THE EXPLORATION OF ESTATE TAX DEFERRAL AND ITS APPLICATION TO REAL ESTATE HOLDINGS

Robert Dyess[*]

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[*] J.D., Class of 2023, Sandra Day O'Connor College of Law at Arizona State University. Mr. Dyess also holds a Certified Public Accountant license in the State of California. The author would like to thank Professor Erin Scharff for her feedback and guidance throughout the creation of this article.

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INTRODUCTION

When a citizen or resident of the United States dies, Congress imposes a tax on the transfer of that individual's taxable estate.[1] The executor of the estate pays the estate tax,[2] and the entire tax is due nine months after the date of the decedent's death.[3] The highest marginal estate tax rate is 40%.[4] However, the tax code provides an exclusion that reduces the portion of an estate that would be subject to the estate tax.[5] In 2023, the exclusion is $12.92 million per decedent.[6] As a result, only estates valued in excess of $12.92 million are subject to the estate tax in 2023. Few taxpayers need to worry about this tax. For taxpayers that are executors of large estates, however, the estate tax will likely be a significant concern. Forty percent of a multi-million-dollar estate may be difficult for some executors to pay within nine months of the decedent's death.

Fortunately, the tax code provides a potential solution to this problem in 26 U.S.C. § 6166. This provision allows an executor to defer payment of the estate tax attributable to closely held trade or business interests, and instead pay the tax in installments.[7] By taking advantage of this deferral, the estate would not have to liquefy business interests to obtain the cash to pay its estate tax bill. Rather, the estate could pay the tax over time with the profits generated from these interests. Aside from addressing liquidity concerns, this provision may also provide relief from the administrative challenges related to selling off business interests without an identifiable market. Additionally, this provision may allow an estate to pass on a valuable family business to a decedent's heirs rather than sell it to pay a lump sum tax obligation.

Although not specifically mentioned in § 6166,[8] closely held real estate interests likely qualify for its treatment. Investments in real estate, like other assets specifically mentioned in the provision, can also have liquidity problems. Consider the following example:

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[1] 26 U.S.C. § 2001(a).

[2] *Id*. § 2002.

[3] *Id*. § 6075(a).

[4] *Id*. § 2001(c).

[5] *Id*. § 2010.

[6] Kay Bell & Tina Orem, *Estate Tax: Definition, Tax Rates and Who Pays in 2020–2021*, NERDWALLET (Feb. 23, 2023), https://www.nerdwallet.com/article/taxes/estate-tax [https://perma.cc/6UYR-LDBH].

[7] 26 U.S.C. § 6166(a).

[8] *See generally* 26 U.S.C. § 6166 (the statute does not mention whether real estate interests qualify for estate tax deferral—it only refers to closely held trades or businesses).

EXAMPLE 1: A decedent owns and manages a large apartment complex with a fair market value of $40,000,000 at the date of death. Assume (1) the estate has already used up its exemption amount,[9] (2) the estate owes $16,000,000 in estate tax (40% rate) on the value of the apartment complex, (3) the estate had a total of $2,000,000 in cash at the date of death in various accounts, and (4) the apartment complex generates $1,000,000 in net rental income every month. Without § 6166, the estate would have nine months from the date of death to pay $16,000,000 in estate taxes attributable to the apartment complex and the $800,000 in estate taxes (40% rate) attributable to the cash. Unless the estate can make a § 6166 election, it will have to either take out a massive loan[10] or sell the complex to pay the property's $16,000,000 in estate tax.[11]

This comment will first examine the general aspects and mechanics of § 6166 and highlight important issues that warrant a taxpayer's attention, including those specific to real estate interests. Afterwards, this comment will explore how a real estate interest may qualify as a closely held trade or business under § 6166 and thus be eligible for estate tax deferral. While § 6166 does not mention real estate interests, the IRS has provided guidance on when real estate interests qualify as closely held trades or businesses.[12] Nevertheless, there is some tension between

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[9] For the sake of simplicity, assume that (1) the estates in every example in this comment have already exhausted their entire $12.92 million exemption amount and (2) all decedents are unmarried unless stated otherwise.

[10] Jennifer Drahos & Eric Smith, *Estate Taxes on a Closely Held Business Under IRC 6166*, WELLS FARGO CONVERSATIONS (Feb. 3, 2021), https://conversations.wf.com/deferring_estate_taxes_on_a_closely_held_business_with_irc_6166/ [https://perma.cc/S36L-5UAV] (noting the discussion of a "Graegin loan" as an option if a taxpayer fails to meet the requirements to defer tax under § 6166); *see also* Estate of Graegin v. Comm'r, T.C. Memo. 1988-477 56 T.C.M. 387. With a Graegin loan, an estate may borrow money to pay estate taxes and immediately deduct all the interest due on the loan as an administrative expense of the estate. To immediately deduct the interest, the estate must reasonably estimate the interest and it must be certain that the interest will be paid.

[11] Except where noted, the author created all examples within this comment. All third-party examples are properly cited.

[12] *See* Rev. Rul. 2006-34, 2006-1 C.B. 1171.

the IRS and the Second Circuit regarding the use of property management companies that raises an open question about when real estate interests constitute a closely held trade or business.[13]

I. EXPLANATION AND ANALYSIS OF 26 U.S.C. § 6166

Before we examine how real estate interests qualify for treatment under § 6166, it is important to understand how the statute operates. This section uses examples to illustrate eligibility requirements, consequences of tax deferral, acceleration triggers, aggregation rules, attribution rules, and the marital deduction.

A. Eligibility

An executor may elect under § 6166 to defer payment of the estate tax only if (1) the decedent was a United States citizen or resident at death, and (2) the gross estate includes an interest in a closely held business with a value exceeding 35% of the adjusted gross estate ("35% Test").[14] The adjusted gross estate is the excess value of the gross estate over the deductions allowed in §§ 2053 and 2054.[15] The deductions allowed in § 2053 include administration expenses, funeral expenses, claims, and mortgages.[16] The deductions allowed in § 2054 include casualty losses.[17] The executor makes the § 6166 election to defer estate taxes when they file the estate tax return (Form 706).[18] See the following examples:

> <u>EXAMPLE 2</u>: A decedent owns a closely held business with a value of $45,000,000. The decedent's adjusted gross estate is valued at $100,000,000. The value of the decedent's closely

[13] *See id.*; *see also* Gilford v. Comm'r, 201 F.2d 735, 736 (2d Cir. 1953). Note the difference in how the IRS and Second Circuit view the use of third-party property management companies. This article will address this difference in greater detail later.

[14] 26 U.S.C. § 6166(a)(1).

[15] *Id.* § 6166(b)(6).

[16] *Id.* § 2053(a).

[17] *Id.* § 2054.

[18] *Id.* § 6166(d); *see also Instructions for Form 706*, IRS, https://www.irs.gov/instructions/i706 [https://perma.cc/A5NU-GMSY] (last visited Jan. 10, 2022) (noting the executor must check "yes" on line 4 of Part 3 – Elections by the Executor and attach the required statements).

held business is 45% of the decedent's adjusted gross estate, which passes the 35% Test.

EXAMPLE 3: If the value of the decedent's closely held business in Example 2 is $20,000,000 instead of $45,000,000, then the 35% Test is not satisfied and the estate would not qualify for tax deferral under § 6166(a)(1).

Section 6166 describes several classes of businesses as closely held for its purposes. First, a sole proprietorship is a closely held business.[19] Second, a decedent's interest in a partnership carrying on a trade or business is considered a closely held business if either (1) such interest is at least 20% of the partnership ("20% Interest Test") **or** (2) the partnership has 45 or fewer partners ("45 Owner Rule").[20] Third, similar to the treatment of partnership interest, stock in a corporation carrying on a trade or business is considered a closely held business if either (1) the decedent owns at least 20% of the voting stock of the corporation ("20% Interest Test") **or** (2) the corporation has 45 or fewer shareholders ("45 Owner Rule").[21] Regarding partnership interest and corporate stock, if the 20% Interest Test is met, then the 45 Owner Rule need not be met (and vice versa).[22] The executor makes these determinations as of the time immediately before the decedent's death.[23] If either the 20% Interest Test or 45 Owner Rule is met, then the closely held business interest must still meet the 35% Test. See the following examples:

EXAMPLE 4: A decedent owns a 25% limited partnership interest in a partnership carrying on a trade or business with a combined equity value of $100,000,000. The partnership has 55 total partners. This partnership interest satisfies the 20% Interest Test and is considered a closely held business.

EXAMPLE 5: A decedent owns 10% of the voting stock of a corporation engaged in a trade or business. The corporation is worth $100,000,000 and has 35 shareholders. The corporation satisfies the 45 Owner Rule.

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[19] 26 U.S.C. § 6166(b)(1)(A).

[20] *Id.* § 6166(b)(1)(B).

[21] *Id.* § 6166(b)(1)(C).

[22] *See id.* §§ 6166(b)(1)(B) and 6166(b)(1)(C) (noting the use of the word "or" rather than "and" between romanettes (i) and (ii) of each section).

[23] *Id.* § 6166(b)(2)(A).

EXAMPLE 6: A decedent owns a 15% limited partnership interest in a partnership carrying on a trade or business with a combined equity value of $100,000,000. The partnership has 60 total partners. This partnership interest does not satisfy the 20% Interest Test or the 45 Owner Rule. It is not eligible for estate tax deferral—even if the estate meets the 35% Test—because it does not meet the definition of a closely held trade or business under § 6166(b).

EXAMPLE 7: A decedent has a sole proprietorship that carries on a trade or business. This is automatically considered a closely held trade or business and will qualify for estate tax deferral if the estate meets the 35% Test.[24]

B. Deferral of Tax—Interest, Liens, and Bonds

If the estate is eligible, then the executor may make the § 6166 election to defer payment of the estate tax attributable to qualifying closely held business interests.[25] This deferred tax is payable in two to ten equal annual installments at the executor's choosing (the "installment period").[26] The estate must pay interest on the full deferred amount with each installment payment.[27] The first installment is due no more than five years after the normal due date for the estate tax payment (i.e., five years and nine months after the date of death).[28] Effectively, the estate tax payments may be deferred for up to five years and then paid in installments for up to ten years after the deferral. Therefore, an estate may take up to 15 years to fully pay its estate tax liability. This deferral may offer a significant reprieve for eligible estates with liquidity issues. However, even though no installment payments are due for the first five years, the estate must still make interest payments during that period (the "interest only period").[29]

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[24] It may be rare for a sole proprietor to face the estate tax because a decedent with a large estate will likely utilize an organizational structure of LLCs, limited partnerships, and corporations to limit liability. Nevertheless, if a decedent operates any business as a sole proprietorship, such as owning and operating a rental property in the decedent's name, then the statute will consider that business to be closely held.

[25] 26 U.S.C. § 6166(a)(1).

[26] *Id.*

[27] *Id.* § 6166(f)(2).

[28] *Id.* § 6166(a)(3).

[29] *Id.* § 6166(f)(1).

Estate tax deferral subjects the estate to interest payment obligations, an estate tax lien, and possibly the obligation to furnish a bond or accept a special lien. The following three subsections will provide more detail on each of these issues.

i. Interest

Interest payments on the deferred tax are calculated under 26 U.S.C. § 6601(j).[30] This calculation involves splitting the tax into two "buckets"—the "2% portion" and the "remainder portion."[31] The "2% portion" is the **lesser** of (1) the deferred tax or (2) the tax on the first $1 million (adjusted for inflation) of the taxable estate.[32] Like the name suggests, the estate pays a 2% interest rate on the "2% portion."[33] For any amount beyond the "2% portion," the taxpayer will pay interest equal to 45% of the statutory rate on underpayments.[34] The rate on underpayments is the quarterly Federal short-term rate determined by the Secretary of the Treasury plus 3%.[35] Thus, the interest rate on a "remainder portion" of deferred estate tax in April 2023 is 3.5%.[36] See the following examples:

> EXAMPLE 8: An estate made a § 6166 election to defer $5,000,000 in estate taxes attributable to closely held business interests and repay them over 15 years. The estate will pay only interest for the first five years of deferral, and then will make equal annual installment payments of $500,000 plus interest for the remaining 10 years. Interest for the first $1,750,000[37] (adjusted for 2023 inflation) of deferred estate tax will be subject to the 2% interest rate. The remaining $3,250,000 will be subject to 45% of the interest rate for underpayments (3.5% for April 2023).

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[30] *Id*. § 6166(f). Note that § 6601 is the general tax code interest provision.

[31] *Id*. § 6601(j)(1).

[32] *Id*. § 6601(j)(2).

[33] *Id.* § 6601(j)(1)(A).

[34] *Id*. § 6601(j)(1)(B).

[35] *Id*. § 6621(a)(2).

[36] *See id.*; *see also supra* note 34; *see also* Rev. Rul. 2023-06. For April 2023, the rate on underpayments is the short-term quarterly interest rate of 4.77% + 3% = 7.77%. The remainder portion interest is 45% of the rate on underpayments, so 45% x 7.77% = 3.5%.

[37] Rev. Proc. 2022-38, 2022-45 I.R.B. 445.

EXAMPLE 9: Assume the same facts as the previous example, except that the estate is only deferring $750,000 in estate tax. In this case, the entire amount will be subject to the 2% interest rate, because it is less than $1,750,000 (adjusted for 2023 inflation). The estate will only pay interest for the first five years, and then will make equal annual installment payments of $75,000 plus interest for the remaining 10 years.

ii. Estate Tax Lien

Regardless of the reason, if the executor does not pay an estate tax obligation by the original due date (nine months from date of death), the tax code grants the IRS an automatic federal estate tax lien attached to the assets of the gross estate for up to ten years following the date of the decedent's death.[38] This means that the IRS will attach an estate tax lien to all assets subject to tax deferral under § 6166. The estate tax lien remains attached to the property even if it is sold to a different owner.[39] This can create an issue if an estate wants to sell real property subject to § 6166, as it would be unable to provide marketable title with the estate tax lien in place.[40] Additionally, the estate tax lien is valid even if it is not publicly recorded.[41] The prevalence of estate tax liens is significant enough to warrant the retention of title insurance by many purchasers of real property from estates.[42] Indeed, many

[38] 26 U.S.C. § 6324(a)(1).

[39] *See* IRM 5.5.8.2 (July 24, 2018); *see also* Kathleen M. Merrigan, *Internal Revenue Manual Updates Provide Welcome Guidance for Federal Estate Tax Lien Release Process*, CUMMINGS & LOCKWOOD LLC (Sept. 4, 2018), https://www.cl-law.com/news-events/internal-revenue-manual-updates-provide-welcome-guidance-for-federal-estate-tax-lien-release-process [https://perma.cc/LL83-AD53].

[40] Merrigan*, supra* note 39.

[41] *Deceased Taxpayers – Selling Real Property That is Part of the Decedent's Estate*, IRS, https://www.irs.gov/businesses/small-businesses-self-employed/deceased-taxpayers-selling-real-property-that-is-part-of-the-decedents-estate [https://perma.cc/3MT6-QHC4] (last visited Jan. 9, 2022).

[42] *See Q & A About Title Insurance*, FIRST AMERICAN TITLE, https://www.firstam.com/title/resources/reference-information/title-insurance-reference-articles/q-a-about-title-insurance.html [https://perma.cc/FMQ5-FG3R] (last visited Jan. 9, 2022) (noting an estate tax lien as an off-record title defect); *see also Why Do You Need Title Insurance?*, CHICAGO TITLE INSURANCE COMPANY, https://www.ctic.com/whyneedtitle.aspx [https://perma.cc/U8GA-M8DE] (last visited Jan. 9, 2022) (noting liens for unpaid estate taxes as a common hidden risk that can cause a loss of title or create an encumbrance on title).

purchasers may likely refuse to purchase a property subject to an estate tax lien if they are aware the lien exists.

Therefore, if the executor wishes to sell real property subject to estate tax deferral, then they must apply for the release of the estate tax lien on that property.[43] The executor must file Form 4422 ("Application for Certificate Discharging Property Subject to Estate Tax Lien") with the IRS at least 45 days prior to the closing date of the sale.[44] To grant the discharge, the IRS must determine whether the estate tax liability is "adequately provided for."[45] Primarily, the IRS considers whether the estate tax liability attributable to the real property in question has already been paid and whether the value of the remaining property in the estate subject to the estate tax lien is adequate to protect the government's interest.[46] For instance, the IRS may discharge the lien if the remaining property in the estate has a fair market value of at least double the amount of the unsatisfied liability secured by the lien (as well as any other obligations with superior priority over the estate tax lien).[47]

If the estimated estate tax for the property is greater than the net proceeds of the sale, and no estimated payment has been made, then the IRS may require that the proceeds be escrowed before granting the discharge.[48] The IRS may also require that the proceeds be held in escrow if the executor is requesting a discharge early in the estate administration process.[49] If the IRS requires the proceeds to be held in escrow, then the purchaser's title company will likely require that the proceeds remain in escrow until the IRS releases the lien.[50] Consequently, a sale of real property subject to § 6166 may be significantly delayed while the IRS reviews and processes the estate tax lien discharge. The executor must pay close attention to the value of the property being sold relative to the value of the remainder of the estate subject to § 6166 because the estate may run into issues with the acceleration of payment, as will be discussed in Part C of this section.

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[43] Merrigan, *supra* note 39.

[44] *Id.*; *see also Form 4422*, IRS, https://www.irs.gov/pub/irs-pdf/f4422.pdf (last visited March 2, 2022) [https://perma.cc/9S8P-C4M9]; *see also* Merrigan, *supra* note 39.

[45] *See* IRM 5.5.8.9 (July 24, 2018); *see also* Merrigan, *supra* note 39.

[46] Merrigan, *supra* note 39.

[47] *Id.*

[48] *Id.*; *see also* IRM 5.5.8.12 (July 24, 2018); *see also* Merrigan, *supra* note 39.

[49] *See* IRM 5.5.8.12.3 (July 24, 2018); *see also* Merrigan, *supra* note 39.

[50] Merrigan, *supra* note 39.

iii. Bonds

The deferral of tax payments under § 6166 can last longer than the 10-year period of an estate tax lien. In these cases, the IRS may require an estate to furnish a bond to secure the payment of the estate tax if deferred longer than 10 years.[51] This bond may not exceed twice the amount of the deferred estate tax.[52] In lieu of a bond, the executor may agree to provide a lien against real and other property sufficient to cover the deferred taxes or interest.[53]

The Tax Court has held that the IRS must determine the requirement for security on a case-by-case basis.[54] In response, the IRS released Notice 2007-90, which provides interim procedures for determining whether a bond or special lien is required for estates that have elected to defer estate tax payments under § 6166.[55] Under Notice 2007-90, the IRS will look to the following three factors to make the determination:

> 1. The nature of the closely held business on which the § 6166 election was made, along with the nature of the business's assets, relevant market factors that may impact the business, financial history and managerial experience of the business;
> 2. The expected manner and ability of the business to make annual tax and interest and the likelihood of making such payments; and
> 3. The business's history of compliance with federal tax requirements.[56]

The IRS will evaluate these factors using information contained in the estate tax return, its attachments, information obtained during an audit, and other available sources.[57]

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[51] 26 U.S.C. § 6165.

[52] *Id.*

[53] *Id*. § 6324A.

[54] *See* Roski v. Comm'r, 128 T.C. 113, 130–31 (2007) (holding that the IRS may not adopt an arbitrary bright-line rule to automatically require a security for estate tax payments deferred for over 10 years and must instead exercise discretion when making such a determination).

[55] I.R.S. Notice 2007-90.

[56] *Id.* at 7–8.

[57] *Id.*at 4–5.

C. *Acceleration of Payment of Deferred Tax*

Deferral terminates if 50% or more of the value of a closely held business interest is (A) sold, distributed, exchanged, or otherwise disposed of; or (B) withdrawn from the business interest in the form of money or other property.[58] If this occurs, the extension of time to pay ceases to apply, and the entire unpaid tax is payable in full upon notice and demand from the IRS.[59] If an estate sells a significant portion of a closely held business interest or withdraws a large amount of cash from that business interest, then the interest is now liquid and deferral is no longer necessary. Because the estate now has cash equal to or greater than 50% of the value of the interest, it presumably can pay the 40% estate tax rate attributable to the entire interest. See the following example:

> EXAMPLE 10: A decedent owns a 40% limited partnership interest in a partnership with a combined equity value of $100,000,000 (40% = $40,000,000 interest). This interest is a qualified closely held business, and the executor of the estate made a § 6166 election to defer payment of the estate tax attributable to this interest. Before the estate makes all the installment tax payments, it sells 75% of its interest in the partnership to the other partners, receiving $30,000,000 in cash. This sale terminates the deferral of tax because it exceeds 50% of the value of the interest. As a result, the remaining unpaid tax attributable to this interest is payable in full upon notice and demand from the IRS.

Accordingly, a cash-out refinance may trigger an acceleration of deferred taxes. In a cash-out refinance, a real estate owner takes out a new mortgage for more than what they owe and receives the difference in cash.[60] Landlords commonly use cash-out refinancing to reinvest in more rental properties or to maintain cash reserves.[61] There are several attributes of a cash-out refinance, but

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[58] 26 U.S.C. § 6166(g)(1)(A).

[59] *Id.*

[60] Kim Porter, *Cash-Out Refinance on an Investment Property: How It Works*, CREDIBLE (Jan. 4, 2022), https://www.credible.com/blog/mortgages/cash-out-refinance-investment-property/ [https://perma.cc/Y525-4BPM].

[61] *Id.*

the most relevant is that a landlord can borrow up to 75% of the property's value.[62] Because this cash is secured by (and therefore attributable to) the real property, the transaction may run afoul of § 6166(g)(1)(A) if the size of the withdrawal is greater than or equal to 50% of the property's value. Thus, taxpayers and practitioners must exercise caution when utilizing cash-out refinancing on real property subject to estate tax deferral. Otherwise, the withdrawal may terminate the tax deferral and cause the outstanding tax to be payable in full. Still, such loans may be beneficial if the taxpayer makes small withdrawals to help pay estate tax installments, provided the aggregate withdrawals over time do not exceed 50% of the property's value.

If the taxpayer fails to pay any installment of principal or interest on time, then the unpaid portion of the tax is payable in full upon notice and demand from the IRS.[63] Thus, taxpayers must make timely payments throughout the deferral period. This full payment is avoidable if the taxpayer pays the delinquent installment within 6 months of its due date.[64] However, the taxpayer must pay a penalty of 5% per month of the delinquent amount.[65]

If an estate has undistributed net income for any taxable year ending on or after the due date for the first installment of deferred tax, then the undistributed amount must be paid as an advance payment of the deferred tax.[66] Undistributed net income in a taxable year is the distributable net income determined under the estate income tax rules, less amounts distributed to beneficiaries, the estate's federal income tax payable, and any normal (not deferred) estate tax paid during the year.[67] To avoid this issue, an estate should distribute all its net income to beneficiaries every year on a timely basis.

[62] *Id.* The maximum loan-to-value ratio depends on the number of rental units owned in the property.

[63] 26 U.S.C. § 6166(g)(3)(A).

[64] *Id.* § 6166(g)(3)(B)(i).

[65] *Id.* § 6166(g)(3)(B)(iii).

[66] *Id.* § 6166(g)(2)(A).

[67] *Id.* § 6166(g)(2)(B).

D. Aggregation of Multiple Business Interests and the Interaction with Valuation Discounts

The language of § 6166(a)(1) implies that the 35% Test only considers single closely held business interest.[68] However, interests in two or more closely held businesses may be combined and treated as an interest in a single closely held business to meet the 35% Test.[69] The estate can aggregate the business interests if at least 20% of the total value of each business is included in the decedent's gross estate ("20% Aggregation Test").[70] See the following example from Private Letter Ruling 200510811:

> EXAMPLE 11: A decedent wholly owned, through trust, two corporations that owned and operated retail automobile dealerships.[71] The decedent also directly owned two real properties and leased them to the dealerships.[72] The decedent was actively involved in the management and operations of the corporations and properties.[73] The IRS qualified all the above as a single closely held business because more than 20% of the value of each business (100% each) was included in the decedent's estate.[74]

Because the statute specifically refers to the **value** of the business interests,[75] it is important to explore how valuation discounts may impact the 20% Aggregation Test. It is possible that a 30% nominal interest in a partnership may only be worth 20% of the total value of the business. For estate tax purposes, the fair market value of an asset is determined by a willing-buyer/willing-seller test.[76] Essentially, the fair value is the price at which the property would change hands

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[68] *See id.* § 6166(a)(1) ("if the value of *an* interest in *a* closely held business . . . exceeds 35 percent . . . ." (emphasis added)).

[69] *Id.* § 6166(c).

[70] *Id.*

[71] I.R.S. Priv. Ltr. Rul. 200518011 (May 6, 2005).

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] 26 U.S.C. § 6166(c) (noting the words "20 percent or more of the total value of each such business").

[76] 26 C.F.R. § 20.231-1(b).

between a willing buyer and willing seller when (1) neither party has an obligation to engage in the transaction and (2) each party has reasonable knowledge of relevant facts.[77] For assets traded on an established market or that have readily ascertainable value (i.e. publicly traded securities), their fair value is the value on the date of the decedent's death.[78] For other assets without an established public market, such as closely held stock or minority partnership interests, we use educated estimates to establish fair value.[79]

When faced with the issue of valuation, courts have held that the value of closely held interests is usually less than the value of similar publicly traded interests.[80] "The factors underlying this premise include the inability to quickly convert the property to cash at minimal cost ("lack of marketability") and the inability, if the interest held is less than a majority interest, to control managerial decisions and other aspects of the entity ("lack of control")."[81] The most relevant factor for the 20% Aggregation Test is lack of control, because any interest in a business below 50% is a minority interest.[82] Such minority interests are subject to a discount for lack of control ("DLOC").[83] A willing buyer would likely value a minority interest with no control over business decisions lower than a controlling interest. There are various methods to determine a DLOC, and the discount itself varies widely.[84]

LLCs and limited partnerships are common ownership vehicles for real estate,[85] so valuation discounts are of particular importance here due to a lack of a public market. Many tax practitioners utilize valuation discounts to reduce estate

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[77] *Id.*

[78] Justin P. Ransome & Vinu Satchit, *Valuation Discounts for Estate and Gift Taxes*, J.ACCT. (June 30, 2009), https://www.journalofaccountancy.com/issues/2009/jul/20091463.html [https://perma.cc/QS3X-RFN6].

[79] *Id.*

[80] *Id.*

[81] *Id.*

[82] Will Kenton, *Minority Interest: Definition, Types, and Examples*, INVESTOPEDIA (July 25, 2020), https://www.investopedia.com/terms/m/minorityinterest.asp [https://perma.cc/WEH4-NAYQ].

[83] Ransome & Satchit, *supra* note 78.

[84] *See generally id.* (detailing the various actuarial methods that expert appraisers use to determine valuation discounts for an estate's business interests).

[85] Carl Zoellner, *Limited Partnerships in Real Estate*, ANDERSON LEGAL, BUSINESS & TAX ADVISORS (Aug. 19, 2020), https://andersonadvisors.com/limited-partnerships-explained/ [https://perma.cc/3TE7-DLE7].

tax liability attributable to real estate and other closely held businesses.[86] Practitioners can accomplish this by employing expert appraisers to apply valuation discounts to closely held real estate interests to reduce the overall value of an estate.[87]

These discounts may be consequential when determining whether certain minority interests meet the threshold of the 20% Aggregation Test. See the following examples:

> EXAMPLE 12: A decedent owns a 30% limited partnership interest in a real estate business with a total value of $10,000,000. If the 30% interest is subject to a 33.33% valuation discount (DLOC), then the $2,000,000 discounted value of the decedent's partnership interest (30% of $10,000,000 minus 33.33% of 30% of $10,000,000) is used to determine whether the decedent's estate held 20% or more of the total value of the partnership ($2,000,000/$10,000,000). The partnership interest meets the 20% Aggregation Test and may be aggregated with other partnership interests that meet the test.
>
> EXAMPLE 13: A decedent owns a 30% limited partnership interest in a real estate business with a total value of $10,000,000. If the 30% partnership interest is subject to a 35% valuation discount, the partnership interest would be valued at only $1,950,000 (30% of $10,000,000 minus 35% of 30% of $10,000,000). Since $1,950,000 is only 19.5% of the total partnership value ($1,950,000/$10,000,000), the 30% partnership interest cannot be aggregated with other partnership interests for purposes of determining whether the decedent's interest in a closely held business satisfies the 35% Test.

The 35% Test also applies to the relationship between the value of a closely held interest and the value of the gross estate;[88] valuation discounts will likely impact this test as well.

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[86] *Valuation Discounts in Estate Planning: Are They Right for Your Business?*, GUDORF LAW GROUP, LLC (Aug. 19, 2021), https://www.daytonestateplanninglaw.com/valuation-discounts-in-estate-planning-are-they-right-for-your-business/ [https://perma.cc/NE2Y-U7P7].

[87] *Id.*

[88] 26 U.S.C. § 6166(a)(1) (noting the use of the word "value").

Overall, it is important that estate planning attorneys pay attention to valuation discounts when formulating an estate plan. While such discounts will reduce the value of the taxable estate (and resulting estate tax liability), they run the risk of rendering an estate ineligible for estate tax deferral under § 6166. The ability to pay the estate tax in installments may outweigh a marginal increase in tax liability, so estate planning attorneys must carefully consider the unique needs of each client.

E. Attribution Rules

For purposes of satisfying the 20% Interest Test, the 45 Owner Rule, and the 20% Aggregation Test, the following attribution rules are applicable:

i. Spousal Attribution

For the 20% Interest Test and the 45 Owner Rule, stock or a partnership interest held by husband and wife as community property, joint tenants, tenants by entirety, or tenants in common is treated as owned by one shareholder or partner.[89] Additionally, an interest held by a surviving spouse with the decedent shall be included in the gross estate of the decedent for the purpose of satisfying the 20% Aggregation Test.[90] See the following example:

> EXAMPLE 14: A decedent owns a 15% interest in a limited partnership and his wife owns a 10% interest in the same limited partnership. Assume that each spouse contributed community property in exchange for his and her interest in the partnership. As a result, each of their interests is community property. Therefore, their combined 25% interest in the partnership is treated as owned by a single shareholder and satisfies the 20% Interest Test. Additionally, they are treated as a single owner for the purposes of the 45 Owner Rule.

ii. Pass-through Entity Attribution (Indirect Ownership)

For the 20% Interest Test and the 45 Owner Rule, but **not** the 20% Aggregation Test, property owned, directly or indirectly, by or for a corporation,

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[89] *Id.* § 6166(b)(2)(B).

[90] *Id.* § 6166(c).

partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.[91] A person is treated as a beneficiary of a trust for this purpose only if that person has a present interest in the trust.[92] See the following example:

> EXAMPLE 15: A decedent is one of two equal beneficiaries of a trust that owns a 50% interest in a limited partnership. Assume that the decedent has a present interest in the trust. Through pass-through entity attribution, the decedent is considered to own a 25% interest in the partnership. The 25% interest satisfies the 20% Interest Test.

iii. Family Attribution

For the 20% Interest Test and the 45 Owner Rule, but **not** the 20% Aggregation Test, all stock and partnership interest held by the decedent or by any member of his family within the meaning of § 267(c)(4) shall be treated as owned by the decedent.[93] Under § 267(c)(4), family members are the decedent's siblings, spouse, ancestors, and lineal descendants.[94] See the following example:

> EXAMPLE 16: A decedent and his son each own a 3% interest in a limited partnership. There are 44 other partners in the partnership, which brings the total number of partners to 46. However, due to family attribution, the decedent's son's interest is treated as owned by the decedent. Thus, for the purpose of satisfying the 45 Owner Rule, the partnership has 45 partners. As a result, the 45 Owner Rule is satisfied and the decedent's 3% interest in the partnership is considered a closely held business.

iv. Aggregation Attribution Election

Family Attribution and Pass-through Entity Attribution normally do not apply for the purpose of satisfying the 20% Aggregation Test. Although the

[91] *Id.* § 6166(b)(2)(C).
[92] *Id.*
[93] 26 U.S.C. § 6166(b)(2)(D).
[94] *Id.* § 267(c)(4).

executor may elect for them to apply, there are some drawbacks to this method.[95] If the executor makes this election, then the estate forfeits the five-year deferral period for payment of the first installment of the estate tax.[96] Instead, the first installment payment of the estate tax is due nine months after the date of death.[97] Additionally, none of the deferred estate tax payments may qualify for the 2% interest rate under § 6601(j).[98] The 2% portion is treated as zero, and instead the entirety of the installment payments are subject to the 45% reduction of the regular underpayment rate.[99] See the following example from Private Letter Ruling 9223028:

> EXAMPLE 17: A decedent owned less than 20% interest in a partnership that owned residential apartment units in several buildings.[100] Other family members owned interest in the partnership and the combined family interest in the partnership exceeded 20%.[101] In addition, the decedent owned more than a 20% interest in a second partnership that owned several apartment buildings.[102] The combined value of the decedent's interests in the two partnerships exceeded 35% of the decedent's adjusted gross estate.[103] The executor made an election to treat the combined partnership interests as a single closely held business under § 6166(c).[104] The IRS ruled that the estate qualified for the § 6166(b)(7) Aggregation Attribution Election.[105] However, the estate was required to pay the first installment by the due date for payment of the estate tax, and the state was not eligible for the 2% interest rate under § 6601(j).[106]

[95] *Id.* § 6166(b)(7).
[96] *Id.* § 6166(b)(7)(A)(ii).
[97] *Id.*
[98] 26 U.S.C. § 6166(b)(7)(A)(iii).
[99] *Id.*
[100] I.R.S. Priv. Ltr. Rul. 9223028 (June 5, 1992).
[101] *Id.*
[102] *Id.*
[103] *Id.*
[104] *Id.*
[105] I.R.S. Priv. Ltr. Rul. 9223028 (June 5, 1992).
[106] *Id.*

F. Marital Deduction

The marital deduction allows a deduction against the value of a decedent's gross estate that is equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse.[107] If a surviving spouse is entitled for life to all income from a property interest, such as if the surviving spouse is the beneficiary of a marital trust that holds the interest, then that property interest is considered to have passed to the surviving spouse and qualifies for the marital deduction.[108] Put simply, one can take the marital deduction by either leaving property directly to a surviving spouse or to a marital trust for the benefit of the surviving spouse. Property eligible for the marital deduction is includable in the taxable estate of the surviving spouse.[109]

If a decedent utilizes a proper estate plan that takes full advantage of the marital deduction, then that decedent's estate would not owe any estate taxes. Additionally, the surviving spouse, upon their own death, can utilize the unused exclusion amount of the decedent on top of their own exclusion amount (a total of $25.84 million in 2023).[110] Additionally, any qualified closely held trade or business interests included in the taxable estate of the surviving spouse are eligible for estate tax deferral under § 6166.[111] If a decedent was actively engaged in a trade or business with respect to assets operated by the decedent, his employees, or agents, they are to the decedent's surviving spouse what they were to the decedent, so long as there is not a material change in the form or operation of those assets.[112] See the following example:

> EXAMPLE 18: A decedent transfers the entirety of his estate, including a 40% interest in a limited partnership that qualifies as a closely held business interest, to a marital trust for the benefit of his surviving spouse. Due to the marital deduction, the estate owes no estate tax. Upon the death of the surviving spouse, she is entitled to utilize the unused portion of the decedent's exclusion amount as well as her own. Additionally, if there is no material change in the form or operation of the 40%

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[107] 26 U.S.C. § 2056(a).
[108] *Id.* § 2056(b)(5)(A).
[109] *Id.* § 2044(b)(1)(A).
[110] *Id.* § 2010(c)(2).
[111] 26 C.F.R. § 20.2044-1(b).
[112] I.R.S. Priv. Ltr. Rul. 200521014 (May 27, 2005).

limited partnership interest, then it will qualify for estate tax deferral under § 6166.

Given the marital deduction, the executor will not need to defer payment of the estate tax under § 6166 until the death of the surviving spouse.

II. REAL ESTATE AS A CLOSELY HELD BUSINESS UNDER § 6166

As stated previously, § 6166 does not specifically address whether interests in real estate qualify as a closely held trade or a business. In fact, § 6166 does not provide a general definition of a trade or business at all, yet it indicates that a trade or business must exist before it may be deemed "closely held."[113] Therefore, we must look outside of § 6166. This paper examines case law, administrative guidance from the IRS, and other sections of the tax code to answer this question.

A. What is a Trade or Business?

Before examining whether real estate holdings qualify as a trade or business, we must first determine what a trade or a business is. Even though the Internal Revenue Code utilizes the phrase "trade or business" hundreds of times throughout its various sections and subsections, it does not define the phrase.[114] The Treasury Regulations are equally silent.[115]

The Supreme Court examined this issue in *Commissioner v. Groetzinger*, holding that a professional full-time gambler's gaming activities rose to the level of a "trade or business" for the purposes of 26 U.S.C. § 162(a).[116] In *Groetzinger*, the Court referenced general comments made in prior cases that included a dictionary definition of "business" and assumed that Congress uses common words in their popular meaning.[117] The Court concluded that "to be engaged in a trade or business, [a] taxpayer must be involved in the activity with continuity and

[113] *See* 26 U.S.C. § 6166(b)(1) (noting the imposition of criteria on a "trade or business" to determine whether it is closely held).

[114] *See* Comm'r v. Groetzinger, 480 U.S. 23, 27 (1987).

[115] *Id.*

[116] *Id.* at 35–36. *See also* 26 U.S.C. § 162(a) (providing for the deduction of ordinary and necessary expenses paid or incurred while carrying on a trade or business).

[117] *Groetzinger*, 480 U.S. at 27–28 (referencing a dictionary definition of business as "[t]hat which occupies the time, attention, and labor of men for the purpose of a livelihood or profit").

regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit."[118] However, the Court was also quick to acknowledge that not every income-producing endeavor constitutes a "trade or business".[119] Thus, the final determination of whether an activity is a "trade or business" rests on the facts and circumstances of each case.[120] The Court expressed reluctance to provide a more specific definition. It instead left Congress with the ultimate responsibility to provide a definition via statute.[121]

To be sure, the Court in *Groetzinger* was only defining a "trade or business" for the purposes of § 162(a).[122] However, § 162(a) provides for the relatively basic concept that a taxpayer may generally deduct ordinary and necessary business expenses.[123] Thus, it will not make sense if the definition of a "trade or business" under this section does not have the same general applicability as other provisions of the same section do. Furthermore, the "facts and circumstances" test in *Groetzinger* reasonably lends itself to general application. Additionally, the IRS provides a definition of a trade or business on a page of its website unrelated to § 162(a) that mirrors the *Groetzinger* definition.[124] As a result, we can reasonably argue that *Groetzinger* provides a general definition of a trade or business.

B. Can Real Estate Holdings Qualify as a Trade or Business?

It follows that if the facts and circumstances surrounding a taxpayer's real estate holdings meet the definition of a trade or business under *Groetzinger*, then the real estate holdings will be considered a trade or business. In fact, there are numerous Tax Court and Circuit Court cases pre-*Groetzinger* affirming rental real

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[118] *Id.* at 35.
[119] *Id.*
[120] *Id.* at 36.
[121] *Id.*
[122] *Id.* at 27.
[123] 26 U.S.C. § 162(a).
[124] *See Business Activities*, INTERNAL REVENUE SERVICE, https://www.irs.gov/businesses/small-businesses-self-employed/business-activities (last updated Mar. 5, 2023) [https://perma.cc/7F83-RAR6] (noting a trade or business is "generally an activity carried on for a livelihood or in good faith to make a profit" and that facts and circumstances determine whether an activity is a trade or business). While we cannot rely solely on a general post on the IRS website, this example does suggest a widespread acceptance of the *Groetzinger* definition of a trade or business.

estate as a trade or business.[125] In *Alvary v. United States*, the Second Circuit held that ownership of rental property is a trade or business if the facts and circumstances show the taxpayer engages in regular and continuous activity relating to the property, even if the taxpayer rents only a single piece of property.[126] Under that decision, if the owner carries on such activities through the use of an agent, then the rental property is still considered a trade or business.[127] Both the Seventh Circuit and Tax Court have cited *Alvary* as support for classifying rental real estate as a trade or business.[128] The *Alvary* court used the similar "regular and continuous activity" language that the Supreme Court later used in *Groetzinger*, which provides further evidence that the *Groetzinger* definition may apply to real estate.[129] See the following examples:

> EXAMPLE 19: A taxpayer owned six different rental properties and personally managed them by performing activities such as seeking new tenants, supplying furnishings, and cleaning the units.[130] The scope of ownership and management activities is an important consideration of whether an activity is a trade or

[125] *See* Alvary v. United States, 302 F.2d 790, 796-97 (2d Cir. 1962) (citing multiple Tax Court and Circuit Court cases).

[126] *Id.*

[127] *Id.*

[128] *See* Central States, Southeast and Southwest Pension Fund v. Personnel, Inc., 974 F.2d 789, 795 (7th Cir. 1992) (citing *Alvary* to note "[c]ourts have long held that leasing real estate is a trade or business for the purpose of determining the availability of business deductions under the Internal Revenue Code"); *see also* Curphey v. Comm'r, 73 T.C. 766, 775 (1980) (citing *Alvary* to conclude a taxpayer's activities were "sufficiently systematic and continuous to place him in the business of real estate rental"); *see also* Cunningham v. Comm'r, T.C. Summary Opinion 2013-27 at 25 (Apr. 1, 2013) (citing *Alvary* to note the "holding of property for rental purposes is generally treated as the use of property in a trade or business").

[129] *See* Alvary, 302 F.2d at 796-97; *see also* Groetzinger, 480 U.S. at 35 (noting similar language of "regular and continuous activity" in both cases).

[130] Curphey v. Comm'r, 73 T.C. at 775 (*as cited by* Stephen Fishman, *Is Your Rental Activity a Business or an Investment?*, NOLO, https://www.nolo.com/legal-encyclopedia/is-your-rental-activity-business-investment.html (last visited Mar. 5, 2023) [https://perma.cc/EDU7-L4E5]).

business.[131] These activities were sufficiently regular and continuous to rise to that level of a trade or business.[132]

EXAMPLE 20: A taxpayer rented out an inherited house for 14 years and managed the property himself or occasionally with the help of an agent.[133] The taxpayer performed little to no upkeep or management work, and he would primarily approve repair estimates sent by the tenants and pay the bills.[134] The taxpayer rented the property to a single tenant until he chose to sell the property.[135] Because his activity was so minimal, the rental property did not rise to the level of a trade or business.[136]

These examples show that the courts scrutinize the magnitude and frequency of management and landlord activities when deciding whether a real estate interest is a business or an investment. It follows that real estate arrangements such as triple net leases may be treated as investments instead of businesses, given the minimal amount of time and activity that an owner would likely devote to managing the property.[137] In summation, if a taxpayer or their agent meets the activity requirements under *Groetzinger* or *Alvary* with respect to real estate holdings, then the real estate holdings will be considered a business instead of an investment.

C. Passive Assets vs. Passive Activity

After establishing that real estate can be considered a business, we turn back to § 6166.[138] Notably, § 6166 states that estate tax deferral is not available for passive assets, and it defines a passive asset as "any asset other than an asset used in carrying on a trade or business."[139] While this definition is a bit vague, the use

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[131] *Id.*

[132] *Id.*

[133] Fishman, *supra* note 130 (citing Grier v. United States, 120 F. Supp. 395, 396 (D. Conn. 1954)).

[134] *Id.*

[135] *Id.*

[136] *Id.* at 398.

[137] Fishman, *supra* note 130 (triple net leases are commercial property arrangements where the tenant is required to manage the property and pay all taxes, insurance, and other expenses, while the landlord simply collects rent).

[138] 26 U.S.C. § 6166(a)(1) (noting use of the phrase "closely held business").

[139] *Id.* § 6166(b)(9).

of the word “passive” may initially suggest that a taxpayer must exceed some activity threshold for a business interest to be eligible for treatment under § 6166.

“Passive assets” do not seem to be defined elsewhere in the Internal Revenue Code, but passive activity is. 26 U.S.C. § 469 defines passive activity for the purpose of disallowing the recognition of losses from such activity.[140] According to § 469(c)(1), passive activity is any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate.[141]

By default, all rental activity is considered passive under § 469.[142] However, a taxpayer’s rental activity is considered active if (1) more than half of the personal services performed in businesses by the taxpayer in a taxable year are performed in real property businesses in which the taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of service during the taxable year in real property businesses in which the taxpayer materially participates.[143] Essentially, a taxpayer has to materially participate in their real estate holdings for at least 750 hours, and this real estate participation must constitute more than 50% of their total material participation in all of their businesses. Importantly, § 469 does not mention the activities of agents, so the taxpayer likely cannot rely on employees of a partnership or LLC to satisfy the material participation requirements on their behalf.[144] I.R.S. Publication 925 seems to corroborate this by specifically referring to the taxpayer as an owner of a business and not referring to the activities of agents.[145] This presents a high bar for real estate owners subject to the estate tax to meet without the use of agents.

It seems inappropriate to apply the passive activity definition from § 469 to the treatment of businesses under § 6166. To reiterate, a passive asset under § 6166 is “any asset other than an asset used in carrying on a trade or business.”[146] The language can be reasonably interpreted to refer to assets held by a business that do not conform with the operations of the business. For example, an LLC that owns

[140] 26 U.S.C. § 469(c)(1).

[141] *Id.*

[142] *Id.* 469(c)(2).

[143] *Id.* § 469(c)(7)(B).

[144] *See generally* 26 U.S.C. § 469 (noting the absence of regard for the activities of agents of the taxpayer).

[145] *Publication 925 (2020), Passive Activity and At-Risk Rules*, IRS, https://www.irs.gov/publications/p925#en_US_2020_publink1000104588 (last visited Aug. 11, 2023) [https://perma.cc/XG23-DWCQ] (While not necessarily binding legal guidance, IRS Publications shed light on the IRS’s views on various tax issues).

[146] 26 U.S.C. § 6166 (b)(9).

and operates rental real estate may incidentally own some stock or bonds.[147] Those investment assets would not be used to carry on the business of rental real estate and will thus likely be excluded from treatment under § 6166. This interpretation is consistent with the determination a court makes between whether a real estate interest is a true business or an investment.[148] Moreover, the term "passive assets" is misleading when compared to its given definition. It would be far more accurate for Congress to change the term to "non-business assets" or "investment assets." Given this re-examination of the passive asset definition in § 6166, it is unlikely that real estate owners will need to be subject to a stringent material participation requirement without the use of agents like the test presented in § 469.

D. Private Letter Rulings

Absent specific case law or statutory guidance, there are many Private Letter Rulings that treat real estate interests as eligible for treatment under § 6166.[149] These Private Letter Rulings at least demonstrate that the IRS intends to allow real estate interests to qualify for § 6166 treatment in some fashion. However, while likely useful for predicting future action by the IRS, Private Letter Rulings are directed only to the taxpayers requesting them and may not be used or cited as precedent.[150] As such, only the taxpayer requesting a Private Letter Ruling may rely upon it.

E. Revenue Ruling 2006-34

Fortunately, the IRS has provided some general guidance on the issue of real estate as a closely held trade or business under § 6166 in Revenue Ruling 2006-34. In this Revenue Ruling, the IRS attempts to distinguish what constitutes an

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[147] *See id.* § 6166(b)(9)(B)(ii) ("The term 'passive asset' includes any stock [held by the business] in another corporation unless" it meets specified criteria). This presumption of stock as a "passive asset" suggests that the statute views passive assets to be investment assets.

[148] *See generally* Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954) (determining whether a home held out for rent rose to the level of a business or was instead an investment).

[149] *See generally* I.R.S. Priv. Ltr. Rul. 200518011 (May 6, 2005); I.R.S. Priv. Ltr. Rul. 200521014 (May 27, 2005); I.R.S. Priv. Ltr. Rul. 9223028 (June 5, 1992) (noting the implicit acceptance of real estate holdings as eligible for estate tax deferral under § 6166 in these separate instances).

[150] 26 U.S.C. § 6110(k)(3).

active trade or business from the "mere management of investment assets."[151] To make this determination, the IRS takes into consideration the activities of the agents and employees of the decedent, partnership, LLC, or corporation.[152] "The fact that some of the activities are conducted by third parties such as independent contractors who are neither agents nor employees of the [decedent or business interest] will not prevent the business from qualifying as an active trade or business so long as these third-party activities are not of such a nature that the activities of the [decedent or business interest and respective agents or employees] are reduced to the level of merely holding investment property."[153]

The IRS provides a nonexclusive list of factors for determining whether a decedent's interest in real property is an interest in an active trade or business:

> 1. The amount of time the decedent (or agents and employees of the decedent or business) devoted to the business;
> 2. Whether the decedent or business maintained an office to conduct or coordinate the activities of the business, and whether the decedent, business, or agents maintained regular business hours;
> 3. The extent to which the decedent, agents, or employees were actively involved in finding new tenants and negotiating leases;
> 4. The extent to which the decedent, agents, or employees provided landscaping, grounds care, or other services beyond the mere furnishing of the premises;
> 5. The extent to which the decedent, agents, or employees made, arranged for, or supervised repairs and maintenance to the property including painting, carpentry, and plumbing; and
> 6. The extent to which the decedent, agents, or employees handled tenant repair requests and complaints.[154]

No single factor is dispositive of whether a real estate interest is a closely held business.[155] Absent a bright-line test, the IRS will review all the relevant facts

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[151] Rev. Rul. 2006-34, 2006-1 C.B. 1173.
[152] *Id.*
[153] *Id.*
[154] *Id.*
[155] *Id.*

and circumstances to make this determination.[156] Many real estate owners use property management companies to handle the day-to-day operations of their properties.[157] If a decedent, or a business in which a decedent has an interest, uses an unrelated property management company to perform most of the activities to operate a real estate interest, then it is unlikely that an active business exists.[158] However, if a decedent or decedent's business uses a **related** property management company, then the opposite may be true. See the following examples from Revenue Ruling 2006-34:

> EXAMPLE 21: A decedent owned a small office park, which consisted of five separate two-story buildings with multiple tenants.[159] The decedent hired a property management company, in which he had no ownership interest, to provide all the necessary services to manage and maintain the office park.[160] These services included advertising and showing the property to new tenants, negotiating and administering leases, collecting rent, and coordinating with independent contractors.[161] As a result, the decedent's interest in the office park is **not** considered to be an active trade or business for the purposes of § 6166 because (1) the decedent fully relied on the property management company to provide all of the necessary services to manage the property, and (2) the decedent had no ownership interest in the property management company.[162]
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> EXAMPLE 22: Assume the same facts as the previous example, except the decedent owned a 20% interest in the property management company.[163] Here, the decedent's significant ownership interest in the company allows his interest in the office park to qualify as an active trade or business.[164]

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[156] *Id.* at 1172.
[157] *Id.* at 1173.
[158] *Id.*
[159] *Id.* at 1172.
[160] *Id.*
[161] *Id.*
[162] *Id.* at 1174.
[163] *Id.* at 1172.
[164] *Id.* at 1174.

The IRS's "facts and circumstances test" in Revenue Ruling 2006-34 is mostly congruent with the *Groetzinger* and *Alvary* holdings. The courts in *Groetzinger* and *Alvary* made a distinction between a business and an investment. Here, the IRS is also making the same distinction. The courts and the IRS both examine the nature and extent of a taxpayer's activities to distinguish between a business or investment. It stands to reason that if a real estate interest qualifies as a business under *Groetzinger* and *Alvary*, then it should likely satisfy Revenue Ruling 2006-34.

F. Revenue Ruling 2006-34 vs. the Second Circuit

Revenue Ruling 2006-34 may differ from the courts regarding real estate interests that use property management companies. For example, in *Gilford v. Commissioner*, the Second Circuit determined a taxpayer's real estate interest to be a trade or business even though the property was entirely managed by an unrelated firm of real estate agents.[165] On the other hand, Revenue Ruling 2006-34 presumes the use of an unrelated property management company renders a real estate interest to be a mere investment.[166]

The *Gilford* court considered the outside real estate firm to be an agent of the taxpayer.[167] Therefore, the court found that the taxpayer vicariously participated in a trade or business through a principal-agent relationship with the firm.[168] A principal-agent relationship manifests when one party (the agent) agrees to act on behalf of another party (the principal) subject to the principal's control.[169] Whether a principal-agent relationship exists depends on individual facts and

[165] Gilford v. Comm'r, 201 F.2d 735, 736 (2d Cir. 1953). The tax issue in this case was whether a taxpayer sustained an ordinary or capital loss on the sale of an inherited fractional interest in real property. The taxpayer fully relied on an unrelated property management company to operate and manage the property.

[166] Rev. Rul. 2006-34, 2006-1 C.B. 1174 (noting the use of an unrelated property management company suggests that an active business does not exist). This is also supported by the holding for "Situation 2" in the Revenue Ruling, where a taxpayer fully relied on an unrelated property management firm to perform all the duties associated with managing the real estate interest. The IRS does not address the possibility of a principal-agent relationship in this scenario.

[167] *Gilford*, 201 F.2d at 736.

[168] *Id.*

[169] RESTATEMENT (SECOND) OF AGENCY § 1 (AM. L. INST. 1958). *See also* RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. L. INST. 2006).

circumstances,[170] but the right of the principal to control the agent is constant across all agency relationships.[171] However, courts have held that a principal "need not exercise physical control over the actions of its agent . . . rather, the agent must be subject to the principal's control over the result or ultimate objectives of the agency relationship."[172] By concluding that a principal-agent relationship existed between the taxpayer and the real estate firm, the court in *Gilford* effectively implied that the taxpayer was able to exert a level of control over the result of the firm's efforts.[173]

While we do not know the degree to which the taxpayer in *Gilford* had control over the real estate management firm,[174] the holding in *Gilford* establishes a difference between the IRS's and Second Circuit's views on the impact of outside property management companies. The relationship between the taxpayer and property manager in *Gilford* is not distinguishable from the relationship between the taxpayer and property manager in Situation 2 of Revenue Ruling 2006-34.[175] Therefore, absent any omitted facts, the Second Circuit and the IRS merely reached different legal conclusions. The Second Circuit recognizes that a principal-agent relationship between a taxpayer and a third-party property management company categorizes a real estate interest as a trade or business; whereas Revenue Ruling 2006-34 views the use of a third-party property management company as almost a "poison pill" that renders a real estate interest as a mere investment. Interestingly, the IRS argued in *Gilford* that the taxpayer's real estate interest was a trade or

[170] Green v. H & R Block, Inc., 735 A.2d 1039, 1048 (Md. 1999).

[171] RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c (AM. L. INST. 2006).

[172] *Green*, 735 A.2d at 1050.

[173] *Gilford*, 201 F.2d at 736. The court states that the firm acted as the taxpayer's agent, however the court does not elaborate on how it came to that conclusion. The "control" factor is necessary to establish an agency relationship, so we can infer that the court found the taxpayer had sufficient control over the firm.

[174] *Id.*

[175] *See id.*; *see also* Rev. Rul. 2006-34, 2006-1 C.B. 1172. The taxpayer in *Gilford* did not do any work herself in connection with the management of the buildings, and the only fact illustrative of her relationship with the real estate firm was that the firm provided her with an accounting of her net income from the property. Similarly, the taxpayer in Situation 2 of the Revenue Ruling relied entirely on the outside management company to operate the property, and the company provided the taxpayer with an accounting of his net income from the property.

business and the taxpayer argued that it was a capital asset.[176] Of course, the IRS is allowed to change its mind over the years—evidenced by its position in Revenue Ruling 2006-34.[177]

Taxpayers in the Second Circuit should be able to enjoy its more permissive approach to the use of third-party property management companies because federal judicial authority outweighs the authority of IRS Revenue Rulings.[178] To be clear, taxpayers under the Second Circuit's jurisdiction who utilize a third-party property management company must still sufficiently satisfy the factors laid out in Revenue Ruling 2006-34 to qualify for estate tax deferral under § 6166. They just are not automatically disqualified for utilizing a third-party property management company. If the third-party management company—as the taxpayer's agent—does not engage in sufficient activity to qualify the real estate interest as a trade or business under Revenue Ruling 2006-34, then the real estate interest will be ineligible for tax deferral.

Taxpayers residing outside of the Second Circuit's jurisdiction may still be able to argue that a real estate interest should qualify as a trade or business under Revenue Ruling 2006-34 even if they utilize an unrelated property management company. The Second Circuit's holding in *Gilford* may be persuasive in other jurisdictions.[179] Revenue Ruling 2006-34 equates the actions of agents with the actions of taxpayers, yet it does not accept the use of a third-party property management company.[180] This contradiction should be challenged. If a taxpayer outside of the jurisdiction of the Second Circuit uses an unrelated property management company to operate their real estate interest, then the taxpayer should argue that the property management company is acting as their agent and use *Gilford* as persuasive authority. Whether or not such an argument is successful will depend on the facts and circumstances of the case. For example, if a taxpayer frequently communicates with a third-party property management company (i.e., through regular phone conversations or email correspondence), then the taxpayer

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[176] *Gilford*, 201 F.2d at 735. The taxpayer wanted to take a capital loss on the sale of the property and carry the unused portion forward to future years, while the IRS argued that the loss was ordinary.

[177] There is a 53-year gap between *Gilford* (decided in 1953) and Revenue Ruling 2006-34 (written in 2006).

[178] *U.S. Federal Tax Law Hierarchy Quick Reference Chart*, AICPA, https://njsea.org/files/u-s-federal-tax-law-hierarchy-quick-reference-chart.pdf (last visited Feb. 20, 2022).

[179] *Id.*

[180] Rev. Rul. 2006-34, 2006-1 C.B. 1171. The IRS repeatedly references the acts of agents in its list of factors to determine whether a real estate interest is a trade or business.

could show that they exert enough direction over the results of the arrangement to establish a principal-agent relationship. If the property management company's actions satisfy the factors of Revenue Ruling 2006-34, then in this case the taxpayer would have a strong argument that their real estate interest is a trade or business. On the other hand, if a taxpayer takes a "fire and forget" approach to their real estate holdings and rarely ever communicates with a third-party property management company, then it is less likely that enough control exists to establish a principal-agent relationship and treat the real estate interest as a trade or business.

All in all, real estate interests may be eligible for estate tax deferral if they (1) satisfy the definition of a trade or business under *Groetzinger* and *Alvary*; (2) satisfy the test provided in Revenue Ruling 2006-34; and (3) qualify under the standard provisions of § 6166. Taxpayers should be able to argue that the use of an unrelated property management company—assuming it evinces a principal-agent relationship—does not single-handedly disqualify a real estate interest as a trade or business.

CONCLUSION

26 U.S.C. § 6166 is a complex and useful provision of the tax code that can provide material relief to estates with illiquid closely held business interests. Real estate interests are inherently illiquid, and thus are prime candidates for tax deferral. Although § 6166 does not explicitly address real estate, it would be against the spirit of the statute to treat real estate that qualifies as a business any differently from other businesses. The IRS acknowledges the eligibility of real estate interests for treatment under § 6166 in Revenue Ruling 2006-34 and multiple Private Letter Rulings. Even if the IRS abandons Revenue Ruling 2006-34, taxpayers will still have a legitimate argument for real estate's inclusion under § 6166 if their real estate interests meet the definition of a business under *Groetzinger* or *Alvary*.

If a taxpayer with real estate holdings believes their estate may be eligible for estate tax deferral under § 6166, then they should ensure that their rental real estate rises to the level of a trade or business. The more actively the taxpayer (or their agents) participates in the operations and management of their real estate interest, then the more likely the real estate interest will be considered a trade or business. Otherwise, the real estate interest will be treated as an investment and will accordingly be denied estate tax deferral under § 6166. This increases the odds that the estate will have to sell off the property to pay the estate tax.

Additionally, if a taxpayer's rental real estate business is managed by an unrelated management company, then the taxpayer should seriously consider

transferring that management control to either an employee or a related property management company. This would satisfy the requirements of Revenue Ruling 2006-34 and avoid potential controversy. Of course, taxpayers may not desire to make the effort to bring property management in-house or purchase a stake in a property management company solely to qualify for estate tax deferral. Alternatively, the taxpayer should establish a clear principal-agent relationship with the management company. Practitioners should consult with their clients to determine what is in their overall best interest.

Taxpayers should also be aware of the general eligibility requirements of § 6166, especially the "35% Test". It is certainly advantageous for a taxpayer to reduce the size of their taxable estate, through creative estate planning techniques, lowering their potential estate tax liability. However, such tactics could possibly render an estate ineligible for tax deferral because they could distort the proportion of a closely held business to the rest of the estate. In this scenario, an estate may have a lower estate tax burden overall, but it might have to pay the entire amount within nine months of death. Once again, this is a situation where individual circumstances will vary, but taxpayers must nonetheless be aware of the potential consequences of reducing the size of their estates and businesses before death.

Situations may arise where an executor or a decedent's family decides to sell real estate subject to tax deferral. This may prove to be time consuming because they will need to petition the IRS to release the estate tax lien attached to that property due to title issues. It may also be difficult to find a buyer willing to wait long enough for the IRS to release the lien. Taxpayers must also be careful not to inadvertently sell 50% of the total assets subject to estate tax deferral. Otherwise, the taxpayer may risk terminating the deferral and triggering an acceleration of the payment of the entire outstanding estate tax.

Overall, eligible taxpayers should strongly consider taking advantage of estate tax deferral under § 6166 for their real estate interests. While there are some hurdles and restrictions related to deferral, it can stand to benefit many estates by easing the burden to immediately pay. By utilizing § 6166, an estate can greatly reduce the necessity sell off assets solely to pay taxes and can preserve the long-term holding of real estate across generations.