Tax Court Addresses Material Participation by Trusts

Tax Court Holds That Services Performed by Trustees Who Are Also Employees May Be Taken into Account in Determining Material Participation for Passive Loss Purposes; Holding Also Relevant for 3.8% Net Investment Income Tax

SUMMARY

On March 27, 2014, in Frank Aragona Trust et al. v. Comm'r, the Tax Court ruled that, in determining whether a trust’s activities are “passive” for purposes of the passive activity loss rules, (i) a trust can qualify for the material participation exception relating to certain taxpayers engaged in real property businesses; and (ii) services performed by individual trustees on behalf of a trust may be taken into account in determining whether the trust “materially participated” in the conduct of a trade or business, including services performed in a trustee’s capacity as employee of a disregarded entity wholly owned by the trust.

The decision is a victory for taxpayers that extends beyond the passive activity loss and real property contexts. The Affordable Care Act of 2010 imposes, beginning in 2013, a new 3.8 percent Medicare tax on net investment income (“NII”) of non-corporate taxpayers. In the case of certain trusts and estates, the NII tax is imposed on undistributed NII. Income from a trade or business in which a taxpayer “materially participates” is generally excluded from NII and the definition of “materially participates” is explicitly cross-referenced to the definition for purposes of the passive loss rules. Accordingly, Aragona Trust should provide guidance for determining whether a trust materially participates in a trade or business, and whether income from that trade or business may be excluded from NII.
DISCUSSION

A. BACKGROUND: MATERIAL PARTICIPATION STANDARD FOR PASSIVE LOSSES, MEDICARE TAX

Under the passive activity loss rules, a taxpayer’s passive activity loss may be disallowed if the taxpayer is an individual, estate, trust, closely held C corporation or personal service corporation. A passive activity loss is the amount by which the aggregate losses from all the taxpayer’s passive activities for the year exceeds the aggregate income from all the taxpayer’s passive activities for the year. A passive activity generally is any activity which involves the conduct of any trade or business in which the taxpayer does not “materially participate.” Real property rental activity is a special case and generally is per se passive; however, rental activity may be treated as non-passive if (i) more than half of the “personal services” performed in trades or businesses by the taxpayer during the year is performed in real property trades or businesses in which the taxpayer materially participates, and (ii) the taxpayer performs more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates. Generally (both in the real property context and otherwise), a taxpayer materially participates in an activity only if the taxpayer is involved in the operation of the activity on a basis which is regular, continuous and substantial. Neither statute nor regulation provide a method for determining how a trust establishes material participation in an activity.

The question of how a trust can materially participate in an activity (relating to real property or otherwise) takes on added significance in the context of the new 3.8 percent tax on NII. In general, this tax applies to estates and trusts that have undistributed NII and also have adjusted gross income over a certain threshold (for 2014, the threshold is $12,150; other rules apply to individuals). NII generally applies to, among other things, all income from a trade or business in which the taxpayer does not materially participate. In contrast, if a taxpayer materially participates in a trade or business activity (and, depending on the circumstances, certain other requirements are met), then income from that activity may be excludible from NII.

While authoritative guidance exists in the relevant Treasury Regulations for determining whether an individual materially participates in an activity (e.g., there is a “500 hour” rule for individuals), little guidance has been available as to how a trust can materially participate in an activity, either in the passive loss or NII contexts:

- In Mattie K. Carter Trust v. U.S., a federal district court in Texas held that material participation should be determined by taking into account the activities of both the trustee and the trust’s non-trustee employees and agents. The court rejected the IRS’s argument that the determination should be made solely by reference to the activities of the trustee, stating that “[s]uch a contention is arbitrary, subverts common sense, and attempts to create ambiguity where there in none.”
- In two Technical Advice Memoranda and a Private Letter Ruling, the IRS, citing legislative history, reiterated its position (rejected in Carter Trust) that a trust materially participates in an activity for purposes of the passive loss rules only if the fiduciaries themselves meet the required standard of regular, continuous and substantial involvement. The most recent Technical Advice Memorandum...
In the preamble to the Final Treasury Regulations on the NII tax issued on November 26, 2013, the Treasury Department postponed regulatory guidance on the issue in the context of the NII tax, stating that, “because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue . . . may be addressed in a separate guidance project issued under section 469 at a later date.”

**B. THE DECISION**

In *Aragona Trust*, a trust owned rental real properties and engaged in other real property business activities. The trust’s rental activities would be treated as *per se* passive activities unless the trust qualified for the real estate exception described above. Of the six trustees, three had limited involvement in the trust’s business (insufficient on their own to establish material participation), and the other three wore “two hats” – the three individuals were both trustees and employees of the trust (specifically, they were employees of a disregarded entity wholly owned by the trust). In addition, the trust employed several other individuals as part of its rental real property business. The IRS argued that the trust’s rental real property activities were passive because the trust did not materially participate in those activities and therefore that losses incurred from those activities were passive activity losses.

The Tax Court disagreed. As a threshold matter, the Tax Court held that “a trust is capable of performing personal services and therefore can satisfy the [real estate] exception.” The court reasoned that “[i]f the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered ‘work performed by an individual in connection with a trade or business.’”

The court then held that the trust materially participated in its real property operations because activities of all six trustees, including the three trustees operating under two “hats” – trustee and employee – should be considered in determining whether the trust materially participates in its real property operations. The court rejected the IRS’s argument that the activities of the three trustees who were also employees should be disregarded as performed in the context of their employment rather than in their role as fiduciary. The court reasoned that, under state trust law, trustees have a duty of loyalty to the beneficiaries of the trust, and that “trustees are not relieved of [that duty] by conducting activities through a corporation wholly owned by the trust” – in other words, even while wearing an “employee” hat, the fiduciary is bound by the duty of loyalty, and so the activities *qua* employee cannot be separated from the responsibilities *qua* fiduciary. The court’s holding on this point is in conflict with the IRS’s analysis in the 2013 Technical Advice Memorandum described above.

However, because the combined activities of the trustees were sufficient to constitute material participation, the court did not reach the larger question of whether the activities of the trust’s non-trustee...
employees should be taken into account in establishing material participation by the trust. Thus, Carter Trust remains the only case addressing this larger question – a decision the IRS has continually disputed.

While this case is favorable to taxpayers, the IRS has not yet announced whether the IRS intends to appeal. Further, the IRS may issue regulations, whether under the passive loss rules or the NII tax, addressing the issue.

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ENDNOTES

1 Section 469(c)(7).
2 Treas. Reg. 1.469-5T(g) reserves a place for a regulation to be titled "Material participation of trusts and estates."
3 See Section 1411.
5 T.A.M. 200733023; P.L.R. 201029014; T.A.M. 201317010.
6 T.D. 9644. Further discussion of the Final Treasury Regulations can be found in the Sullivan & Cromwell LLP Publication entitled "Final Regulations and New Proposed Regulations Implement the 3.8% Tax on Net Investment Income of Individuals, Estates and Trusts with Income in Excess of Statutory Thresholds" (December 20, 2013). Sullivan & Cromwell LLP Publications may be obtained by following the instructions at the end of this publication.
7 A commenter criticizing T.A.M. 201317010 put the point as follows: “a trustee cannot take off her trustee hat when she puts on the hat of employee, manager or director of a business the trust owns. The authorities are explicit. Thus, the trustee’s fiduciary duties follow her when she also takes on a role in the family business. She cannot disregard her fiduciary duties to the beneficiaries. Thus, nothing she does in the trust-owned business is done outside her “fiduciary capacity.”” Letter from Richard Dees to Catherine Hughes (Treasury), 2013-TNT 193-8 (Sept. 25, 2013).
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