Peter A. Cooper *Legislative Service Commission*

H.B. 563

123rd General Assembly
(As Introduced)

Reps. **Wilson, Stevens, Smith, Patton, Allen, Healy, Metelsky, Logan, Verich, Ford, Luebbers, R. Miller, Roberts, Flannery, Boyd, Gooding, Barnes, Sullivan, Barrett, Redfern, Hartnett, D. Miller, Jones, Distel, Perry, James, DePiero**

BILL SUMMARY

- Permits estates 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.
- Provides for the recapture of some or all of the tax savings 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.
- The deduction applies to the estates of decedents dying after 2000.

CONTENT AND OPERATION

Estate tax: taxable estate and tax rates

Ohio's main estate tax is levied on the value of the taxable estate. The taxable estate generally is the value of the estate's assets on the date of the decedent's death, excluding the value of assets transferred to the decedent's surviving spouse, public employee pension and survivors' benefits, funeral and estate administration expenses, charitable gifts, outstanding and unpaid claims, and unpaid mortgages or indebtedness with respect to property in the estate.[1]

The tax rates are graduated, as follows:

[1] *Estates may elect to have the estate's assets valued on an alternate date if allowed by federal estate tax law.*

Value of the gross estate	Tax
$0 to 40,000	2%
$40,001 to 100,000	$800 plus 3% of amount over $40,000
$100,001 to 200,000	$2,600 plus 4% of amount over $100,000
$200,001 to 300,000	$6,600 plus 5% of amount over $200,000
$300,001 to 500,000	$11,600 plus 6% of amount over $300,000
$500,001 and over	$23,600 plus 7% of amount over $500,000

Every estate is entitled to a $500 credit against the estate tax liability, which is equivalent to exempting the first $25,000 of an estate's taxable value.

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.

Ohio estate tax deduction for family-owned businesses

(secs. 5731.14 and 5731.20)

The bill 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 bill, 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 bill 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 bill itself.

Decedent

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.)

Form of business; closely held interest

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 to 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

(sec. 5731.20(D))

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

(sec. 5731.20(A) and (C))

As under federal law, the bill 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 within seven months after the event triggering the recapture occurs.

HISTORY

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Introduced	02-01-00	pp. 1581-1582

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