GBQ Partners Certified Public Accountants and Consultants

Listen. Plan. Execute.

500 South Front Street ▪ Columbus, Ohio 43215 ▪ www.gbq.com

SALT WATCH

Current State of The States

December 14, 2006
Vol. 2006-16

Ohio Supreme Court Declares Income of an ESBT Taxable to Grantor

Background and Impact on Ohio Taxpayers

The Ohio Supreme Court held in *Knust v. Wilkins*, 111 Ohio St. 3d 331 (Ohio 2006) (decided November 22, 2006) that income of a grantor trust designed as an electing small business trust ("ESBT") under I.R.C. § 1361 *et seq.* is taxable to the grantor personally, and that designation as an ESBT for federal income tax purposes does not alter the Ohio tax treatment of the trust's income.

The relevant facts of *Knust* are as follows. Two separate trusts were created, solely with shares of stock of an S corporation. It was undisputed that the trusts were grantor trusts and that the trusts were properly designated as ESBTs for federal income tax purposes. *See I*.R.C. § 1361(e)(3). On February 26, 2000, and subsequent to the ESBT elections, the trusts sold the shares of S corporation stock. Each trust received $16 million and paid federal income tax on the sale proceeds. During the same year, the grantors/individual trustees of the trusts reported and paid Ohio personal income tax on the proceeds from the sale of S corporation stock, for which they filed a refund.

The refund request was denied by the Tax Commissioner and affirmed on appeal by the Board of Tax Appeals ("BTA"). The BTA agreed with the Tax Commissioner, holding the two trusts were grantor trusts and the ordinary rule for taxing grantor trusts (*i.e.*, income earned by such a trust is taxed not to the trust but rather to the grantor himself/herself) was not changed by the fact that the trusts were designated as ESBTs under federal tax law.

The Ohio Supreme Court ("Court"), in turn, affirmed the decisions of the BTA and the Tax Commissioner. The only question before the Court was whether the trusts' status as ESBTs for federal income tax purposes changed the taxability of the income that the grantor trusts earned. The Court ultimately determined it did not.

The Court reasoned that nothing in the Internal Revenue Code suggests that the taxability of a grantor trust changes or is otherwise modified when the trust is designated as an ESBT. *See* I.R.C. § 641 (c); *see also* I.R.C. §§ 671-679 (grantor trust rules). The Court did not find persuasive the fact that the grantors of the trusts did not include the trust income as part of their own federal adjusted gross income. The Court stated that the Tax Commissioner was not confined to follow such a statement of reported earnings in applying provisions of the Internal Revenue Code.

The Court found support for its conclusion in a recently adopted Treasury Regulation. The regulation, which applies to taxable years ending on and after December 29, 2000, provides that a grantor trust designated as an ESBT is taxed as an ordinary grantor trust. *See* Treas. Reg. §§ 1.641(c)-1(c); 1.641(c)-1(k). Although the trusts in question terminated once the S corporation stock was sold in February 2000, the Court found that the trusts' taxable years ended on December 31, 2000 as a result of (1) the year end dates shown on the trust returns filed for federal income tax purposes, and (2) the lack of evidence suggesting an earlier taxable year end. That portion of the decision is somewhat debatable given the fact the sale of the S corporation stock terminated the trusts prior to the applicability of the regulation. *See* Justice O'Donnell's dissenting opinion.

Congress created the ESBT designation in 1996 (P.L. 104-188) and gave trusts designated as ESBTs the power to own stock in S corporations. Generally, for

Material discussed in this publication is meant to provide general information regarding a time-sensitive development in state and local tax. GBQ advises those who receive this publication to seek professional advice before taking any action based on the information presented. Any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

GBQ Partners
Certified Public Accountants and Consultants

Listen. Plan. Execute.

500 South Front Street ▪ Columbus, Ohio 43215 ▪ www.gbq.com

SALT WATCH

Current State of The States

December 14, 2006
Vol. 2006-16

Ohio Supreme Court Declares Income of an ESBT Taxable to Grantor

federal income tax purposes S items of income, deduction and credit were taxed according to special rules of taxation for ESBTs under I.R.C. § 641(c). That is, such items were taxable to the trust itself and not the beneficiaries of the trust. On the other hand, non-S items were taxed according to the normal trust taxation rules. There was some confusion at the federal level about the taxation of ESBTs that also qualified as grantor trusts, until Treasury Regulation §1.641(c)-1(c) was adopted which stated the grantor trust rules prevail over the ESBT rules.

For many years in Ohio, trusts were not subject to income tax. The Ohio Department of Taxation took the position, however, that ESBTs otherwise qualifying as grantor trusts were taxable as grantor trusts (*i.e.*, the federal grantor trust provisions take precedence over the ESBT provisions). *See* Information Release 2000-01 (January 19, 2000). In 2002, the law was changed pursuant to Senate Bill 261 which subjected trusts to income tax at the state level and effectively shut down the planning opportunity for ESBTs in Ohio. The *Knust* decision is the first time the Court has addressed the taxation of an ESBT that also qualifies as a grantor trust. It is anticipated that not much litigation will ensue as a result of *Knust* in light of Treasury Regulation § 1.641 (c)-1(c).

Action Items

GBQ will continue to monitor this development, as necessary. GBQ SALT professionals are available to assist you in determining how best to address tax issues related to the *Knust* decision.

FOR MORE INFORMATION, PLEASE CONTACT:

Lynne M. Froling, JD, MBA, LLM
Director, State & Local Tax Services
614-883-3856
lfroling@gbq.com

Douglas T. Malicki, CPA
Director, State & Local Tax Services
614-883-3864
dmalicki@gbq.com

GBQ Partners LLC is the largest locally owned accounting and consulting firm in Central Ohio. With over 100 associates and key strategic relationships, GBQ is large enough to handle the sophisticated needs of progressive, geographically dispersed organizations and the perfect size to provide personal attention. GBQ has the depth and breadth of technical knowledge and experience to provide superior service and thought leadership that effectively addresses your company's business needs.

Material discussed in this publication is meant to provide general information regarding a time-sensitive development in state and local tax. GBQ advises those who receive this publication to seek professional advice before taking any action based on the information presented. Any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.