Why the Ohio ESBT Doesn't Work

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At least once every two weeks this author is asked by both clients and practitioners alike to render his opinion on the following transaction:

T owns 100% of S-Corporation. S-Corporation generates $500,000 of taxable income each year. T, who is in a 40% federal and 7% Ohio marginal income tax bracket, pays federal income tax of $200,000 and Ohio income tax of $35,000 on this income each year. T will contribute all of her stock in S-Corporation to herself as trustee of her revocable trust. T, as trustee of her revocable trust, will make an election under I.R.C. §1361(e) to treat the trust as an Electing Small Business Trust (ESBT) for federal income tax purposes beginning January 1 of next year. At the end of next year, T, as trustee of her revocable ESBT, will file a federal fiduciary income tax return for the year reporting S-Corporation's taxable income of $500,000. ESBT will pay federal income tax of $200,000 pursuant to I.R.C. §641(c). T, as trustee of her revocable ESBT, will not file an Ohio income tax return on behalf of ESBT since Ohio does not impose an income tax on accumulated trust income. See generally R.C. 5747.01 and R.C. 5747.02. T will not report any of S-Corporation's taxable income on her federal individual income tax return. T hopes to save $35,000 in Ohio income tax annually on S Corporation's taxable income as a result of engaging in this transaction.

The author's opinion on this transaction has not yet changed since he first reviewed it shortly after the enactment of the I.R.C. §§1361(e) and 641(c) (originally enacted as §641(d)). The transaction will not provide the hoped for savings of Ohio income tax. The analysis of this transaction for federal and Ohio income tax purposes is fairly simple and straight-forward. The analysis is set forth as follows.

For federal income tax purposes, the income taxation of trusts and estates is determined under Subchapter J of Subtitle A of the I.R.C. Subchapter J is divided into two parts. Part I provides for the income taxation of trusts and estates. Part II provides for the taxation of income in respect of a decedent. Part I is further divided into six subparts. Subpart A, consisting of §641 through §645, provides general rules for the income taxation of trusts and estates. Subpart B, consisting of §651 and §652, provides for the income taxation of simple trusts. Subpart C, consisting of §661 through §664, provides for the income taxation of complex trusts and estates. Subpart D, consisting of §§665 through 668, provides for the now largely irrelevant throwback rules. Subpart E, consisting of §671 through §679, provides for the income taxation of grantor trusts. Subpart F, consisting of §681 through §683, includes other miscellaneous provisions.

Subpart E preempts and supersedes Subparts A through D. Congress has provided for this result in I.R.C. §671. The first sentence of §671 lets taxpayers know that if a grantor or another person is treated as the owner of any portion of a trust the income of that portion of the trust will be attributable to the grantor or other person, not the trust. The second sentence of §671 plainly tells taxpayers that the income taxation of the remaining portion of the trust, the portion not treated as being owned by the grantor or another person, is determined by Subparts A through D. The second sentence states, "(a)ny remaining portion of the trust shall be subject to subparts A through D." I.R.C. §671. The King's English can't be much more clear than this.

Although §671 sets forth the statutory authority for the supremacy of Subpart E over Subparts A through D, the Treasury regulations also recognize this axiom. Treasury Regulations §1.641(a)-0(b), states as follows:

> Subparts A, B, C, and D (section 641 and following), Part I, Subchapter J, Chapter 1 of the Code, relate to the taxation of estates and trusts and their beneficiaries. ***These subparts have no application to any portion of the corpus or income of a trust which is to be regarded, within the meaning of the Code, as that of the grantor or others treated as its substantial owners.*** See Subpart E (section 671 and following), Part I, Subchapter J, Chapter 1 of the Code, and the regulations thereunder for rules for the treatment of any portion of a trust where the grantor (or another person) is treated as the substantial owner. (Emphasis added.)

A grantor is treated as the owner of any portion of a trust for which she retains the power to revoke the trust. I.R.C. §676. If a grantor retains the power to revoke the entire trust she will be treated as the owner of the entire trust for federal income tax purposes and she will be required to report the income generated from all of the trust's assets on her federal income tax return.

An ESBT election made on behalf of the trust under I.R.C. §§1361(e) and 641 will not change this result. This is so because Congress has placed §641 in Subpart A, which is only applicable to any portion of a trust not treated as being owned by the grantor or another person. I.R.C. §671. Therefore, the ESBT provisions have no impact on any of the income of a revocable trust.

The trustee of a revocable ESBT may or may not file a federal fiduciary income tax return. If the trustee files a federal fiduciary income tax return and remits federal income tax on behalf of an ESBT there is no special magic that results. The trustee is free to file any return she wants in any form she wants, including a piece of paper that states ``take all of my money.'' She may even remit all of the trust's money with the return. The fact remains that federal law requires that the income from a revocable trust be recognized by the grantor. I.R.C. §671

For Ohio income tax purposes, Ohio imposes personal income tax on an individual's federal adjusted gross income subject to various modifications. R.C. 5747.01. Since an individual's federal adjusted gross income includes all of the income related to a trust for which the individual has retained a power to revoke, the income from such revocable trust will be subject to Ohio income taxation because Ohio does not subtract this income from federal adjusted gross income. R.C. 5747.01.

Consequently, the Ohio ESBT, as proposed in the aforementioned transaction, doesn't work. T will be required to recognize and report all of S-Corporation's taxable income on her federal individual income tax return and, as a result, on her Ohio individual income tax return as well. T will be required to pay $35,000 in Ohio income taxes both before and after implementation of the proposed transaction.

I'm always sure to ask my practitioner friends who advocate the integrity of this transaction whether or not they will sign T's individual income tax returns as the paid preparer. They always tell me ,"no." I always tell them, "good."

ADDENDUM

Readers should take note that on 1-19-00, just before the publication deadline of this material, the Income Tax Audit Division of the Ohio Department of Taxation issued an Information Release entitled, "Grantor Trust Provisions Take Precedence Over ESBT Provisions." The Information Release discloses that the Department of Taxation will officially take the position that the grantor trust provisions of a trust will effectively supersede the ESBT provisions of a trust for purposes of Ohio income taxation for taxable years beginning after 12-31-99. Readers should consult the Information Release for more information with regard to this development.❖

Applicability of Common Law Conflicts of Interest Principles to the Non-Ohio Grantor Who Seeks to Create an Ohio Dynasty Trust

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A dynasty trust has been defined as one with respect to which the transferor has allocated his or her $1,000,000 exemption from the generation-skipping transfer tax and which pays income and/or principal to the descendants of the grantor in succeeding generations for as long as local law permits the trust to endure.[1] In, Ohio, until 3-22-99, a trust could endure only for as long as permitted under the rule against perpetuities.[2] Effective 3-22-99, Ohio permits trusts to be drafted to exempt themselves from the rule against perpetuities. See R.C. 2131.09(B).[3]

Grantors and trustees from states that do not yet permit trusts to endure beyond the perpetuities period may seek to create a trust governed by the new Ohio law. However, traditional common law conflicts of law provisions will still be applicable to determine whether R.C. 2131.09(B) applies to a given trust. The purpose of this article is to discuss the applicability of those principles in situations where a grantor seeks to create an Ohio dynasty trust.

Requirements for creating a dynasty trust in Ohio.

Under the new Ohio law, the grantor of the trust can exempt the trust from the rule against perpetuities if two (B)(1) requirements are met: 1) the trust instrument must specifically provide that the rule against perpetuities or the provisions of R.C. 2131.08(B) shall not apply to the trust[4] ***and*** 2) the trustee must have an unlimited power to sell all trust assets, ***or*** one or more persons, one of whom may be the trustee, must have the unlimited power to terminate the entire trust.

R.C. 2131.09(B)(2) states that it will apply to the interpretation of a testamentary or inter vivos trust

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Are LLC's Now the Ohio Entity of Choice for Estate Planning Purposes?

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Introduction

H.B. 312, effective 12-3-99, changed certain rules governing the withdrawal of a member from a limited liability company ("LLC"). The new law eliminates 1) the requirement that all remaining members of an LLC consent to the continuation of the LLC upon withdrawal of a member in order to avoid the dissolution of the LLC and 2) the right of a withdrawing member to receive the fair value of such member's membership interest as of the withdrawal date and instead the withdrawing member is treated as an assignee of such membership interest. The rule in 1) above can be overridden, however, by provisions within the operating agreement.

More specifically, H.B. 312 added new R.C. 1705.43(C), which applies to LLC's formed on or after 12-3-99, or LLC's formed prior to that date if their governing documents are amended after that date to specifically state that this new section shall apply to that entity. In addition, H.B. 312 amended R.C. 1705.12 to reduce the aforementioned rights of a withdrawing member. This is the second time since its original enactment that Ohio's LLC law has been amended to be more accommodating for valuation discounts in the context of federal estate and gift taxes. For discussion of the LLC law as it was originally enacted, see Galloway, *Limited Liability Companies May Now Be Formed In Ohio*, 4 PLJO 137 (May/June 1994). For a discussion of the first set of