

AUGUST 2024

PRESERVING YOUR LEGACY: ESTATE TAX DEFERRAL FOR CLOSELY HELD BUSINESSES

If you have any questions about this Advisory, please contact:

MICHAEL T. CLEAR
203.363.7675
mclear@wiggin.com

ROBERT W. BENJAMIN
212.551.2602
rbenjamin@wiggin.com

DANIEL L. DANIELS
203.363.7665
ddaniels@wiggin.com

SETH E. ELLIS
561.910.7510
sellis@wiggin.com

HELEN C. HEINTZ
203.363.7607
hheintz@wiggin.com

DAVID W. KESNER
203.498.4406
dkesner@wiggin.com

LEONARD LEADER
203.363.7602
lleader@wiggin.com

VANESSA L. MACZKO
203.363.7667
vmaczko@wiggin.com

ERIN D. NICHOLLS
203.498.4319
enicholls@wiggin.com

CAROLYN A. REERS
203.363.7668
creers@wiggin.com

One of the challenges facing owners of closely held businesses is how to preserve their business legacy in the event of their death. The federal estate tax, which applies to estates exceeding \$13.61 million in 2024, can pose a significant financial burden on the heirs of business owners, especially if the estate (i.e., the taxpayer) consists of illiquid or hard to value business assets. To ease this burden, Internal Revenue Code section 6166 allows certain estates that include closely held business interests to defer paying part of the estate tax for up to 14 years, with interest. However, not all closely held businesses qualify for this deferral, and the IRS has issued several rulings to clarify the criteria for eligibility. This advisory will explain the basic requirements of section 6166, discuss how the IRS determines whether a closely held business is an active trade or business or a passive asset holder and analyze a recent ruling that offers guidance for closely held businesses that own real estate.

GENERAL REQUIREMENTS FOR DEFERRAL OF ESTATE TAX FOR CLOSELY HELD BUSINESSES

The executor/administrator of an estate may elect to defer estate tax attributable to a closely held business interest if (1) the decedent was a citizen or resident of the United States, (2) the business interest is greater than 35% of the adjusted gross estate (gross estate less certain deductions), and (3) the executor elects this deferral on a timely filed estate tax return. The amount of the tax deferral is limited to the portion attributable of the tax to the closely held business interest.

Generally, three types of interests qualify for tax deferral of a closely held business 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 such partnership had 45 or fewer partners, or 20% 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 such corporation had 45 or fewer shareholders, or 20% 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 receive tax deferral.

CONTINUED

PRESERVING YOUR LEGACY: ESTATE TAX DEFERRAL FOR CLOSELY HELD BUSINESSES

MATTHEW E. SMITH
203.363.7639
msmith@wiggins.com

GEORGE R. FREUND
561.910.7512
gfreund@wiggins.com

SCOTT G. RICHMAN
561.910.7516
srichman@wiggins.com

KATERYNA BAKHNAK
212.551.2855
kbakhnak@wiggins.com

MARY MARGARET COLLEARY
212.551.2637
mcolleary@wiggins.com

RUTH FORTUNE 203.363.7658
rfortune@wiggins.com

ASHTON C. MALKIN
561.910.7511
amalkin@wiggins.com

MARISSA A. O'LOUGHLIN
203.363.7674
moloughlin@wiggins.com

KAITLYN A. PACELLI
203.363.7635
kpacelli@wiggins.com

ANDREW S. PHILBIN
203.363.7606
aphilbin@wiggins.com

MI-HAE K. RUSSO 212.551.2619
mrusso@wiggins.com

PASSIVE ASSETS NOT ENTITLED TO ESTATE TAX DEFERRAL

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 RULING 2006-34

Through Revenue Ruling 2006-34, the IRS outlined its position on whether an interest in real property can constitute an active trade or business. In doing so, the IRS outlined factors it will consider in determining if a decedent's real estate activities were sufficiently active to qualify the real property interest as a closely held business interest for purposes of section 6166.

The IRS stated that it will consider activities of the decedent, agents, employees, or 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 noted 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;

CONTINUED

PRESERVING YOUR LEGACY: ESTATE TAX DEFERRAL FOR CLOSELY HELD BUSINESSES

- 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 stated 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 included 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.

Example 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 stated that the decedent’s ownership and management of the mall qualifies as an interest in a closely held business. The IRS pointed 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.

Example 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 stated that the decedent was not involved in an active trade or business and that the interest did not qualify as a closely held business.

Example 3. Same as example 2, except the decedent owned 20% of the management company. The IRS found 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.

CONTINUED

PRESERVING YOUR LEGACY: ESTATE TAX DEFERRAL FOR CLOSELY HELD BUSINESSES

Example 4. The decedent owned a 1% general partner interest and a 20% 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 noted that the determination of whether the limited partnership carried on a trade or business is made through the partnership activities. The IRS determined 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 noted 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.

Example 5. The decedent owned 100% 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 determined 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.

APPLICATION OF REVENUE RULING 2006-34

Since Revenue Ruling 2006-34 was released, the IRS has issued several private letter rulings applying the factors provided. For example, in [PLR 200845023](#) (November 7, 2008), the decedent died holding an interest in an LLC that held partial interests in three pieces of real property. Neither the decedent nor the LLC provided any management services for one of the properties. However, the decedent handled all day-to-day management for the other two properties as a full-time employee of the LLC including: setting rental rates and lease terms; review of rental applications; lease execution; rent collections; lease terminations; authorization of repairs; building and grounds maintenance; and hiring contractors and overseeing work. Following

CONTINUED

PRESERVING YOUR LEGACY: ESTATE TAX DEFERRAL FOR CLOSELY HELD BUSINESSES

This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.

decedent's death, a management company was hired to take over the decedent's responsibilities. Based on these factors, the IRS characterized the LLC as a "company running a real estate rental operation," not merely a passive owner of income producing assets. As a result, the IRS found that the value of the decedent's interest in the LLC attributable to the two properties she was actively engaged in managing qualifies as an interest in a closely held business for purposes of section 6166.

Although the guidance of Revenue Ruling 2006-34 only extends to interests in real estate, the IRS has indicated through private letter rulings that the factors provided are helpful in evaluating whether other interests, such as managing personal property, are those of an active trade or business. For example, in **PLR 201343004** (Oct. 25, 2013), decedent died holding an interest in two companies that had several operating divisions. One of the divisions managed personal property. Still however, the IRS considered the following factors about the division: it maintained several warehouses and offices where their employees conducted business, the employees of the division engaged in actively negotiating leases, inspecting equipment, shipping equipment, arranging repairs, and hiring and monitoring third party contractors. Accordingly, the IRS concluded that the activities of the division constitute an active trade or business for purposes of section 6166.

CONCLUSION

Revenue Ruling 2006-34 provides welcome clarity to section 6166 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. Although more recent rulings in this area do not create a bright line test for how much activity is necessary to convert the passive ownership of real estate to a trade or business, they indicate that a decedent's (or its agents or employees) involvement in the management and operations of real property is critical.