

DEFERRING ESTATE TAXES JUST GOT A LITTLE EASIER (With Proper Planning)

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For individuals who own interests in one or more successful family or privately owned businesses, the potential estate tax liability attributable to those interests may be of great concern. These business interests will be included in the owner's gross estate for federal estate tax purposes and, to the extent estate tax is due, the business owner may be concerned that there are insufficient liquid assets in his/her estate to pay the tax and his/her surviving family members will be forced to sell the business in order to pay the tax. In order to mitigate this potential problem of families being forced to sell the business in order to pay an estate tax, Congress has provided a method for opting to pay this tax in installments rather than in a lump sum soon after the death of the business owner. This option is provided in Section 6166 of the Internal Revenue Code.

If an "interest in a closely-held business" is part of an individual's gross estate and the value of such business interest exceeds 35% of the adjusted gross estate, then the payments of the related estate tax (i.e., the tax attributable to the value of the business interest) can be deferred for five years. Interest on the tax is required to be paid during this five year period, after which the tax (and accrued interest) is required to be paid in installments over the succeeding ten years. The rate of interest required to be paid is significantly less than the rates typically available through commercial borrowing. Although the interest paid is not deductible for income tax purposes, and is not deductible as an administration expense on the decedent's estate tax return, the lower interest rate and deferral of estate tax available under Section 6166 can provide a substantial benefit.

The primary issue in determining eligibility for the estate tax deferral under Section 6166 is whether the business interest constitutes a qualifying "interest in a closely-held business" versus mere management of investment assets. This issue has been particularly relevant to individuals who own interests in real estate (e.g., residential rental properties, commercial properties and entities that own such property).

After thirty years of little guidance in this area, the IRS recently published a revenue ruling (Rev. Rul. 2006-34) that provides needed assistance and, importantly, establishes criteria that will be easier to satisfy for purposes of qualifying as an "interest in a closely-held business." The IRS states in the ruling that it will consider the following nonexclusive factors:

- The amount of time the owner (or agents and employees of the owner, partnership, LLC or corporation) devoted to the trade or business;
- Whether an office was maintained from which the activities of the owner,

partnership, LLC, or corporation were conducted and whether regular business hours were maintained;

- The extent to which the owner (or agents and employees of the owner or the partnership, LLC or corporation) was actively involved in finding new tenants and negotiating and executing leases;
- The extent to which the owner (or agents and employees of the owner, partnership, LLC or corporation) personally made, arranged for, performed or supervised repairs, maintenance to the building (whether or not performed by independent contractors), including 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.

In addition to listing the above factors, the revenue ruling also discussed five examples. The examples varied based upon (i) the level of activity of the owner, (ii) whether employees or agents of the owner (or the business entity) were involved in the management activities, and (iii) the owner's level of ownership in the business entity that performed the management activities. A summary of the five examples discussed in the ruling can be found by visiting our website: www.mmpph.com.

Several positive conclusions can be drawn from this new revenue ruling.

1. The ruling makes it clear that an owner need hold only an interest in a closely-held entity that conducts an active trade or business. Thus, merely owning a significant limited partnership interest in a limited partnership that conducts an active trade or business can now qualify for installment treatment under Section 6166.
2. The ruling underscores the fact that, if the owner controls and supervises the activities of the owner's agents and employees, then the activities of these agents and employees can be attributed to the owner for purposes of Section 6166.
3. Similar to the above, the ruling provides clear support for the position that the activities of a co-owner, like a partner (who might be a family member), can qualify a business interest for Section 6166 treatment when the co-owner, acting on behalf of the jointly owned entity, provides the requisite level activity.

Consequently, many owners of real property and/or entities that own real property may now qualify for Section 6166 installment treatment by simply altering their level of activity, their

oversight of employees or agents, and/or their level of ownership in an entity that actively controls and oversees real property. Due to the significant benefits associated with the lower interest rate and deferral of estate tax available under Section 6166, we look forward to assisting our clients in analyzing and implementing, if necessary, the guidelines set forth in this new revenue ruling.

If you have any questions regarding Deferring Estate Taxes or other Estate Planning matters, please call us at (619) 239-7777 or BNDevan@mmpph.com.