

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

When the level of estate tax is significant but an immediate payment would require the untimely liquidation of one or more assets, the ability to defer payment of the estate tax can be quite important to all involved. A section of the Internal Revenue Code (Section 6166) sets forth the requirements for deferring the tax on the value of a closely held business included in the estate. The basic requirements are: (i) the value of the closely held business must exceed 35% of the total value of the estate; (ii) the interest in a closely held business must be either that of a sole proprietor, (iii) the individual must have owned a 20% interest in the business entity, or the business entity (whether partnership or corporation) must have had 45 or fewer owners.

The issue has always been what is a qualifying “interest in a closely held business” versus mere management of investment assets. This issue has been particularly relevant to owning interests in real estate (eg. residential rental properties, commercial properties and entities that own such property). Thus, when will owning real property constitute an interest in a closely held business and not merely a non-qualifying passive investment?

After thirty years of little guidance, the IRS has recently published a revenue ruling (Rev. Rul. 2006-34) that provides needed assistance and, importantly, establishes criteria that will be easier to satisfy. 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 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) what level of ownership in the business entity that performed the management activities did the owner have.

Situation 1. The owner (“A”) owned a strip mall. A handled the day-to-day operation, management, maintenance, and most repairs. More complex repairs were handled by an unrelated independent contractor, selected by the owner and regards to which the owner reviewed and approved work. The ruling concluded that the section 6166 election was available (and would also been available if the mall had been owned by a single-member LLC). Clearly the level of work and involvement provided by A was sufficiently high to satisfy the active trade or business requirements.

Situation 2. The owner had a small office park which he held as a sole proprietorship, consisting of five separate two-story buildings, each of which had multiple tenants. The owner hired an unrelated property management company to lease, manage and maintain the office park. The management company provided all necessary services, including advertising for new tenants, showing the property, negotiating and administering leases, collecting rents, and arranging for independent contractors to perform necessary repairs, snow removal, security and janitorial services. The management company provided a monthly accounting to the owner. The ruling concluded that the section 6166 election was not available because the owner relied completely on the management company to provide all essential services without any significant participation in the management or oversight of the property.

Situation 3. The facts in Situation 3 were the same as Situation 2 except the owner held a 20% interest in the management company. The level of service provided by the management company was sufficient to conclude that the company was involved in an active trade or business as a result of its management and oversight activities. Because the owner held a significant interest in the management company, the section 6166 election was available. Importantly, the ruling did not reference any level of activity by the owner in the management company, only the owner’s “significant interest” in the management company.

Situation 4. Here, the owner held a 1% general partnership and a 20% limited partnership interest in an LP that owned three strip malls. These malls comprised 85% of the value of assets in the LP. This suggests that the other 15% was liquid assets or investments. The owner, as GP, provided the LP with all services necessary to operate the business, including daily maintenance and repairs. The owner received specific compensation for his services. In the performance of the his duties, the owner, either personally or with the assistance of employees or agents, performed substantial management functions, including collecting rents, negotiating leases, performing daily or routine maintenance (or hiring, reviewing and approving the work of third party contractors), and making decisions regarding periodic renovations. The ruling first states: “Because the limited partnership, rather than (the owner), owned the interest in the strip malls, the nature and level of the activities of the limited partnership must be evaluated.” The ruling concludes:

Thus, the limited partnership carried on an active trade or business or business.

Because the strip malls were used in carrying on the partnership's active trade or business, they are not passive assets . . . and their value is not excluded from the value of (the owner's) interest in the partnership for purposes of section 6166. [The owner's] interest in the limited partnership qualifies as an interest in the closely held business for purposes of section 6166. (Because (the owner) owned at least 20 percent of the partnership, the conclusion would be the same even if (the owner's) activities were instead performed by another employee, partner or agent of the partnership.) (Emphasis added)

Thus, very importantly, just the ownership of a limited partnership interest, and nothing more, can be classified as closely-held business property if the partnership itself is engaged in substantially performing active management of the property and the 20% threshold requirement is satisfied. Consequently, there is now confirmation that we can look past the individual owner and into the entity to satisfy the activity test.

Situation 5. The owner held 100% of the stock in MNO, an automobile dealership. The owner was active in a variety of executive and oversight functions. D also owned the real property used by MNO under a triple-net ("NNN") lease. MNO's employees performed maintenance on the property. In the process of upholding the section 6166 election with respect to both the stock and the real estate, the IRS reasoned that MNO conducted an active trade or business (which, therefore, qualifies the stock for section 6166), and that the real property was used exclusively for the active trade or business. Because the owner held a significant interest in MNO, whose activities with regard to the real property constituted active management, the owner's interest in the real property also qualifies as an active trade or business.

Again, importantly, many business owners own personally real property that is leased to the operating business. Now, with this ruling, it is likely that the value of such leased real property can also constitute a trade or business for purposes of section 6166.

CONCLUSION

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 limit 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 his agents and employees, then such 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 alone enable qualifying for section 6166 treatment when the partner, acting on behalf of the jointly owned entity, provides the requisite level of an active trade or business.

Consequently, many real property owners may now qualify for section 6166 installment treatment by simply altering their level of activity, their oversight of employees or agents, or their level of ownership in an entity that does actively control and oversee the real property. We look forward to assisting our clients in analyzing and implementing, if necessary, the guidelines set forth in this new revenue ruling.