the county auditor must certify the amount of the excess to the Tax Commissioner, who must certify the amount to the Director of Budget and Management for payment from the General Revenue Fund to the county treasury. The county auditor then must draw warrants on the county treasurer in favor of the appropriate fee funds or officers.

Federal estate tax deduction for family-owned businesses

Federal law permits estates to avoid federal estate tax on the part of the estate consisting of family-owned businesses inherited by or passed to family members--so called "qualified family-owned business interests." The interests are deducted in computing the value of the estate that is subject to the federal estate tax. The amount deducted may be up to $675,000. The estate is still entitled to the federal "unified credit," but the amount of qualified family-owned business interests deducted plus the amount of the estate excluded under the unified credit cannot exceed $1.3 million. Also, claiming the deduction does not preclude the estate from claiming the federal "special use" valuation for farms and closely held businesses, whereby real property is valued according to its actual use rather than its hypothetical highest and best use.

Federal law prescribes several restrictions intended to ensure that the deduction is claimed only for bona fide family businesses, including specifying who is a "qualified heir"; requiring that the business be closely held by no more than three different families; requiring that the business constitute a major part of the overall estate; requiring that the business has been held by the family for several years before the decedent died; disallowing the deduction for certain kinds of businesses; and requiring that, in the event a qualified heir disposes of their interest or ceases to participate in the business within ten years, the heir must pay a recapture tax.

<u>Ohio estate tax deduction for family-owned businesses</u>

(secs. 5731.14 and 5731.20)

The act proposes an Ohio estate tax deduction modeled closely after the federal deduction for qualified family-owned business interests. An estate must claim the federal deduction in order to claim the Ohio deduction. The deduction may be claimed only to the extent that the federal deduction is taken, and only to the extent that the business interest is included in the value of the Ohio gross estate and not deducted under another provision. For example, a business interest could not be deducted as a qualified family-owned business interest if it was already deducted under Ohio's unlimited marital deduction as a transfer to the surviving spouse.

For qualified family-owned business interests to be deducted under the act, the decedent who passes the interests, the heirs who receive them, and the business itself must satisfy criteria specified in federal law, as explained below. Since the act incorporates the various qualifications and features of the federal deduction by referring to the federal law, most of the provisions described below are to be found in the Internal Revenue Code rather than in the act itself.

<u>Decedent</u>. The decedent must have been a United States citizen or resident at the time of his or her death. The value of all of a decedent's qualified family-owned business interests (whether passed upon death, or as a gift during the decedent's lifetime) must constitute at least 50% of the value of the decedent's adjusted gross estate. The decedent (or a member of the decedent's family) must have owned the business for a total of at least five of the eight years preceding the decedent's death, and the decedent (or a family member) must have materially participated in the business for that period of time. (Material participation implies physical work or participation in managing the business.)

<u>Form of business; closely held interest</u>. The business must be either a proprietorship, or some other form of business organization that is closely held in the sense that it satisfies one of the following ownership profiles:

- At least 50% is owned by the decedent or the decedent's family;

- At least 70% is owned by members of two different families and at least 30% is owned by the decedent or the decedent's family;

- At least 90% is owned by members of three different families and at least 30% is owned by the decedent or the decedent's family.

Ownership in a business may be held directly or indirectly. If a person owns a share of a business indirectly (i.e., the person owns a share of one business that owns a share of a second business), then the person's indirect ownership interest in the second business is not considered in determining whether ownership of the first business satisfies the ownership requirements shown above.

Nature of business. The interest deducted must be an interest in a "trade or business," as that term is construed under federal estate tax law. Although the term is not specifically defined for the qualified family-owned business deduction, it probably has the same meaning as it has for the special estate valuation rules for family farms and closely held businesses: "an active business such as [a] manufacturing, mercantile, or service enterprise, or . . . the raising of agricultural or horticultural commodities, as distinguished from passive investment activities." The trade or business also must be carried on for profit. (See 26 C.F.R. sec. 20.2032A-3.)

Certain businesses may not claim the deduction, including the following:

- Those having their principal place of business outside the United States;

- Those having at least 35% of their adjusted ordinary gross income as personal holding company income (other than banks and building and loan companies). Personal holding company income includes income from dividends, various rents and royalties, annuities, and personal service contracts.

- Those having stock or debt that was publicly tradable within three years of the decedent's death.

The deduction also cannot be claimed for the part of a business consisting of cash or marketable securities in excess of the reasonable day-to-day working capital needs of the business and held to produce personal holding company income.

Qualified heirs. To qualify for the deduction, a business interest must be transferred from the decedent's estate to a qualifying heir (or otherwise acquired by a qualified heir from the decedent's estate), or as a gift from the decedent to the qualified heir during the decedent's life as long as the gift is held continuously by the heir from the date of the gift to the decedent's death.

A qualified heir includes an ancestor of the decedent; the decedent's spouse; a lineal descendant of the decedent, the decedent's spouse, or the decedent's parents (i.e., children, grandchildren, siblings, stepbrothers, stepsisters, nephews, nieces); or the spouse of any of those lineal descendants. (Legally adopted children are treated as children by blood.) Qualified heir also includes a person who was actively employed by the business for at least ten years before the decedent's death but who does not bear one of the forgoing familial relationships with the decedent.

If a qualified heir is not a United States citizen, then the deduction may be taken only if that heir's inherited interest in the business is held in a trust organized under federal or state law and having at least one trustee that is a United States citizen or a domestic corporation.

Agreement. In order to claim the deduction, the executor of an estate must make an election on the Ohio estate tax return. Also, every qualified heir receiving a qualified family-owned business interest must agree, in writing, to pay the recapture tax if any of the events described below under "***Recapture tax***" occurs.

Recapture tax. As under federal law, the act imposes a recapture tax if heirs do not continue to own their shares of the business for at least ten years after the decedent's death (unless the heir dies before that time) or if the qualified heir (or one of the heir's family members) does not materially participate in the business for a total of at least five years during any eight-year period ending within ten years after the decedent's death. The recapture tax also is imposed if, within ten years after the decedent dies, a qualified heir loses United States citizenship and does not hold the business interest in a United States trust, or if the business' principal place of business is moved outside the United States. In the case of a proprietorship, the recapture tax is not imposed if a qualified heir disposes of their interest within the ten-year period as long as the property associated with that interest is used in a trade or business by a member of the heir's family.

The recapture tax is equal to the tax savings that resulted from the deduction being taken ("tax differential with respect to the estate"), plus interest at the statutory rate from the day the estate tax would have been payable until the day the recapture tax is paid. If more than one qualified heir received a qualified family-owned business interest, then the recapture tax is prorated to reflect only the tax savings attributable to the business interest received by the heir who prematurely disposes of their interest, ceases to materially participate, loses citizenship, or moves the business outside the United States ("tax differential attributable to a qualified family-owned business interest").

If the event triggering the recapture occurs within the first six years after the decedent dies, the recapture tax is equal to the entire tax savings enjoyed by a qualified heir; if the event occurs in the seventh year, only 80% of the tax savings is recaptured; if in the eighth year, 60%; if in the ninth year, 40%; and if in the tenth year, 20%.

The recapture tax must be paid by the first day of the seventh month after the event triggering the recapture occurs.

Fiduciary duty to distribute IRA income annually from certain trusts

(sec. 1339.412)

Continuing law limits the period over which income from property in certain trusts may accumulate in the trust before being distributed. The trusts in question are inter vivos and testamentary trusts by which property is transferred to a surviving spouse, and the property in the trust qualifies for the federal and Ohio estate tax marital deductions.[1, 2] Income from such property may not accumulate in the trust for more than one year unless the creator of the trust expressly stated in the trust instrument that receiving the marital deduction is less important than the accumulation of income for more than one year. Under federal and Ohio estate tax law, if income were to accumulate for more than one year, and the surviving spouse has a life estate in the property, the accumulation of the income would jeopardize qualification of the property for the estate tax marital deductions.

The act imposes a statutory duty on the trustee of a trust that qualifies for a marital deduction to annually (or more often) distribute to the surviving spouse the income of an Individual Retirement Account (IRA) of which the trust is a

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[1] *An inter vivos trust (or "living trust") is a trust that is created and takes effect during the creator's lifetime. A testamentary trust is a trust that is created by a will and takes effect upon the death of the creator. A particular form of testamentary trust likely to be affected by the act is a qualified terminable-interest property trust ("QTIP"), which is a trust for transferring property between spouses upon the death of one of the spouses. Property in such a trust is considered part of the surviving spouse's estate, and thus not taxable as part of the decedent spouse's estate.*

[2] *Under both federal and Ohio law, an unlimited amount of property may be transferred from one spouse to the surviving spouse without any estate tax being incurred on that transfer.*

beneficiary. The purpose of the change appears to be to preserve the marital deduction qualification for an IRA in such a trust in response to a recent Internal Revenue Service bulletin governing how such accounts must be treated under the marital deduction. The trustee's duty is satisfied if the trust instrument expressly provides that the surviving spouse has a right to withdraw all of the trust assets or a right to compel the trustee to withdraw and distribute the income of the IRA to the surviving spouse. The changes apply to trust instruments executed before or after the act's effective date.

Formerly, the trustee of a trust that existed on October 1, 1996, could elect to exempt the trust from the provisions of continuing law dealing with the prohibition against certain income accumulating in a trust for more than one year. (October 1, 1996, was the effective date of the prohibition, which is described in the first paragraph of this section of the analysis.) The act provides that the trustee of a trust executed after October 1, 1996, also can elect to not apply those provisions to the trust.

Committee to propose further reductions in estate taxes

(Section 3)

The act creates a joint House-Senate committee to propose the elimination, by 2006, of estate taxes on all but the most valuable estates by eliminating the basic estate tax levy and retaining only the two "pick-up" taxes. One of the pick-up taxes is levied in an amount equal to the amount by which the maximum federal credit for state death taxes exceeds the basic Ohio estate tax. Since the maximum federal credit exceeds the Ohio basic tax only for estates valued at over about $3.15 million under the act, only estates valued higher than that amount pay the pick-up tax. Therefore, elimination of the basic tax and retention of only the pick-up tax would lower the Ohio tax on all estates below $3.15 million; estates with higher values would not be affected unless the federal credit were to be changed by Congress.[3] The other pick-up tax is for generation-skipping transfers that are incident to the death of a person. It is levied in an amount equal to 5% of the federal generation-skipping transfer tax.

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[3] *Elimination or reduction of the Ohio pick-up taxes would not reduce the total amount of combined federal/state taxes paid by an estate. Instead, the amount of federal tax owed would increase by the same amount as the Ohio tax is reduced. Thus, the pick-up taxes are the minimum amount of estate tax that may be levied by Ohio without the state relinquishing revenue to the federal treasury. Only a reduction by Congress in the maximum federal credit would reduce an estate's combined state/federal liability.*

The committee is to consist of three members from each house, two of whom are to be members of the majority party and one of whom is to be a member of the minority party of the respective houses. The committee is to issue a report of its proposal to the Governor and the majority and minority leaders of each house by December 1, 2001. The proposal is to incorporate any effort by the federal government to eliminate the federal estate tax. The committee is to be known as the Joint Committee on Estate and Death Taxes.

HISTORY

ACTION	DATE	JOURNAL ENTRY	
Introduced	03-16-99	p.	205
Reported, S. Ways & Means	05-17-00	p.	1727
Passed Senate (29-4)	05-17-00	pp.	1751-1753
Reported, H. Finance & Appropriations	05-23-00	pp.	2056-2057
Passed House (94-3)	05-24-00	pp.	2069-2073
Senate Concurrence (32-1)	05-25-00	pp.	1857-1858

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