DECEDENT'S RENTAL OF REAL ESTATE: APPLICATION OF INTERNAL REVENUE CODE SECTIONS 2032A AND 6166

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I. INTRODUCTION

In a decedent's estate, where the asset inventory includes a substantial amount of real estate leased to others, the fair market valuation of such real estate may create a substantial gross estate for federal estate tax purposes. If the estate cannot utilize a marital[1] or charitable[2] deduction, then substantial federal estate taxes may be due even though the unified credit available to the estate would eliminate some of this tax liability.

In such a situation, a careful review of the decedent's rental arrangements and business activities may enable the estate to take advantage of significant estate tax provisions to reduce the amount of the estate tax calculated or to ease the payment of the tax obligation which is attributable to certain assets included in the federal gross estate calculations.

The purpose of this article is to examine the provisions of Internal Rev-

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1. I.R.C. § 2056 (West 1983).

2. *Id.* § 2055.

enue Code Sections 2032A and 6166 as they relate to situations which involve real estate leased by the decedent prior to death. This examination will include consideration of the Code, regulations and letter rulings dealing with these requirements. Although the Internal Revenue Code restricts the use of letter rulings as precedent,[3] the rulings will be helpful to the understanding of the application of various requirements to fact situations arising throughout the country. A further objective of the article is to consider a number of factors which an estate planner may want to examine in the estate planning process with a view toward utilizing either of the provisions being discussed.

II. Section 2032A: The Valuation of Certain Farm and Real Property.

The general rule for valuing property included in an individual's gross estate for federal estate tax purposes is to include such property at its fair market value as of the date of death of the decedent[4] or the alternate valuation date, six months later.[5] If, however, an estate can take advantage of the provisions of Code Section 2032A, the estate will be able to reduce the valuation of real estate from its fair market value to the value which the property had in its use at the time of the decedent's death. The maximum amount of this reduction in value is $750,000 in the case of decedents dying in 1983.[6] This means that an estate would value a real estate asset twice. Once at its "fair market value" and then a second time at its "use value" as of the date of the decedent's death. The fair market value of the asset would then be reduced to the use value, subject to the maximum reduction allowed. This use value figure would then become the value of the asset included in that federal gross estate calculation.

A. Requirements: Qualified Use; Qualified Heir.

In order to qualify for the application of this special valuation provision, the decedent must have been a citizen or resident of the United States at death and the pre-death and post-death requirements must also have been met. The property must also meet the definition of "qualified real

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3. *Id.* § 6110(j)(3). This section provides:

(j) Special Provisions . . .

(3) Precedential Status.—Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent. The preceding sentence shall not apply to change the precedential status (if any) of written determination with regard to taxes imposed by subtitle D of this title [Miscellaneous Excise Taxes].

Id.

4. *Id.* § 2031.
5. *Id.* § 2032.
6. *Id.* § 2032A(a)(2).

property" which essentially means that the property is located in the United States, was either passed by or acquired from a decedent by a "qualified heir" and was being used in a "qualified use" by the decedent or a member of the decedent's family on the date of the decedent's death.[7] Within this requirement are a number of key terms which are further defined for the purposes of this section. For example, "qualified use" means that the property is used as a farm for farming purposes or in a trade or business other than the trade or business of farming.[8] In using the language "trade or business," the regulations state that the term applies only to an active business such as manufacturing, mercantile or service enterprise, or to the raising of agricultural or horticultural commodities as distinguished from passive investment activities.[9] A "qualified heir" means a member of the decedent's family which is further defined to mean an individual's parent, grandparent, spouse, children, grandchildren, children and grandchildren of a spouse, brothers, sisters, nephews, nieces, and spouses of these individuals.[10] From the viewpoint of the executor of the estate, the use of the property at the time of death and the disposition of the property become very important requirements in evaluating the estate's ability to take advantage of special use valuation.

1. *Asset Values; Pre-Death Requirements.*

Among the additional requirements are those which specify that:

a. Fifty percent or more of the value of the gross estate, less mortgages and debts applicable to real and personal property which is included in the gross estate, is comprised of the adjusted value of real and personal property which was used in the qualified use as of the date of death by the decedent or a member of his or her family and which will pass to or is acquired from the decedent by a qualified heir.[11]

b. Twenty-five percent or more of the value of the gross estate, less mortgages and debts on real estate included in the gross estate, is comprised of the adjusted value of the real estate which is used in the qualified use and is being considered for treatment under this section.[12] For property which is held by either a partnership or a corporation, special rules determine if the decedent's ownership interest in the partnership is sufficiently large to be considered as an interest in a closely held business.[13]

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7. *Id.* § 2032A(b)(1).
8. *Id.* § 2032A(b).
9. Treas. Reg. § 20.2032A-3(b), T.D. 7710, 1980-2 C.B. 254.
10. I.R.C. § 2032A(e)(1)(2).
11. *Id.* § 2032A(b)(1)(A)(i)(ii).
12. *Id.* § 2032A(b)(1)(B) (West 1983).
13. *Id.* § 2032A(g) (incorporating § 6166(b)(1)). Under (e)(1)(2)§ 6166(b)(1) an interest in a closely held business means . . . an interest as a partner in a partnership carrying on a trade or business, if 20 percent or more of the total capital interest in [the] partnership is included in

c. For five of the eight years preceding an individual's death, retirement or disability, the decedent or a member of the decedent's family must have used the property for the qualified use and materially participated in the operation of the farm or other business.[14]

d. The parties who have an interest in the real property acknowledge their liability for the payment of additional estate tax if the property is sold or the qualified use ceases within the recapture period of ten years after the individual's death. This acknowledgement is in the form of an agreement with the Internal Revenue Service which must be filed when the election to use this provision is made.[15] If the qualified heir is the decedent's spouse, a minor, a disabled person or a student, such a heir can satisfy the requirement of continuing the use by actively managing the farm or business.[16] This requirement is generally less complex than the material participation requirement.[17]

In assessing these requirements, the estate executor must first be concerned with important mathematical calculations for the real estate alone in comparison to the value of the entire estate, as adjusted, and for the real and personal property which is used in the farm or other trade or business which involves the real estate in comparison to the value of the entire estate as adjusted. In making these calculations, the executor would be utilizing fair market value figures which are not reduced by the application of the rules of section 2032A. It is also important to note that in valuing real or personal property for the purposes of these percentage tests, the concept of "adjusted value" is used and this requires that all mortgages or debts applicable to the property be deducted from the value of the property as used in the percentage calculations.[18]

2. *Material Participation Requirement.*

One of the most complex requirements of section 2032A is that which requires that a decedent or a member of the decedent's family must have materially participated in the operation of the farm or other trade or business which uses the real estate being considered.[19] The determination of "material participation" in a given situation is to be made following the requirements of another Code section, 1402(a)(1), which involves the calcula-

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determining the gross estate of the decedent, or [the] partnership had 15 or fewer partners; or an interest in corporation carrying on a trade or business if 20 percent or more in value of the voting stock of [the] corporation is included in determining the gross estate of the decedent, or [the] corporation had 15 or fewer shareholders.

14. *Id.* § 2032A(b)(1)(C); § 2032A(b)(4).
15. *Id.* § 2032A(b)(1)(D); § 2032A(d)(2); § 2032A(c).
16. *Id.* § 2032A(c)(7)(B).
17. *Id.* § 2032A(e)(12).
18. *Id.* § 2032A(b)(3); § 2053(a)(4).
19. *Id.* § 2032A(b)(1)(C) (West 1983).

tions of net earnings from self-employment.[20] Under this section of the Code, gross income derived from a trade or business is considered as "net earnings." In regard to rental income from real estate, the situation becomes more involved. Generally, the Code excludes such real estate rentals from "net earnings," except in the situation where the landowner and the tenant on the property have an arrangement between themselves which provides that the tenant will produce agricultural or horticultural commodities on the property and that the landowner will materially participate in the production or management of the production operation.[21] For the purpose of these requirements, the actions of the landowner and tenant alone are to be considered, without regard to the actions of an agent of either the owner or the tenant.[22]

3. *Share Rental Arrangements.*

For our consideration of real estate rentals, the type of lease arrangement generally described in Code section 1402 is that of a share rental arrangement which involves the landowner and tenant in the business management and production. Regulations describe "production" as engaging to a material degree in the physical work related to the production of a commodity, furnishing a substantial portion of the machinery, implements or livestock used in producing the commodity or furnishing or advancing funds to cover a substantial part of the expenses involved in producing the commodity.[23] If a tenant or landowner was to simply furnish machinery, implements, and livestock and incur expenses, the regulations state that such an arrangement will not satisfy the requirements. Factors such as furnishing capital or providing for the payment of expenses, however, may be significant in situations where the tenant or landowner has not provided a material degree of the physical work involved.[24] The executor of the estate, therefore, must closely examine such share rental arrangements to evaluate the obligations of landlord and tenant as to the physical work provided by each, the source of capital employed in the enterprise, and the liability for payment of debts and expenses incurred in the operation. In reaching a conclusion, the executor is required to weigh the evidence obtained from the examination against the standards of "material degree" and "substantial part."

"Management of the production" is described in the regulations as engaging to a material degree in the management decisions regarding the production activity, especially inspecting production activities and advising and consulting with landlord or tenant as to the production of the commodity.[25]

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20. *Id.* § 2032A(c)(6).
21. *Id.* § 1402(a)(1).
22. *Id.*
23. Treas. Reg. § 1.1402(a)-4(b)(3)(ii) (1963).
24. *Id.*
25. *Id.* § 1.1402(a)-4(b)(3)(iii) (1963).

Managerial decisions can include such things "as when to plant, cultivate, dust, spray, or harvest a crop," inspection, advice and consultation as to crop rotation, crop selection, livestock selection, and equipment utilization.[26] If a landlord or tenant was to simply select the crop or livestock produced or the equipment used, the regulations conclude that such activities alone would not meet the requirements, but such factors may be used to evaluate the involvement of a landowner or tenant who periodically advises, consults, and inspects the producing activity on the land and makes other decisions regarding the production activities on the land.[27] In such a situation, the executor must carefully examine the arrangement between the landowner and tenant with an eye toward identifying the decision making authority and responsibility of each party and weighing this evidence against the "material degree" standard.

If the real property in question is indirectly owned, as in a partnership, trust or corporation, there must exist the same type of arrangement which called for the decedent owner or a family member to materially participate in the business.[28] If a person's involvement is on a full-time basis this arrangement must still exist although it may be satisfied by holding an office in which certain material functions are inherent.[29] Neither nominally holding a salaried position as a corporate officer or director nor a listing as a partner with a share of profits and losses will, standing alone, support a finding of material participation.[30]

As the concept of "material participation" is determined by rules which determine net income from self-employment, the regulations reference a test to determine the required participation.[31] If a decedent or a member of his or her family is self-employed with respect to the farm or other trade or business, the income from the farm or business must be earned income for self-employment tax purposes if the recipient of the income is to be considered to be materially participating. If the recipient has paid self-employment taxes, such payment will not, however, be conclusive as to the determination of material participation. If, however, self-employment taxes have not been paid, then it will be presumed that the recipient has not materially participated. This presumption can be overcome by proof of material participation, an explanation of why self-employment taxes were not paid, and payment of all taxes, interest, and penalty on these unpaid taxes.[32]

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26. *Id.*
27. *Id.*
28. *Id.* § 20.2032A-3(f)(1) T.D. 7710, 1980-2 C.B. 254.
29. *Id.* § 20.2032A-3(f)(2) T.D. 7710, 1980-2 C.B. 254.
30. *Id.*
31. *Id.* § 20.2032A-3(e) T.D. 7710, 1980-2 C.B. 254.
32. See IRS Letter Ruling 8207006 which limited the amount of back self-employment taxes that can be collected to those that are within the applicable statute of limitations and that accrued in taxable years that constitute part of the five years chosen to meet the requirement.

From this discussion of the material participation requirements it seems fairly clear that a simple cash rental of real estate, without involvement by a landowner in the activity which takes place on the land, will not be able to satisfy the requirement. Passive collection of rent, salaries, draws, and dividends from the farm or other business will not meet the material participation test.[33] If the tenant in a cash rental is a "member of the decedent's family", then such person's activities, if adequate under the definitions, can be used to meet the requirement. In assessing a given situation, an executor should also keep in mind that the requirement of material participation is measured in the period prior to a person's death, retirement *or* disability, an alternative situation which may benefit many estates.

This concept can be used to meet the pre-death requirement and a somewhat similar approach can be used to satisfy the continued-use requirement to avoid the recapture tax.[34] In this latter instance, however, the family with which we are concerned is the family of the qualified heir and not that of the decedent. This situation can lead to some interesting, but perhaps undesirable results. For example, assume that a parent devised real estate to a child. If the child could not continue to materially participate in the qualified use, the child could not reach an agreement to have the parent's brother or sister operate the qualified use and still meet the requirement. The decedent's brother would not be a family member of the qualified heir although the brother would fall within the definition of a family member of the decedent. The same result would apply to a situation where a surviving spouse is the qualified heir and the decedent's brother or sister is asked to continue the qualified use. Although the brother or sister would fall within the definition of the decedent's family member, neither would meet the definition of a family member of the surviving spouse.

4. *Active Management: An Alternative Test.*

In addition to the definition of "family member," a special rule exists to cover situations where the qualified heir is the surviving spouse, under age twenty-one, a student or disabled. In any of these situations, the recapture tax threat could become significant if the "qualified heir" did not meet the material participation requirement and a member of the qualified heir's family could not perform those activities. The special rule allows these select qualified heirs, namely a surviving spouse, a minor, a student, and a disabled person, to meet an alternative test of "active management" rather than the "material participation" test.[35] This test will apply only during the time that the qualified heir attends school, is under age twenty-one or is disabled. If a fiduciary has been appointed in the case of a minor or a dis-

33. Treas. Reg. § 20.2032A-3(a) T.D. 7710, 1980-2 C.B. 254.
34. I.R.C. § 2032A(c)(6) (West 1981).
35. *Id.* § 2032A(b)(5), (c)(7)(C).

abled person, then active management by such fiduciary would be sufficient.

In trying to define what is meant by "active management," the Code simply says that the term means making management decisions of a business nature other than daily operating decisions.[36] The Report of the House Ways and Means Committee adds to the Code's definition of "active management" and describes it as a factual determination made without regard to the self-employment tax requirements of section 1401 of the Code.[37] Among farming activities, various combinations that constitute "active management" are inspecting growing crops, reviewing and approving of annual crop plans before planting, making substantial numbers of management decisions, and approving expenditures for other than nominal operating expenses in advance of the time the funds are extended.[38] The report also describes management decisions as decisions on what to plant, how many animals to raise, where to market crops, how to finance business operations, and what capital expenditures are to be made.[39]

In reviewing activities in light of the "active management" test, the activities of the select qualified heir alone are those of concern. Neither a family member nor an agent of the select qualified heir can perform activities which count toward satisfying the active management requirement.[40]

In comparing the material participation requirement to that of the active management test, those select qualified heirs have an easier standard to satisfy and, thus, the benefits of electing special use valuation may be applicable to a larger number of estates than was previously possible. If a decedent had materially participated in the qualified use prior to death, a surviving spouse, who becomes the qualified heir in the estate of the first spouse who dies, may use the first decedent's period of material participation to tack on to the surviving spouse's period of active management in order to continue or to initially qualify the estate for section 2032A use valuation treatment.[41]

Regarding the share rental of real estate, the active management test may provide significant latitude to those select individuals who can qualify for such treatment. In drafting or negotiating share lease arrangements in the post death period such heirs should be mindful of the level of activities which will qualify for active management and consider including such activities in the list of landowner responsibilities and obligations. If the heir cannot perform these activities or does not desire to fulfill the active management role, then a cash lease to a member of the heir's family may provide an alternative if the tenant's activities meet the material participation require-

36. *Id.* § 2032A(e)(12).
37. H.R. REP. No. 201, 97th Cong., 1st Sess. (1981).
38. *Id.*
39. *Id.*
40. *Id.*
41. I.R.C. § 2032A(b)(5)(A).

ments. A cash lease to an unrelated party which involves no activity by the landowner will trigger an imposition of the recapture tax.[42] Although the requirements have been substantially liberalized, they are far from having been eliminated. Executors, counsel, and qualified heirs must continue to pay attention to these requirements in order to avoid undesirable results.

III. The Closely Held Business and Extension of Time for Payment of Estate Tax

If section 2032A treatment is not applicable or desirable, or it does not completely reduce the estate's tax liability, the estate executor may want to consider utilizing section 6166. This section enables an estate with business assets to take advantage of an installment payment arrangement whereby the estate tax attributable to the business assets that is included in the gross estate is paid in installments over time at an attractive interest rate on the unpaid balance. For the first five years, interest is paid on the amount of the estate tax which is deferred. This amount is the result obtained by multiplying the total estate tax due by the ratio of the closely held business asset to the gross estate adjusted for losses during administration, expenses, indebtedness, and taxes.[43] Hence, the deferral arrangement will not defer the entire federal estate tax due. At the end of the five year period, the first installment of the tax is due and these installments can be made in two or more, but not more than ten, equal annual payments.[44] As the first installment payment of the tax is due five years after the date for payment of the tax and each successive installment is due annually thereafter, the maximum time to defer the payment of these taxes is fourteen years and nine months after an individual's death.

The objective of the section is to permit the deferral of the payment of the federal estate tax where, in order to pay the tax, it would be necessary to sell assets used in a going business and thus disrupt or destroy the business enterprise.[45]

A. *Interest in a Closely Held Business*

In order for this payment deferral election to be applicable, the section requires that the estate have as part of its assets an "interest in a closely held business" which has as its value an amount which exceeds thirty-five percent of the adjusted gross estate.[46]

The term "interest in a closely held business" is defined in the Code to mean a proprietorship interest; a partnership interest if twenty percent or

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42. *Id.* § 2032A(c)(6)(B)(ii).
43. *Id.* § 6166(a)(2)(A)(B).
44. *Id.* § 6166(a)(1).
45. Rev. Rul. 75-365, 1975-2 C.B. 471.
46. I.R.C. § 6166(a)(1).

more of the total capital interest of the partnership is included in the decedent's gross estate or the partnership had fifteen or fewer partners or stock; or in a corporate interest if twenty percent or more of the value of the voting stock is included in the decedent's gross estate or the corporation had fifteen or fewer shareholders.[47] These requirements invision the decedent as a substantial owner of the business interest included in the estate; the time for making such business interest determintion is immediately before the decedent's death.[48]

An additional requirement for the business enterprise is that it carry on a "trade or business." Although the Code provides definitions and special rules for section 6166 application, there is no definition of "trade or business." As one might expect, the question of what is a trade or business has been litigated over the years in cases dealing with the management of real estate;[49] sublease of office space originally leased on a ninety-nine year term which was indefinitely renewable;[50] the lack of a profit motive for engaging in an activity which generated substantial expenses in excess of income;[51] and rental of real property when the individual had engaged in other activity.[52] In these cases the courts concluded that the activities described would constitute a trade or business most frequently for the purpose of determining whether certain expenses were "deductible" business expenses. In regard to section 6166 and its viewpoint of what constitutes a trade or business, the Internal Revenue Service has taken a different approach.

In Revenue Ruling 61-55, advice was requested whether working interests and royalty interests in oil and gas properties would be considered as a "trade or business" within the meaning of section 6166.[53] The Service concluded that the ownership, exploration, development and operation of oil and gas properties by the decedent constituted a "trade or business," but the ruling went on to state that simple ownership of royalty interests in oil properties did not constitute a "trade or business" within the meaning of section 6166.[54] Later, three Revenue Rulings were issued to examine more closely the distinctions raised in Revenue Ruling 61-55.

Revenue Ruling 75-365, focused on the question of whether a "trade or business" existed in the situation where the decedent's assets included rental commercial property, rental farm property and notes receivable.[55] Prior to death, the decedent regularly maintained a rental office from which

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47. *Id.* § 6166(b)(1).
48. *Id.* § 6166(b)(2)(A).
49. Higgins v. Commissioner, 312 U.S. 212 (1941).
50. Fackler v. Commissioner, 45 B.T.A. 708 (1941).
51. Frank v. United States, 577 F.2d 93 (9th Cir. 1978).
52. Hazard v. Commissioner, 7 T.C. 372 (1946); Lagreider v. Commissioner, 23 T.C. 508 (1954).
53. Rev. Rul. 55, 1961-1 C.B. 713.
54. *Id.*
55. Rev. Rul. 365, 1975-2 C.B. 471.

rental and note payments were collected, leases were negotiated, loans were made and the maintenance of the properties was contracted to others. In reaching the question presented, the Ruling stated that the determination of what amounts to a trade or business should not be made merely by reference to a broad definition or the case law determinations made for some other purpose or some other section of the Code.[56] Rather, the determination should be found in keeping with the intent of the legislature in enacting this specific section of the Code. The Ruling concluded that section 6166 was intended to apply only with regard to a business such as a manufacturing, mercantile or service enterprise rather than the management of investment assets. Referencing Revenue Ruling 61-55, the conclusion was reached that grouping together assets which produce income simply by virtue of owning the assets and not as a result of the conduct of a business in and of itself does not amount to an interest in a closely held business within the intent of section 6166.[57]

In Revenue Ruling 75-366, the question involved farm assets which the landowner had leased to tenant farmers under terms whereby the owner shared in the expenses of producing the crops and the profits generated by the enterprise.[58] In addition, the lease terms provided that the landowner was to participate in management decisions regarding the enterprise. These decisions were described as what crops to plant, what fields to plant or pasture, how to utilize the subsidy program, annd what steps to take as to weed control. The landowner also made frequent visits to the property and occasionally delivered supplies to the tenants. The Ruling stated that an individual is engaged in the business of farming if the individual cultivates, operates or manages a farm for gain or profit, either as owner or tenant, or if the individual received a rental based upon farm production rather than a fixed rental.[59] Under these circumstances the Ruling views farming as a productive enterprise much like a manufacturing entity and not simply the management of an income producing asset.

In Revenue Ruling 75-367, the question involved a mix of assets including all of the stock of a home contracting corporation, real property upon which the corporation built homes, a business office and warehouse used by the corporation and the decedent, and rental properties which were built by decedent's corporation and owned by the decedent personally after the decedent purchased them from the parties who originally purchased them.[60] Following such repurchase, decedent rented the properties and collected rental income. In viewing each of these assets the ruling concluded that the stock of the home contracting corporation engaged in home construction did

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56. *Id.*
57. *Id.*
58. Rev. Rul. 366, 1975-2 C.B. 472.
59. *Id.*
60. Rev. Rul. 367, 1975-2 C.B. 472.

qualify as a trade or business as did the decedent's proprietorship interest in the real estate sales and development activity and the business office and warehouse.[61] On the question of the rental properties, however, the Ruling referenced the intent of section 6166 that it apply with respect to a business such as a manufacturing, merchantile, or service enterprise, as distinguished from management of investment assets. Based on this intent, the decedent's interest in the home rental activity was viewed as the management of investment assets and not that of a trade or business within the meaning of section 6166.[62] Luckily for the estate, those assets which were found to constitute a trade or business were sufficient in amount to satisfy the percentage requirements and the executor was able to elect the deferral treatment to that extent.[63]

From these four rulings has developed what is popularly called the active versus passive trade or business test.[64] Various commentators and writers have also questioned the legitimacy of the Service's position which is contrary to the case law definitions previously discussed. In one article the legislative history of section 6166 was examined and the conclusion drawn that Congress appeared to have been concerned with the character of the decedent's ownership, not the nature of the business conducted by the enterprise.[65] The percentage requirements of the section are specific and seem to seek out a substantial ownership interest rather than a specific business type. The author also points out that the Revenue Rulings had been issued prior to the 1976 Tax Reform Act and the 1981 Economic Recovery Tax Act[66] and, therefore, the Service could point to this fact to argue that Congress did not intend a different result since it could have changed the law to defeat the IRS rulings but did not do so.[67]

In another article, the author considered this situation from the viewpoint of the rules of statutory construction and commented that it may not have been Congress' intent to have an active trade or business standard under Section 6166.[68] The author asserts that the prior case law had recognized the rental of commercial annd residential property as constituting a trade or business and presumably this broad definition had prompted Congress to use the term "active trade or business" in those statutes which were

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61. *Id.*

62. *Id.*

63. *Id.*

64. Hardee, *The Elective Deferral of Payment of Estate Taxes*, 120 TR. & EST. 29, 30 (Dec. 1981).

65. *Id.*

66. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

67. *Hardee, supra* note 64, at 30.

68. Barcal, *IRS "Active" Trade or Business Requirement for Estate Tax Deferral: An Analysis*, 54 J. TAX'N. 52 (1981).

not intended to apply to passive investment enterprises.[69] Thus, the author concludes, if Congress had not intended sections 6166 and 6166A to apply to passive investment enterprises, it could have easily substituted, "conducting an active trade or business" for "carrying on a trade or business" or revised the language some other way to achieve its purpose.[70] What conclusion should be drawn from the language actually used by Congress? Since Congress used words which had been interpreted by the courts, it is reasonable to presume that Congress intended the broad case law definition to apply rather than the somewhat different and restrictive meaning set forth in the Revenue Rulings.[71]

In a third article the author comment on the active versus passive business situation by asking, what should be the crucial factor in determining what is and what is not a trade or business?[72] The author suggested that the key factor should be whether the proprietor produces something of value which is over and above the passive income or rental value which the property would generate.[73] When the proprietor's acts add something of value to the overall operation and the quality and quantity of such acts determine the amount of such income, then the enterprise should be viewed more as a personal service trade or business rather than merely the passive management of an asset.[74] In considering this proposition in light of the factors referenced in Revenue Ruling 75-366, was it not the involvement of the landowner in the enterprise itself which led to the conclusion that the individual was engaged in the business of farming? If a person were to make decisions and perform acts which influence the output or expenses of a business enterprise then such activities may influence the profit performance and potential of the enterprise. Such influence may, however, lead to a negative result or a negative result may be produced by factors beyond the control of the person, such as general economic factors which influence the determination of a property's passive income or rental value. Market factors themselves are not static and the passive income or rental value could be expected to fluctuate. In this proposal, however, concentration on the acts of the proprietor may not be significantly different from the viewpoint taken by the Service in Revenue Ruling 75-366, but it would at least provide an executor with points to argue in support of a contention that an activity does meet the determination of a trade or business.

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69. *Id.* at 53.

70. *Id.* In this regard, Barcal cites I.R.C. §§ 355(b) and 1372(e)(5) and the Regulations thereunder as examples where Congress has specifically referred to an active trade or business requirement. Barcal, *supra* note 68, at 53.

71. *Id.*

72. Mills, *Deferral of Federal Estate Taxes or When is Operating Rental Property Not a Trade or Business,* 6 ORANGE COUNTY (CALIF.) B.J. 442 (1979).

73. *Id.* at 448. *Accord* Hood, Chalstrom, Brown, *Special Elections: The Use of Sections 6166A and 303 of the Internal Revenue Code,* 47 UMKC L. REV. 485 (1979).

74. *Mills, supra* note 72, at 448.

The argument that the IRS determination of an active trade or business requirement violates the rules of statutory construction must await a judicial determination to which section 6166 has not yet been subjected. There may be many reasons why this issue has not been definitively litigated to this point, but for the immediate future, the Service can be expected to rely on the Revenue Rulings promulgated over these past years.

B. *Activities that Will Satisfy the Active Business Requirement and Who Can Perform Them*

Assuming the propriety of the Service's view that an active trade or business is required, to whom should the executor look to determine if the active requirement has been met? Unlike the requirements of section 2032A of the Code,[75] there is no provision which allows the executor to consider the actions of the decedent's family members in determining the trade or business requirement. Indirect ownership of a trade or business through partnership shares or corporate stock can satisfy the requirements if the business itself is an "active" business as described above and meets the percentage requirements.[76]

Under regulations issued prior to the repeal of section 6166A, it was not necessary that all of the assets of a partnership or corporation actually be used in carrying on the trade or business required to satisfy section 6166A.[77] In the case of a proprietorship, the regulations provided that only those assets of the decedent which were actually used in the trade or business would be included as part of a closely held business. The regulations cite as an example a building which is used as both a residence and a commercial establishment. The part used as a residence will not be considered as part of the trade or business.[78]

In a series of letter rulings, the Service clarified its view on the nature of activities performed and the persons who can perform such activities.[79] Letter Ruling 8133015 involved a farmer who suffered a stroke which per-

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75. I.R.C. § 2032A(b)(1) (West 1983).

76. *Id.* § 6166(b)(1)(B)-(C).

77. Treas. Reg. § 20.6166A-2(C)(1) (1960).

78. *Id.* § 20.6166A-2(C)(2).

79. If, however, the individual himself performs these activities, then the type and kind of activities become most important. In Letter Ruling 8145008, June 29, 1981, a landowner owned a 36 unit apartment house which the decedent operated until his death. The landowner had provided all services to operate and maintain the enterprise, except for occasionally hiring others who worked under his close supervision. Services performed by the landowner included repairs to structures, fixtures and equipment, gardening, grounds maintenance, cleaning, painting, collection, bookkeeping, tax return preparation, lease negotiations, evictions and purchasing. In assessing these facts, the ruling concluded that decedent's activities were unlike those listed in Revenue Ruling 75-367 as the decedent had actually performed repairs and other maintenance rather than contracting it out. Therefore, the decedent's activities were sufficient to be considered a trade or business and eligible for installment payment treatment.

manently incapacitated him.[80] After the stroke, the farmer and his spouse crop share leased their property to different tenants. The involvement of the farmer and spouse included providing funds and making decisions jointly with the tenants. The decedent's spouse was involved in management of the farms, but the farmer and his spouse did not personally perform any of the physical work activity on the farm.[81] After citing Revenue Rulings 75-365, 75-366, and 75-367, the Ruling stated that in order for the rental of property to constitute an active trade or business under section 6166, "the executor must demonstrate that the decedent's employee or agent normally performed substantial personal service in managing, maintaining and leasing the property."[82] The Ruling concluded that at death the farms were actively managed by decedent's spouse acting on behalf of the decedent and, therefore, the decedent was a proprietor in an active trade or business.[83]

In Letter Ruling 8133022, the estate consisted primarily of an interest in a rental real estate complex.[84] During her lifetime, the decedent was the resident manager at the complex where she performed most of the necessary work herself and supervised other work performed by her employees and contractors. When the decedent suffered a stroke, her spouse assumed full responsibility for the management and operation of the complex. When the spouse became unable to continue to manage the property, he entered into an agreement with a bank which gave the bank a general power of attorney over his financial affairs and created an agency relationship for the bank to act in the management and operation of the rental complex. In performing its duties, the bank, through a trust officer, regularly consulted with the spouse until his death a few months after his wife had died. The estate of each spouse included an interest in the real estate as an asset in the gross estate.[85] In evaluating the facts, the Ruling referenced Regulation 20.6166A-2(C)(2) and went on to state that the facts of a particular case will determine whether an asset is used in a trade or business. In regard to a proprietorship, the ruling found that only the activities of the decedent and his agents and servants could be taken into account in determining whether or not the decedent, at the time of death, was a proprietor in a trade or business.[86] In the case of a partnership or corporation, however, the activities of all partners or employees of the corporation could be taken into account regardless of the complete passivity of the decedent.[87] This recognized that in some situations a proprietor's interest in rental property might fail to

80. Letter Rul. 8133015, April 29, 1981.
81. *Id.*
82. *Id.*
83. *Id.*
84. Letter Rul. 8133022, May 1, 1981.
85. *Id.*
86. *Id.*
87. *Id.*

qualify as a trade or business whereas a partnership or corporate interest might qualify.

In regard to the activities of an agent or employee of a proprietor, the Ruling found that where an agent or employee acts on behalf of the owner and is subject to the owner's control and supervision, then the owner can be considered to be actually participating in the operation of the business and not simply managing investment assets.[88] It is recognized that in many cases, death is preceded by a period of incapacity which greatly reduces or even terminates the active role of the individual in the business. It would be unreasonable to deny the benefit of the installment payment arrangement to an estate based on the fact that prior to death the decedent became incapacitated, could not participate in the business and sought to appoint an agent to carry out his or her functions. The conclusions of this Ruling are rather surprising in light of the fact that the Code specifically refers to the determination of a closely held business interest as a determination taking place immediately before the decedent's death.[89] Unlike the provisions of section 2032A, there is no specific statutory recognition of the retirement or disability situation, yet the ruling recognizes the realities of life. To create a more restrictive situation by requiring an "active" business entity where no such statutory authority exists does not seem to square or settle comfortably with this liberal interpretation where more restrictive statutory authority exists. One additional factor is significant and that is that the spouse, within limits of his age and health, continued to consult with the agent as to management policy and thereby, the Ruling concludes, he continued to participate in the management of the complex. On the issue of whether the rental enterprise was a trade or business the Ruling concluded that it did meet the requirements.

In Letter Ruling 8134009, a landowner had granted a general power of attorney to her son-in-law before her death.[90] The son-in-law had also been the tenant on the landowner's property and the lease terms provided that the rental be based on farm production. The landowner did not personally participate in the operation and management of the farm but she had contributed chemicals and fertilizer. The landowner's tenant contributed equipment, labor and funds to paying operating expenses.[91] The Ruling evaluated these facts and concluded that the owner's farm was managed and operated by a tenant who was acting on her behalf. Therefore, decedent was a proprietor in an active trade or business and the estate was eligible for section 6166 treatment.[92]

A similar fact situation was presented in Letter Ruling 8134010, where a

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88. *Id.*
89. I.R.C. § 6166(b)(2)(A) (West 1983).
90. Letter Rul. 8134009, April 28, 1981.
91. *Id.*
92. *Id.*

landowner had leased her farm under an agreement which provided that the rental was dependent upon production rather than a fixed rental.[93] The landowner became incapacitated and was confined to a nursing home. The landowner had previously granted a power of attorney to her sister and her attorney in fact actively participated in the management of the landowner's farm by supervising the tenant's activity, directing the tenant as to crops to plant, when to sell, when to harvest and the choice of fertilizer and chemicals.[94] In evaluating these facts, the Ruling concluded the farm was "actively managed by an individual acting on decedent's behalf pursuant to a power of attorney" granted by the landowner.[95]

Letter Ruling 8244003 also examined the question of a proprietor acting through an agent in a share rental situation.[96] The agents of the proprietor had participated in the management and supervision of the farm. The landowner had not considered rentals as self-employment income and hence no tax was paid. In examining this factor, the Ruling stated that the payment or non-payment of self-employment tax was immaterial to the question of whether an estate qualified for installment payment treatment.[97] The Ruling also stated that making the installment payment arrangement dependent upon the payment of self-employment tax would defeat congressional intent in enacting section 6166 to avoid forced sale of a business to pay estate taxes.[98] As was mentioned in the discussion of section 2032A requirements, payments of self-employment tax is a crucial consideration under that section, but is not so under section 6166.

In a situation which had a more informal relationship between the landowner and agent, Letter Ruling 8144012 examined a case where a landowner's son had taken over the operation of the farm when the landowner became incapacitated.[99] To the extent of her abilities, the landowner continued participation. After the son took over, the farm was operated by the son who received all proceeds, made all payments, and gave decedent a portion to meet personal expenses. Throughout this period the landowner and her son resided together on the farm. There was no indication of a formal or informal agreement or understanding between the landowner and son, but the Ruling concluded that the farm was actively managed and operated by the decedent's son acting on behalf of the decedent and was therefore eligible for installment payment treatment.[100] This Ruling may indicate the role which a close relative could play in the agency determination and the im-

93. Letter Rul. 8134010, April 29, 1981.
94. *Id.*
95. *Id.*
96. Letter Rul. 8244003, May 1, 1982.
97. *Id.*
98. *Id.*
99. Letter Rul. 8144012, July 29, 1981.
100. *Id.*

pact which the relationship has on the formalities required to establish agency.

In Letter Ruling 8140020, the estate needed to have the decedent's real estate, which was leased to the decedent's corporation, included in the determination of trade or business so that the required percentage limits could be met.[101] The decedent's only activity regarding the lease was to collect the rent. The corporation was responsible for the payment of all repairs, maintenance, and so on. On these facts, the Letter Ruling referred to Revenue Ruling 75-367 which held that collecting rent and making mortgage payments and repairs was not a sufficient activity to constitute a trade or business.[102] In this lease situation, the landowner had done even less than that by simply collecting rent. In regard to this Ruling two points should be mentioned. If the land had been owned by the corporation, then perhaps the percentage limit could have been met since the entire value of the corporation would have been included, even though some of the corporate assets were not utilized in carrying on the trade or business.[103] The second point is that the objective of section 6166 has been cited to be the need to preserve a small business and avoid its breakup by the need to raise funds to pay estate taxes.[104] In this situation, there may not have been a grave threat to a business breakup since the property owner and stockholder were one and the same. In such a situation there might be greater flexibility between the entities which would enable the business to remain intact. While there may have been substantial business or tax reasons why the land was not included in the corporation, that decision had repercussions in the estate arena, and it may be advisable for planners to examine these impacts in evaluating various options when selecting an estate plan.

As mentioned at the outset, the Code restricts the use of letter rulings as precedent, but some interesting points can be drawn from these situations. The majority of the situations involved share rental arrangements where the landowners had transferred management authority and responsibility to someone who acted on behalf of the landowner. In some situations the transfer of responsibility was formalized by the creation of a power of attorney, but in other situations the transfer was informally arranged and may not have been evidenced by any formal document. Where an informal arrangement existed between the landowner and the agent, a family relationship existed which may have made it easier to reach the conclusion. In regard to the landowner's involvement in share rental arrangements or in management of a real estate rental complex, the significant factor seems to be the nature and type of activity which was performed by the landowner or someone acting on the landowner's behalf. On one extreme is the fact situa-

101. Letter Rul. 8140020, June, 1981.
102. *Id.*
103. Treas. Reg. § 20.6166A-2(C)(1) (1960).
104. Rev. Rul. 75-365, 1975-2 C.B. 471.

tion portrayed in Revenue Ruling 75-367 where the landowner collected rents and contracted out most of the other activities. On the other extreme is Letter Ruling 8145008 where the landowner personally performed almost every conceivable service or function needed to keep a thirty-six-unit apartment complex going smoothly.[105] Between these two points must be countless situations where some functions are personally performed and others are contracted out, but in the case where the services are contracted out, it should not be forgotten the acts of an agent or employee can be attributed to the person who has created this relationship. In effect, the management of rental property may be accomplished by someone who lacks the plumbing, electrical, and carpentry skills that some possess and still satisfy the trade or business requirements for a proprietorship. If an individual is to personally perform the service and maintenance function, then it would appear that the chance of satisfying the requirement increases as the number of personally performed services increase. In comparison, the requirements of section 2032A and section 6166 each have their own set of peculiar technical elements which can be troublesome from the viewpoint of an executor. It is possible for both sections to be available to some estates, particularly those where the landowner has entered into a share rental arrangement with a person who meets the definition of a member of the landowner's family. Whether or not an estate takes advantage of both sections will be dependent upon the plans of the family member to whom the property will be transferred as a result of the landowner's death.

IV. Estate Planning Considerations

In evaluating an estate plan which involves a substantial amount of real estate currently being used in a business, some important points to develop are the objectives of the estate owner and the intentions of the designated heirs. Does the heir intend to continue to operate a business? Does the estate owner intend the business to continue through the efforts of the next generation?

The heir's intentions are important because special use valuation requires the continued use of the property in the qualified use for the duration of the recapture tax period.[106] The installment payment of estate taxes requires the acceleration of the remaining unpaid taxes if the heir disposes of fifty percent or more of the closely held business interest.[107] While it may not be possible to conclusively determine an heir's intentions regarding the property, this point would be worth asking in the plan evaluation.

Another consideration would be to examine the nature of the business and the value of the real estate and business interest in relation to the per-

105. Letter Rul. 8145008, June 29, 1981.
106. I.R.C. § 2032A(c)(1) (West 1983).
107. *Id.* § 6166(g)(1).

centage requirement set forth in the Code.[108] This should determine if the estate would meet the active business requirement and the value ratios needed to apply the sections. In regard to the installment payment of estate taxes, it should be remembered that if the closely held business interest is a partnership or a corporation it is not necessary that all of the corporate assets be devoted to the active trade or business and the change of business organization has been suggested as an important planning consideration for this section.[109]

The next consideration would be to examine the nature of the landowner's present business organization and arrangement regarding the business and real estate. For example, if neither a landowner nor a member of his or her family had materially participated in a qualified use for five of the last eight years, a determination should be made as to how much of this requirement can presently be met including utilizing time prior to retirement or disability[110] which will be dependent upon the landowner's situation at the time work begins on the plan. If the time requirement cannot be presently met, can it be met in the future? What is the state of the landowner's health? Could the landowner be expected to survive for five years if a cash lease were negotiated with a family member and qualification for section 2032A treatment hinged on the material participation of the family member? In regard to the installment payment of estate taxes attributable to a closely held business, the business interest is determined at the landowner's death and no pre-death requirements come into play.

Other factors to consider in the planning process would be the income tax situation which faces a qualified heir of property subject to section 2032A treatment. As the heir will take the special use value as basis for tax purposes,[111] depreciation and subsequent capital gain may be affected. Another factor to view is the income which the tax savings gained will generate over time. In deciding to elect the installment payment arrangement, income generated by the investment of the deferred amount can also be projected and considered before reaching a decision.[112]

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108. *Id.* §§ 2032A(b)(1)(A)-(B), 6166(a)(1).

109. *Mills, supra* note 72, at 450; *Hardee, supra* note 64, at 31; Cummins, Weinberg, Roth, *The Active Business Requirement for Estate Tax Deferral; How Little Activity Qualifies?* 59 TAXES 647, 652 (1981).

110. I.R.C. § 2032A(b)(1)(C) (West 1983); § 2032A(b)(A)(B) (West 1983).

111. *Id.* § 1014(a)(1)(3) (West 1983).

112. 5 HARL, AGRICULTURAL LAW: AGRICULTURAL ESTATE, TAX AND BUSINESS PLANNING, § 42.05[2] (1983).