

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

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Refer Reply To:

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Date:

12-15-00

Legend

Dear

This letter responds to your request for a private letter ruling dated August 11, 2000, supplemented by your submissions of November 22 and December 7, 2000, concerning whether Decedent's interests in certain real estate qualify as an interest in a closely held business for purposes of section 6166 of the Internal Revenue Code (Code). You had also requested a ruling on section 2057 of the Code, but the office of the Assistant Chief Counsel (Passthroughs and Special Industries) informed you that it is declining to rule on that matter until regulations are issued.

FACTS

Decedent owned and operated 82 rental units (single and multiple family residences) on 20 parcels of real property. Decedent began acquiring and renovating properties in Town in 1960 to supplement his wages from the construction industry, which were affected by weather and building cycles. By 1980, Decedent stopped working in the construction industry and concentrated on managing and maintaining the rental properties. He worked 4-5 days a week as a manager or co-manager. By the early 1990's, property values in Town had risen to such an extent that the cash flow

from the rental operation was not sufficient to acquire additional properties.

From the original acquisitions until the time of his death, Decedent found tenants, negotiated leases, collected rents, and paid the expenses for the operation of the rental units. Decedent paid the expenses of maintaining the properties. The standard lease form submitted with the ruling request shows that the tenants do not bear the expense of maintenance. Decedent performed almost all repairs including plumbing, electrical repair, carpentry, roofing, door repair, and appliance repair (stoves and heaters). On rare occasions when the repairs were beyond Decedent's capabilities, he hired others. Decedent or his employees maintained the grounds of the properties. Decedent's employees included A, decedent's daughter, and B, his son. A and B also helped Decedent manage the properties and perform maintenance and repair services. Tenants would call Decedent at all hours of the night if something was wrong with a unit. Either Decedent, A, or B would respond to the calls. Decedent also employed several others as handymen and to maintain the grounds. Decedent reported the rental income on Schedule E, Supplemental Income and Loss; it was not treated as self-employment income subject to the self-employment tax.

At the time of Decedent's death, one-half of a duplex unit was Decedent's residence. You are not including the value of that unit in the section 6166 election. Also, Decedent provided one-half of another duplex unit to A rent-free out of love and affection (and not as compensation for services) for the year preceding his death. The other half of the duplex was rented out.

At the time of Decedent's death, the 20 parcels of property were valued at approximately \$a. Cash on hand totaled approximately \$b. Decedent's normal monthly cash income, in excess of costs, from operating the business was much less, between \$c and \$d. The excess cash on hand was from insurance proceeds for a rental property that was destroyed by fire. The total insurance payout was approximately \$e. Prior to Decedent's death, \$f of the insurance proceeds had been expended. At the time of his death, Decedent planned to use all of the insurance proceeds in his possession to complete the repairs and remodeling. The proceeds were not enough to complete the renovation without incurring debt. Rather than incurring debt, Decedent removed the debris and performed the preliminary construction work before hiring licenced contractors to complete the remainder of the repair as required by local law.

LAW

Interest in a closely held business

Section 6166(a)(1) of the Code provides that if the value of an interest in a closely held business, which is included in determining the gross estate of a decedent who was (at the date of his death) a citizen or resident of the United States, exceeds 35 percent of the adjusted gross estate, the executor may elect to pay part or all of the tax imposed by section 2001 in two or more (but not exceeding ten) equal installments.

Section 6166(a)(3) provides that if such an election is made, the first installment shall be paid on or before the date selected by the executor, which is a date not more than five years after the date prescribed by section 6151(a) for payment of the tax.

Section 6166(b)(1)(A) of the Code defines the term "interest in a closely held business" to include an interest as a proprietor in a trade or business carried on as a proprietorship.

Section 6166(b)(2)(A) of the Code provides that the determination under section 6166(b)(1) shall be made as of the time immediately before the decedent's death.

Rev. Rul. 75-365, 1975-2 C.B. 471, holds that rental commercial property, rental farm property, and notes receivable included in decedent's gross estate do not constitute an interest in a closely held business under section 6166 where the decedent maintained a fully equipped business office, collected rental payments on the properties, received payments on notes receivable, negotiated leases, made occasional loans, and directed the maintenance of the properties by contract with third parties. Under these facts, decedent's relationship to the assets was merely that of an owner managing investment assets to obtain the income ordinarily expected from them.

Rev. Rul. 75-366, 1975-2 C.B. 472, holds that a farm rented to a tenant farmer constitutes an interest in a closely held business under section 6166 where the decedent paid 40 percent of the expenses, received 40 percent of the crops, made almost daily visits to inspect and discuss operations, occasionally delivered supplies to the tenant, and actively participated in the important management decisions of the tenant.

Rev. Rul. 75-367, 1975-2 C.B. 472, holds that a decedent's ownership of land that was held for the purpose of building homes, of stock in a corporation that built homes on such land, and of a business office and warehouse that were used by both the corporation and decedent, together qualify as an interest in a closely held business under section 6166. However, eight homes built by the decedent's corporation that were sold and later repurchased by the decedent, who collected the rents, made the mortgage payments and made the necessary repairs and maintenance to the homes in order to maintain the condition and appearance of the rental homes, were not an interest in a closely held business because the decedent's relationship to the properties was merely that of an owner managing investment assets to obtain the rents ordinarily expected from them.

Assets used in a business; passive assets

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 used by him in the trade or business. Thus, if a building was used by the decedent in part as a personal residence and in part for the carrying on of a mercantile business, the part of the building used as a residence does not form any part of the interest in the closely

held business. Whether an asset will be considered as used in the trade or business will depend on the facts and circumstances of the particular case. For example, if a bank account was held by the decedent in his individual name (as distinguished from the trade or business name) and it can be clearly shown that the amount on deposit represents working capital of the business as well as nonbusiness funds (e.g., receipts from investments, such as dividends and interest), then that part of the amount on deposit which represents working capital of the business will constitute a part of the interest in the closely held business. On the other hand, if a bank account is held by the decedent in the trade or business name and it can be shown that the amount represents nonbusiness funds as well as working capital, then only that part of the amount on deposit which represents working capital of the business will constitute a part of the interest in the closely held business.

Section 6166(b)(9) of the Code provides that for the purposes of section 6166(a)(1) and in determining the closely held business amount, 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. Section 6166(b)(9)(B)(i) provides that the term "passive asset" means, in general, any asset other than an asset used in carrying on a trade or business

The determination of whether a cash reserve constitutes a "passive asset" for purposes of section 6166(b)(9) depends on whether the cash reserve is used in the carrying on of a trade or business. For example, the legislative history of section 6166(b)(9) provides that an asset which forms part of the working capital or which constitutes reasonable reserves for the financing of a specifically identified project is not a passive asset. For example, a reserve for expansion of a factory building that is reasonably expected to be completed within two years of the time the contributions to the reserve fund are made would be a reasonable reserve. See S. Rept. No. 169 (Vol. I), 98th Cong., 2d Sess. 711, 714 (1984).

ANALYSIS

Interest in a closely held business

Section 6166 was enacted to permit the deferral of the payment 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-producing assets only where the assets formed a part of an active enterprise producing business income rather than income solely from the ownership of property. Section 6166 was intended to apply only with respect to a business such as a 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 from them. In

determining the level of activity carried on by a taxpayer, the activities of agents and employees are taken into account. On the other hand, the activities of third parties such as independent contractors or lessees, who are neither agents nor employees, are not taken into account.

Decedent's activities with respect to the properties included activities associated with merely managing investment assets, such as collecting rents, paying taxes, making mortgage payments, and making necessary repairs. However, Decedent's level of activity in connection with the 82 units, as assisted by his employees, was greater than the level of activity of the decedent in Rev. Rul. 75-367, in which the operation, maintenance, and repair of the eight homes was insufficient to constitute a business enterprise. As a result, Rev. Rul. 75-367 does not control the outcome in the instant case. Rev. Rul. 75-365 does not control the instant case either because Decedent and his employees operated, maintained, and repaired the properties; in contrast, in Rev. Rul. 75-365 the decedent personally performed no such services, but merely contracted with third parties to provide them. Decedent performed substantial renovations on his properties from the 1960's to the time of his death. Although Decedent had not acquired new properties for renovation since the early 1990's, he performed substantial renovations on the units destroyed by fire. Accordingly, the interests in 82 units on the 20 properties constitute an interest in a closely held business for purposes of section 6166.

Assets used in a business; passive assets

In the case of a sole proprietorship, each asset is examined at the time immediately preceding the decedent's death to determine if it was actively used in the trade or business. Under section 20.6166A-2(c)(2) of the regulations, one-half of value the property inhabited rent-free by A, as well as one-half of the value of the property inhabited by the Decedent, are not considered have been used by Decedent in his business at the time of his death for purposes of section 6166.

Assets that are passive in nature are not taken into account under section 6166(b)(9) of the Code. Cash reserves may be passive in nature. However, the cash balance described above constitutes an accumulation of a reasonable reserve for replacing the units destroyed by fire and it constitutes an asset actively used in carrying on a trade or business for purposes of section 6166 rather than a "passive asset" within the meaning of section 6166(b)(9).

CONCLUSION

Based on the information provided and the representations made, we conclude that Decedent's interests in the 82 units on the 20 properties constitute an interest in a single closely held business for purposes of section 6166 of the Code. Accordingly, provided the other requirements of section 6166 of the Code are met, the federal estate tax attributable to Decedent's interest in the closely held business may be paid in installments under section 6166. However, the estate may not use the installment

treatment for one-half of the value the property that A lived in as well as for one-half of the value the property that Decedent lived in. The cash on hand at the date of Decedent's death is properly includible in the value of the assets of the business for purposes of section 6166(a)(1).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no consideration has been given to the treatment of Decedent's compensation for employment tax purposes. Whether a decedent did or did not pay self-employment tax does not control whether an estate qualifies to pay the estate tax in installments.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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.

Pursuant to the power of attorney on file in this office, a copy of this letter is being sent to the Taxpayer's authorized representative.

Sincerely,

Arlene A. Blume for

JUDITH M. WALL
Chief, Branch 2
Office of Assistant Chief Counsel
(Administrative Provisions & Judicial Practice)

Enclosures (2):

Copy of this letter

Copy for section 6110 purposes