SECTION 6166 TAX DEFERRAL FOR REAL ESTATE

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We have explained to our clients the availability of 15 year estate tax deferral under Section 6166 of the Internal Revenue Code. This benefit is available when a substantial portion of an estate consists of a closely held business.

The question of whether Section 6166 treatment is available for a real estate portfolio is a fact intensive analysis that, in sum, focuses on whether the decedent's activities were greater than that which a mere investor in real estate would perform. Clients who wish to give their executors a strong basis to elect this treatment should speak with us about ways in which their activities can be directed so that their real estate investments gain the character of a business.

In 1975, the IRS issued a trio of revenue rulings which were helpful in discerning the difference between mere real estate investment activity, for which Section 6166 deferral is not available, and the active management of a real estate business, for which deferral treatment is available. In Rev. Rul. 75-365, the decedent owned commercial properties and farm properties which he would rent. Prior to his death, the decedent maintained an office from which he negotiated leases, collected rent, made occasional loans, received payments on notes, and hired contractors for the maintenance of his properties. The IRS said that this was merely investment activity and was not a business.

On the other hand, the active management of a business was found by IRS to exist under the facts of Rev. Rul. 75-366. Interestingly, the decedent in this case also rented farm property to another person. The difference here was that the business terms of the agreement between the decedent-landlord and the farmer-tenant gave the decedent an interest in the success of the tenant's business. The decedent received 40% of the crops, paid 40% of the expenses and made almost daily visits to the property to participate in decisions concerning the management of the farm. The decedent's estate also received deferral treatment with respect to the value of a corporation in Rev. Rul. 75-367 because the corporation was engaged in building homes for sale on land that it owned. Although the ruling doesn't specify, its appears likely that the corporation paid ordinary income tax on the sale of each home it built, as a dealer, rather than capital gains tax, as an investor would.

More recently, two private letter rulings issued by IRS provided further guidance on what constitutes a business. In both, the IRS said the estates qualified as businesses. The decedent in Ltr. Rul. 200339043 owned through a revocable trust, the shares of two S-corporations which, in turn, owned a significant number of shopping center and office properties. The corporations managed the properties with ten full time employees. The decedent was in daily contact with the CFO of the corporations and personally made all significant

decisions regarding personnel and leasing. In addition to doing the things described in Rev. Rul. 75-365 (supra), the letter ruling notes that the corporations marketed the properties for rent, handled tenant complaints, coordinated professional services and provided services to tenants, as required by the leases, such as elevator, cleaning, and HVAC. The IRS's analysis focused on the many activities which the decedents' corporations did with their own agents and employees rather than with outside contractors. The corporations' interest in a mountaintop radio transmission site was found not to qualify because the lease for that facility imposed few management obligations on decedent's corporations. Notwithstanding the disqualification of this asset, the other assets owned by the corporations passed muster and received 6166 treatment.

In Ltr. Rul. 200340012 the decedent owned multi-family properties individually or in limited liability companies. Management of the properties was conducted by the decedent and his son, along with five part-time employees. The decedent hired outside contractors only for major repairs, performing all other repairs and maintenance items with his own employees. He and his son interviewed all prospective tenants. The letter ruling specifically noted that the decedent and his son devoted up to 14 hours per day to management of the properties, worked on weekends, and were on call 24/7 for emergencies. The fact that the decedent's health in the final three years of his life prevented him from performing the activities in which he had previously engaged did not disqualify the estate from Section 6166 treatment. During that period he delegated day to day management to his son and consulted with his son daily.