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Date:  
February 17, 2005

In Re:

Date of Death:

Legend

Decedent:

Decedent's Spouse:

Date 1:

Date 2:

Date 3:

Date 4:

State X:

A:

Property 1:

Property 2:

Property 3:

Property 4:

Property 5:

LLC 1:

LLC 2:

LLC 3:

LLC 4:

LLC 5:

Proprietorship 1:

Entity 1:

Trust:

Trust A:

Trust B:

Trust C:

Dear \_\_\_\_\_ :

This letter is in response to your request for a private letter ruling, dated October 18, 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's Spouse died on Date 1, a resident of State X. Decedent died on Date 2, also a resident of State X.

When Decedent's Spouse experienced intermittent health problems throughout her lifetime, Decedent assumed the duties Decedent's Spouse customarily performed for the various real estate interests. When Decedent experienced physical limitations

herself, Decedent's Spouse managed her individually owned real estate interests as her agent under a durable power of attorney. Further, if Decedent or Decedent's Spouse experienced health problems, A, their son, assumed their various duties.

As of the date of Decedent's Spouse's death, Decedent's Spouse was managing various properties through Proprietorship 1, which had 20 full-time employees, including A. Decedent, Decedent's Spouse, or A, supervised various agents and employees, including on-site managers for the larger properties, who approved of rental applications, performed routine maintenance and repair, and kept financial records. The employees worked in, or out of, the building which Decedent's Spouse maintained an office to oversee the entire operation. Following Decedent Spouse's death, A qualified the Decedent Spouse's estate to do business in State X as Entity 1. A continues to run the business in the same manner in which Decedent and Decedent's Spouse operated the various real estate interests during their lifetimes.

At Decedent's death, the assets to which Trust A was entitled to as residuary beneficiary of Decedent Spouse's Estate included: five apartment complexes and related buildings; thirteen single-family rental residences; 54,000 square feet of commercial rental space; 100% ownership interest in LLC 1, whose principal asset is Property 1; 95% ownership interest in LLC 2, whose principal asset is Property 2; and 100% ownership interest in LLC 3, whose principal asset is Property 3. At the time of Decedent's death, Decedent also had the following ownership interests: 99% ownership interest in LLC 4, whose principal asset is Property 4; 69% ownership interest in LLC 5, whose principal asset is Property 5; and 5% ownership interest in LLC 2.

Decedent's Spouse formed Trust on Date 3, and amended and restated it on Date 4. Trust contains Trust A, Trust B, and Trust C. Trust provides that, upon Decedent Spouse's death, the assets of Trust would be divided among three trusts, Trust A, Trust B, and Trust C. Trust B would be funded first with assets from Trust equal in value to Decedent Spouse's remaining available generation-skipping transfer (GST) exemption. Trust A would be funded second with assets from Trust that qualify for the marital deduction. Trust C would be funded with the remaining assets from Trust.

Trust A provides that, upon Decedent Spouse's death, if Decedent survived him, a fractional share of Trust assets are to be placed in Trust A, a marital trust. All of the net income from Trust A would be paid at least quarterly, to Decedent for her life from the time of his death. In addition, the trustee of Trust A may from time to time pay to or apply for the benefit of Decedent, such sums from the principal of Trust A as may be reasonably necessary to provide for Decedent's care, maintenance, and support in her accustomed manner of living and her hospital, medical, dental and nursing expenses and expenses of invalidism, taking into consideration any other means readily available for such purpose. Upon the death of Decedent, a portion of the remaining principal of Trust A would be placed in Trust B, a GST trust, equal to Decedent's unused GST exemption, and the balance of the principal of Trust A would be placed in Trust C. Trusts B and C would be established for the benefit of A, and any of his issue.

On Decedent's Spouse's timely filed United States Estate (and Generation-Skipping Transfer) Tax Return, Form 706, Decedent's Spouse's Executor elected to treat Trust A as a qualified terminable interest property (QTIP) that qualified for the marital deduction in determining the federal estate tax payable by reason of his death. Trust provides that upon Decedent's death the trustee shall from the remaining principal of Trust A place in Trust B an amount equal to Decedent's remaining generation-skipping transfer exemption and shall place the remaining principal of Trust A in Trust C.

### Rulings Requested

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

1. Whether Decedent's interest in certain real estate assets qualifies as an interest in a closely held business within the meaning of section 6166(b)(1).
2. Whether the transfer of assets comprising the closely held business from Trust A to Trusts B and C of Trust will not constitute a distribution, sale, exchange, or other disposition of an interest in a closely held business under section 6166(g)(1)(A) and therefore will not result in acceleration of installment payments.

### 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 a disposition of an interest under section 6166A would not be a disposition under section 6166. As a result, the regulations under section 6166A are considered applicable to this ruling request to the extent that those regulations are not inconsistent with the language of section 6166.

Under section 6166(a), if the value of an interest in a closely held business included in determining the gross estate of a decedent exceeds 35 percent of the adjusted gross estate, the executor of the estate may elect to pay part or all of the tax imposed by section 2001 (estate tax) in two or more (but not exceeding ten) equal installments.

Section 6166(b)(1) of the Code provides that the term "interest in a closely held business" means:

- (A) an interest as a proprietor in a trade or business carried on as a proprietorship;

- (B) an interest as a partner in a partnership carrying on a trade or business, if-
  - (i) 20 percent or more of the 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
- (C) 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)(A)-(C). 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).

Section 6166(b)(9)(A) provides that for 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 the portion of such interest which is attributable to passive assets held by the business. Section 6166(b)(9)(B)(i) provides that "passive asset" means, in general, any asset other than an asset used in carrying on a trade or business.

Section 6166(g)(1)(A) provides that if: (i) any portion of an interest in a closely held business which qualifies under section 6166(a)(1) is distributed, sold, exchanged, or otherwise disposed of, or money and other property attributable to such an interest is withdrawn from such trade or business, and (ii) the aggregate of such distributions, sales, exchanges, or other dispositions and withdrawals equals or exceeds 50 percent of the value of such interest, then the extension of time for payment of tax provided in section 6166(a) shall cease to apply, and the unpaid portion of the tax payable in installments shall be paid upon notice and demand from the Secretary.

Section 6166(g)(1)(D) provides that the acceleration rule of section 6166(g)(1)(A) "does not apply to a transfer of property of the decedent to a person entitled by reason of the decedent's death to receive the property under the decedent's will, the applicable law of descent and distribution, or a trust created by the decedent." For purposes of determining whether acceleration of payments is triggered, the phrase "distributed, sold, exchanged, or otherwise disposed of" is broad in scope and "comprehends all possible ways by which an interest in a closely held business ceases to form a part of the gross estate." Treas. Reg. § 20.6166A-3(e)(2).

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.

Section 2031 provides that the value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Sections 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).

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.

### 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.

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 certain assets included in the Decedent’s Spouse’s estate qualify as an interest in a closely held business, they retain the same character when distributed to the Decedent. If Decedent’s Spouse was actively engaged in a trade or business with respect to certain assets operated by Decedent’s Spouse, his employees or agents, the assets are to Decedent what they were to Decedent’s Spouse, so long as there is not a material change in form or operation of those assets.

Decedent’s level of activity in connection with Properties 1, 2, 3, 4, and 5, attributable to LLCs 1, 2, 3, 4, and 5, respectively, 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, Decedent's Spouse, A, agents, and employees 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, the 20 full-time employees reported to Decedent, Decedent's Spouse, or A. Decedent and Decedent's Spouse were not passive owners of income producing assets, but rather running a large scale real estate rental operation. Thus, Decedent's Spouse, up until his death, as assisted by employees and agents, operated Properties 1, 2, 3, 4, and 5 as active businesses. After Decedent Spouse's death, Decedent, A, and their employees and agents, continued to operate Decedent Spouse's assets as an active trade or business for the benefit of Decedent up until her death, and the assets retain their character as an active trade or business. Accordingly, Decedent's interests in LLCs 1, 2, 3, 4, and 5 which own Properties 1, 2, 3, 4, and 5, 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 LLCs 1, 2, 3, 4, or 5 should not be included.

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.

On the estate tax return for Decedent's Spouse, the executor elected to have Trust A treated as qualified terminable interest property under section 2056(b)(7). Trust provides that, upon Decedent Spouse's death, if Decedent survived him, a fractional share of Trust assets are to be placed in Trust A, a marital trust. All of the net income from Trust A would be paid at least quarterly, to Decedent for her life from the time of his death. This provision satisfies the requirement under section 2056(b)(7) that the surviving spouse have a qualifying income interest for life in the trust. Trust satisfies the other requirements under section 2056(b)(7) and the regulations thereunder. Accordingly, the value of Trust A on the date of Decedent's death is includable in her gross estate under section 2044. To the extent Decedent owned or had an interest in the other assets listed above, these assets would be includable in Decedent's estate under section 2031 or 2033.

Section 2044(c) provides that, for estate tax purposes, property included in the gross estate of the decedent under section 2044(a) is treated as passing from the decedent to the recipient of the property. Accordingly, property included in the gross estate under section 2044(a) is treated for estate tax purposes in the same manner as those interests specifically described in section 6166(g)(1)(D). Further, Treas. Reg. § 20.2044-1(b) specifically provides that the estate tax imposed on property includable under section 2044 is eligible for the installment payment of tax under section 6166. Accordingly, we conclude that the transfer of assets from Trust A to Trusts B and C of Trust will not

constitute a disposition of closely held business property within the meaning of section 6166(g)(1)(A).

### 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 in certain real estate assets qualify as interests in a closely held business within the meaning of section 6166(b)(1).
2. The transfer of assets from Trust A to Trusts B and C of Trust will not constitute a distribution, sale, exchange, or other disposition of an interest in a closely held business under section 6166(g)(1)(A) and therefore will not result in acceleration of installment payments.

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 should 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 \_\_\_\_\_ at \_\_\_\_\_.

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