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Estate Tax Deferral if Estate Assets Consist Largely of Closely Held Business Interests: Internal Revenue Code §6166

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The death of an owner of a closely held business may create a tax liability that can cripple the business. Generally, federal estate taxes are due nine months from the date of death. But Internal Revenue Code section 6166 allows estates that consist of a required percentage of one or more "closely held businesses" to delay paying estate tax, by permitting a four year deferral period to be followed by ten annual installment payments. However, closely held businesses that hold real estate have often been locked out of this deferral opportunity because the IRS requires the business to be an "active trade or business," not merely a business holding investment assets. This article outlines the basic requirements for estate tax deferral when the decedent held a closely held business, reviews the previous revenue rulings on passive assets, and summarizes a new revenue ruling that provides factors the IRS will consider when evaluating whether an estate with a closely held business and real property assets qualifies for section 6166 relief.

General Section 6166 Requirements

The executor/administrator of an estate may elect to defer estate tax attributable to a closely held business interest if (a) the decedent was a citizen or resident of the United States, (b) the business interest is greater than 35% of the adjusted gross estate (gross estate less sections 2053 and 2054 deductions), and (c) the executor

elects this deferral on a timely filed return. The amount of the tax deferral cannot exceed the ratio of the value of the closely held business amount to the adjusted gross estate multiplied by the net federal estate tax payable. (Thus, only the portion of the tax attributable to the closely held business interest can be deferred.)

Generally, three types of closely held business interests qualify for tax deferral under section 6166(b)(1):

1. An interest in a trade or business carried on as a proprietorship;
2. An interest in a partnership carrying on a trade or business, if either the partnership had 45 or fewer partners or 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent; and
3. An interest in a corporation carrying on a trade or business, if either the corporation had 45 or fewer shareholders or 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent.

A business must be engaged in an active trade or business as of the date of the decedent's death to qualify for the tax deferral.

Passive Assets Not Deferrable

IRC section 6166(b)(9) provides that "the value of any interest in a closely held business shall not include the value of that portion of such interest which is attributable to passive assets held by the business." A passive asset is "any asset other than an asset used in carrying on a trade or business." Historically, this requirement severely limited the ability of holders of real estate to qualify for the estate tax deferral. Revenue Rulings 75-365 and 75-367 describe situations where real estate holdings were deemed to be passive assets that do not qualify for the estate tax deferral.

In Revenue Ruling 75-365, the decedent maintained a fully equipped business office to collect rental payments on commercial and farm properties, receive payments on notes receivable, negotiate leases, make occasional loans, and direct the maintenance of properties by contract. The IRS determined that the owner merely managed assets for income and was not involved in a trade or business. Therefore, deferral was not allowed for the tax attributable to the closely held business.

In Revenue Ruling 76-367, the decedent owned 100% of the stock of a corporation that built homes on land owned and developed by the decedent, together with a business office and warehouse used by both the corporation and by the decedent in the land development activities. The IRS determined that these were interests in a closely held business. However, the IRS also determined that the eight homes owned by the decedent and rented to tenants, where the decedent collected rents, made mortgage payments, and performed repairs and maintenance, did not constitute an interest in a closely held business because the decedent's interest in those homes was merely an investment.

A New Approach: Revenue Ruling 2006-34

In Revenue Ruling 2006-34, the IRS outlines factors it will consider in determining whether real property interests constitute interests in a closely held business for purposes of IRC section 6166.

The IRS states that it will consider activities of the decedent, agents, employees, and the partnership, LLC, or corporation to determine whether the activities constitute an active trade or business. A business' use of independent contractors will not disqualify the business as an active trade or business as long as the business is not merely holding investment property. However, the IRS notes that the use of an unrelated property management company that performs most of the activities associated with the real estate interests suggests that an active trade or business does not exist.

The Service provided the following nonexclusive list of factors to help determine whether an active trade or business exists:

- The amount of time the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) devoted to the trade or business;
- Whether an office was maintained from which the activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purpose;
- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) was actively involved in finding new tenants and negotiating and executing leases;
- The extent to which the decedent (or agents and employees of the decedent,

partnership, LLC, or corporation) provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;

- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including, without limitation, painting, carpentry, and plumbing; and
- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) handled tenant repair requests and complaints.

The IRS states that "no single factor is dispositive of whether a decedent's activities with respect to the real property (or the activities of a partnership, LLC, or corporation through which decedent owns the real property) constitute an interest in a closely held business for purposes of section 6166." The IRS includes five examples to apply these factors. In each case, the only section 6166 requirement at issue is whether the activity qualifies as an active trade or business.

Situation 1. At the time of his death, the decedent owned a ten store strip mall and personally handled the day-to-day operation, management and maintenance of the mall. Decedent sometimes hired an independent contractor to perform repairs. The decedent would select the contractor, review and approve any work performed. The IRS states that the decedent's ownership and management of the mall qualifies as an interest in a closely held business. The IRS points out that the use of the independent contractors did not prevent the decedent's activities from rising to the level of an active trade or business.

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Situation 2. At the time of his death, the decedent owned a small office park consisting of five separate two-story buildings, each with multiple tenants. The decedent hired a management company (in which the decedent had no ownership interest) to lease, manage, and maintain the office park. The IRS states that the decedent was not involved in an active trade or business and that the interest did not qualify as a closely held business.

Situation 3. Same as situation 2, except the decedent owned 20 percent of the management company. The IRS finds that the management company was actively managing the office park. Because the decedent owned a significant interest in the management company, the activities of the management company allow the decedent's interests in the office park to qualify as an interest in a closely held business.

Situation 4. The decedent owned a one percent general partner interest and a 20 percent limited partnership interest in a limited partnership. The limited partnership owned three strip malls that constituted 85% of the value of the limited partnership's assets. The decedent

provided the limited partnership with all services necessary to operate the business, including daily maintenance to and repairs of the malls. The decedent (personally or with agents or employees) performed substantial management functions, including collecting rental payments and negotiating leases, performing daily maintenance and repairs (or hiring, reviewing and approving work of independent contractors), and made decisions regarding periodic renovations of the strip malls. The IRS notes that the determination of whether the limited partnership carried on a trade or business is made through the partnership activities. The IRS determines that the limited partnership carried on an active trade or business and that the decedent's interest qualifies as an interest in a closely held business. The IRS also notes that because the decedent owned at least 20% of the partnership, the decedent's ownership interest qualifies for the deferral even if another employee, partner, or agent of the partnership (and not the decedent) performed similar activities as the decedent performed.

Situation 5. The decedent owned 100 percent of stock in a corporation that sold cars, automotive parts, and repair services.

The decedent made all decisions regarding the corporation including the approval of all advertising and marketing promotions, management and acquisition of inventory, and matters relating to dealership personnel (including supervising all employees). The decedent also owned the real property that was leased to the dealership. The corporation employees' performed all maintenance and repairs to the real property. The IRS determines that the decedent's interest in the corporation qualifies as an interest in a closely held business. Additionally, because the decedent owned a significant interest in the corporation, which actively managed the property, the decedent's interest in the real property also qualifies as an interest in a closely held business.

Conclusion

Revenue Ruling 2006-34 provides welcome section 6166 clarity for estates holding closely held business interests consisting of real property. Of particular importance is the willingness of the Service to consider decedent's ownership interests in real property management companies (including minority ownership interests) as demonstrating decedent's participation in an active trade or business.

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