

Internal Revenue Service

Number: **200518047**

Release Date: 5/6/2005

Index Number: 6166.00-00, 6166.01-00,
6166.03-00, 6166.50-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

Telephone Number:

Refer Reply To:
CC:PA:APJP:B02
PLR-154189-04

Date:
January 27, 2005

In Re:

Date of Death:

Legend

Decedent:

Date 1:

Date 2:

Date 3:

State X:

State Y:

State Z:

Decedent's Spouse:

A:

B:

Trust:

Property 1:

Property 2:

Property 3:

Property 4:

Property 5:

Property 6:

Property 7:

Property 8:

Partnership 1:

Partnership 2:

Corporation 1:

Proprietorship 1:

Dear _____ :

This letter is in response to your request for a private letter ruling, dated September 29, 2004, and supplemental correspondence dated December 16, 2004, and December 17, 2004, concerning whether Decedent's interests in certain real estate qualify as an interest in a closely held business for the purposes of section 6166 of the Internal Revenue Code ("Code").

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Facts

Decedent died on Date 1, a resident of State X. Decedent's Spouse died on Date 2, also a resident of State X. At the date of death, Decedent owned numerous closely-held businesses.

Decedent was a _____ general partner in Partnership 1, _____ individually and _____ through Corporation 1, his wholly owned S corporation. Decedent was also a _____ limited

partner in Partnership 1, which operates Property 1. Property 1 was contributed to Partnership 1 on Date 3 and is located in State Y. Property 1 consists of an 18 hole golf course constructed on 132 acres, clubhouse building, maintenance shop, a cart storage building, and other related improvements.

Decedent and other investors developed Property 2. Property 2 was contributed to Partnership 2 in Date 3. Partnership 2 leases Property 2 to Corporation 1, which operates and manages Property 2, which is located in State Y. Decedent was a 2% general partner, individually and through Corporation 1, and a limited partner, individually and through Corporation 1, of Partnership 2. Property 2 consists of a 36 hole golf course constructed on 373 acres, a 32 station driving range, practice area, putting greens, a clubhouse with pro shop, restaurant, a maintenance facility, cart storage building, and miscellaneous storage buildings.

Decedent owned Property 3 and operated it as a sole proprietorship. Property 3 is managed by Corporation 1. Property 3, which is located in State Z, consists of an 18 hole course constructed on 165 acres, driving range, clubhouse, maintenance shop, cart storage building, and miscellaneous storage buildings.

As stated above, Properties 1, 2, and 3 were all operated and managed by Corporation 1, an S corporation owned by Decedent. Decedent's activities related to Properties 1, 2, and 3 included: the hiring and firing of all key employees; setting compensation; attending monthly meetings to inspect the properties; meeting with staff, customers, contractors; and making purchasing, maintenance, and capital improvement decisions. Decedent also personally reviewed daily operations reports for two to three hours per day and was consulted on all non-routine decisions.

Property 4, consisting of several improved lots and vacant land adjacent to Property 3, is wholly owned as a sole proprietorship by Decedent for future development. Due to regulatory delays because of environmental studies, this property has not been developed.

Property 5, consisting of agricultural land adjacent to Property 2, is owned by Partnership 2. Property 5 was down-zoned before development could proceed.

Property 6 consists of two office buildings in State Y, which currently has 14 tenants. Property 7 consists of an office building also in State Y, which currently has 15 tenants. Properties 6 and 7 were jointly owned by Decedent and another individual. Decedent employed property management companies to provide janitorial services, trash removal, landscaping, and repairs and maintenance for Properties 6 and 7. Decedent paid utilities, real property taxes, and insurance, which were recovered from tenants through common area maintenance charges. The property management companies,

Decedent's agents, were required to obtain approval from Decedent for all non-routine matters and reported to him directly regarding every aspect of the maintenance of the properties. Decedent made frequent trips to State Y to meet with the on-site property managers, inspect the properties, and make all major maintenance and capital improvement decisions.

Property 8 consists of four retail buildings in State Y, which currently has 14 tenants. Decedent employed a property management company to provide janitorial services, trash removal, landscaping, and repairs and maintenance for Property 8. Decedent owned Property 8 wholly. Decedent paid utilities, real property taxes and insurance, which were recovered from tenants through common area maintenance charges. Decedent personally approved all capital expenditures and tenant improvements related to Property 8, and reviewed financial reports on a regular basis. Decedent was also responsible for review, approval, and execution of all tenant leases.

Decedent also owned and operated Proprietorship 1 as a sole proprietorship to oversee, manage, develop, and provide services to all properties. Decedent required the property managers to consult with him almost daily and required his direct approval for most decisions.

Decedent's son, A, worked with Decedent for the twenty years preceding his death. When Decedent's health began deteriorating, Decedent relied on A and B, a co-trustee of the Trust, to handle the day-to-day activities of managing Decedent's various investments. Although Decedent relied on A and B in the two years preceding his death, Decedent retained ultimate control over major decisions, and met with A and B on a regular basis. Up until his death, Decedent kept in contact with A, B, and other employees by telephone and fax on an almost daily basis. As of the date of this ruling, A and B continue to operate the businesses in the same manner by which Decedent operated his businesses.

Under the terms of Decedent's testamentary instruments, a marital trust was established for the benefit of Decedent's Spouse. The Decedent's estate may choose to fund the marital trust with closely held business assets owned by the Decedent at the time of his death.

Rulings Requested

On the basis of the above facts and representations, the following rulings have been requested:

1. Whether Decedent's interests in Properties 1, 2, 3, 4, 5, 6, 7, and 8, Partnership 1, Partnership 2, Corporation 1, and Proprietorship 1 qualify as an interest in a

closely held business for purposes of section 6166.

2. If Decedent's closely held business assets are used to fund the marital trust and a qualified terminable interest property election is made, whether upon Decedent Spouse's death, those interests qualify as closely held business assets for purposes of section 6166.

Relevant Authorities

The Tax Reform Act of 1976 created a new section 6166 of the Code and redesignated the former section as section 6166A. Pub. L. No. 94-455, § 2004(a). The Economic Recovery Tax Act of 1981 repealed section 6166A and amended section 6166 so that it would apply in most cases that were previously governed by section 6166A. Pub. L. No. 97-34, § 422(d). Neither the Economic Recovery Tax Act of 1981 nor its legislative history indicate any intent on the part of Congress that an interest that constitutes an interest in a closely held business under section 6166A would not qualify under section 6166. As a result, the regulations under section 6166A are applicable to this ruling request to the extent that those regulations are not inconsistent with the language of section 6166.

Section 6166(a)(1) of the Code permits an executor to elect to pay part or all of the estate tax in two or more (but not exceeding ten) equal installments if a decedent was a citizen or resident of the United States on the date of death, and the value of an interest in a closely held business that is included in a decedent's gross estate exceeds 35 percent of the adjusted gross estate.

Section 6166(b)(1) defines the term "interest in a closely held business" to mean:

- 1) an interest as a proprietor in a trade or business carried on as a proprietorship;
- 2) an interest as a partner in a partnership carrying on a trade or business, if-- (i) 20 percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent, or (ii) such partnership had 45 or fewer partners; or
- 3) stock in a corporation carrying on a trade or business if-- (i) 20 percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent, or (ii) such corporation had 45 or fewer shareholders.

I.R.C. § 6166(b)(1). The determination under section 6166(b)(1) shall be made as of the time immediately before the decedent's death. I.R.C. § 6166(b)(2)(A).

Under section 6166(b)(9)(A), for purposes of section 6166(a)(1) and determining the closely held business amount, the value of an interest in a closely held business does

not include the value of that portion of the interest that is attributable to passive assets held by the business. The term "passive asset" is defined in section 6166(b)(9)(B)(i) as any asset other than an asset used in carrying on a trade or business.

Section 6166(c) provides that interests in two or more closely held businesses, with respect to each of which there is included in determining the value of the decedent's gross estate of 20 percent or more of the total value of each such business, shall be treated as an interest in a single closely held business.

Section 20.6166A-2(c)(1) of the Estate Tax Regulations provides that, in order for the interest on a partnership or the stock of a corporation to qualify as an interest in a closely held business it is necessary that the partnership or the corporation be engaged in carrying on a trade or business at the time of decedent's death. For interests in a partnership or stock in a corporation carrying on a trade or business, however, it is not necessary that all assets of the partnership or corporation be used in carrying on the trade or business. Treas. Reg. § 20.6166A-2(c)(1).

Section 20.6166A-2(c)(2) of the Estate Tax Regulations provides that, in the case of a trade or business carried on as a proprietorship, the interest in the closely held business includes only those assets of the decedent that were actually utilized by him in a trade or business.

Rev. Rul. 75-365, 1975-2 C.B. 471, considered a situation where a decedent individually maintained a fully equipped business office to collect rental payments on commercial and farm rental properties, receive payments on notes receivable, negotiate leases, make occasional loans, and direct the maintenance of the properties by contract. The ruling holds that the decedent was merely an owner managing investment assets to obtain the income ordinarily expected from them, rather than conducting a business. Therefore, the commercial and farm rental properties and notes receivable included in the decedent's gross estate did not constitute an interest in a closely held business for purposes of section 6166.

Rev. Rul. 75-366, 1975-2 C.B. 472, involved a decedent who paid 40 percent of the expenses, received 40 percent of the crops and actively participated in important management decisions of a tenant farm included in the decedent's gross estate. The decedent made almost daily visits to inspect and discuss operations, and occasionally delivered supplies to the tenants. The ruling holds that farming under these circumstances is a productive enterprise like a manufacturing enterprise distinguishable from management of investment assets. Therefore, the decedent's farm asset constitutes an interest in a closely held business.

Rev. Rul. 75-367, 1975-2 C.B. 472, holds that a decedent's ownership of 100 percent of the stock of an electing small business corporation that built homes on land owned and developed by the decedent and a business office and warehouse used by the corporation and the decedent constituted an interest in a closely held business. The

ruling holds, however, that eight homes built by the corporation that decedent owned and rented, collected rents, made the mortgage payments, and made necessary repairs and maintenance, was not an interest in a closely held business because the decedent's interest in such homes merely represented an investment.

Section 2001 imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States.

Under section 2056(a), for purposes of section 2001, the value of the taxable estate is determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to the surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

Section 2056(b)(1) provides the general rule that, if the interest in property passing to the surviving spouse is a terminable interest, the interest will not qualify for the marital deduction. A terminable interest is one where on the lapse of time, on the occurrence of a contingency, or on the failure of an event or contingency to occur, an interest passing to the surviving spouse will terminate or fail.

Section 2056(b)(7)(A) provides an exception to the nondeductible terminable interest rule in the case of "qualified terminable interest property." Under section 2056(b)(7)(B)(i), qualified terminable interest property is property (a) which passes from the decedent, (b) in which the surviving spouse has a qualifying income interest for life, and (c) to which an election applies.

Under section 2056(b)(7)(B)(ii), generally, the surviving spouse has a qualifying income interest for life if the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, and no person has a power to appoint any part of the property to any person other than the surviving spouse during the spouse's lifetime.

Under section 2056(b)(7)(B)(v), the election is to be made by the executor on the estate tax return. The election, once made, is irrevocable.

Section 2044(a) and (b) generally provide that on the death of the surviving spouse, the surviving spouse's gross estate includes the value of any property subject to a qualified terminable interest property election for which a marital deduction was allowed under section 2056(b)(7).

Analysis

Section 6166 was enacted to permit the deferral of the federal estate tax where, in order to pay the tax at one time, it would be necessary to sell assets used in a going business, and thereby, disrupt or destroy the business enterprise. This section was

intended to permit deferral of tax on income rather than income solely from the ownership of a property. Section 6166 was intended to apply only with respect to a business such as manufacturing, mercantile, or service enterprise, as distinguished from management of investment assets.

As Rev. Ruls. 75-365, 75-366, and 75-367 suggest, the level of the activity is the factor that distinguishes a trade or business under section 6166 from the act of merely managing rental property to obtain the rents ordinarily expected in the course of business. In determining the level of activity carried on by a proprietorship, partnership, or corporation, the activities of agents and employees are taken into account.

Under the facts presented, Partnership 1 and Partnership 2 had less than 45 partners and Corporation 1 had less than 45 shareholders. Therefore, Decedent's interests in Partnership 1 and Partnership 2 and Corporations 1 will constitute interests in a closely held business if the partnership and the corporation were engaged in a trade or business. Similarly, properties directly owned by Decedent as a sole proprietor will constitute interests in a closely held business if Decedent was engaged in a trade or business with respect to such properties.

Decedent's Interest in Partnerships 1 and 2 and Properties 1, 2, and 3

Decedent's level of activity in connection with Properties 1, 2, and 3 determines whether the properties are part of a trade or business for purposes of section 6166. The activities with respect to the properties by Decedent and his agents went beyond the typical activities associated with merely managing investment assets such as collecting rents, making mortgage payments, and making necessary repairs. With respect to the day-to-day management of these properties, Decedent kept in almost daily contact with his employees. Decedent met with staff, made purchasing, maintenance, and capital improvement decisions, and reviewed daily operations reports. Thus, Decedent, as assisted by his employees and agents, operated Properties 1, 2, and 3, as active businesses.

Accordingly, Decedent's interests in Partnerships 1 and 2, which own Properties 1 and 2, respectively, are interests in a closely held business. However, for purposes of determining the value of an interest in a closely held business under section 6166, the value of any passive assets of Partnerships 1 or 2 should not be included. Further, Decedent was engaged in a trade or business as a sole proprietor carrying on a proprietorship with respect to Property 3.

Decedent's Interest in Properties 4 and 5

At the time of Decedent's death, there were no active plans to develop Properties 4 and 5 due to environmental and zoning issues. Because these properties could not be developed, they must have been held as passive assets. Accordingly, Decedent's interests in Property 4 (directly owned by Decedent) and Property 5 (attributable to

Partnership 2) are not included in determining the closely held business amount for purposes of section 6166.

Decedent's Interest in Properties 6, 7, and 8

Although Decedent hired property management companies to manage the day-to-day operations of Properties 6, 7, and 8, this factor does not necessarily weigh against a determination that an active trade or business exists because the activities of an agent can be attributable to a decedent. The property management companies consulted Decedent for non-routine decisions, who made frequent on-site trips, and handled leases. A sufficient portion of the activities of Decedent, A, his agents, and his employees were devoted to the performance of substantial other services for Properties 6, 7, and 8. Decedent's control over the activities of A, his agents, and his employees was such that the activities of A, his agents, and his employees are attributable to Decedent. Thus, Decedent's activities went beyond those of an owner managing investment assets to obtain the rents ordinarily expected from them and his interest in these properties is included in determining the closely held business amount for purposes of section 6166.

Decedent's Interest in Proprietorship 1 and Corporation 1

Decedent's level of activity in connection with Partnerships 1 and 2, and Properties 1, 2, 3, 6, 7, and 8, as assisted by A and B in the years immediately preceding his death, was greater than the level of activity of the decedent described in Rev. Rul. 75-365. While Decedent's activities in part included those associated with merely managing investment assets, Decedent actively participated in the management and operation of these properties either through Proprietorship 1, Corporation 1, or through his contact with his agents. Consequently, Decedent is a proprietor in a trade or business carried on as a proprietorship with respect to Proprietorship 1. Because 100% of Corporation 1's stock is included in determining Decedent's gross estate, Decedent's interest in Corporation 1 is an interest in a closely held business under section 6166.

Under section 6166(c), Decedent's interests in Properties 3, 6, 7, and 8, Partnerships 1 and 2, Proprietorship 1, and Corporation 1 are treated as interests in a single closely held business. This is also consistent with the fact these interests were treated as a single integrated business during Decedent's lifetime.

Decedent's Spouse's Interests

If the Decedent's executor makes a qualified terminable interest property election with respect to property passing to the marital trust, and Decedent's Spouse is granted a qualifying income interest for life in the marital property, then the Decedent's estate will be allowed a marital deduction for the value of the property funding the trust. Upon Decedent Spouse's death, the value of the marital trust corpus, determined as of Date 2, will be includible in her gross estate pursuant to section 2044.

A determination as to whether an interest in a closely held business exists is to be made at the time immediately preceding a decedent's death. Therefore, if the assets included in the Decedent's estate qualify as an interest in a closely held business, they retain the same character when distributed to the Decedent's Spouse. If Decedent was actively engaged in a trade or business with respect to certain assets operated by Decedent, his employees or agents, the assets are to Decedent's Spouse what they were to Decedent, so long as there is not a material change in form or operation of those assets.

After Decedent's death, A and B continued to operate Decedent's assets as an active trade or business for the benefit of Decedent's Spouse up until her death, and the assets retain their character as an active trade or business. Thus, the estate tax attributable to the closely held business assets held in the marital trust that are includable in Decedent Spouse's gross estate under section 2044, can be paid in installments under section 6166, provided the other requirements for qualification under section 6166 are met.

Conclusions

Based on the facts and information submitted and the representations set forth above, we rule as requested with respect to the following:

1. Decedent's interest as a sole proprietor with respect to Properties 3, 6, 7, and 8, and Proprietorship 1, qualifies as an interest in a closely held business within the meaning of section 6166(b)(1), but Decedent's interests in Properties 4 and 5 do not qualify. Decedent's interest as a partner in Partnerships 1 and 2, qualifies as an interest in a closely held business within the meaning of section 6166(b)(1). Decedent's stock in Corporation 1 constitutes an interest in a closely held business within the meaning of section 6166(b)(1).
2. Decedent Spouse's closely held business assets, funded from the marital trust and for which a qualified terminable interest property election was made with respect to Decedent's estate, will qualify for purposes of section 6166 provided all other requirements are met.

Accordingly, provided the other requirements of section 6166 are met, the federal estate tax attributable to Decedent's interest in the closely held business may be paid in installments under section 6166.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter must be attached to Decedent's federal estate tax return.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

If you have questions, please contact .

Sincerely,

Assistant Chief Counsel
(Administrative Provisions & Judicial Practice)

By: Blaise G. Dusenberry
Special Counsel, Administrative Provisions &
Judicial Practice
(Procedure & Administration)

Enclosures:

Copy of letter

Copy for section 6110 purposes

cc: