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Tax Court Rules On Material Participation by Trusts

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On March 27, 2014, the United States Tax Court ruled in *Frank Aragona Trust v. Commissioner*,[1] instructing on the question of material participation of trusts. In a case of first impression, the Tax Court held that a trust qualified for the "real estate professional" exception under the passive loss rules by materially participating in a trust-owned real estate business. As a result, the trust could deduct losses incurred in conducting the real estate business as losses from non-passive activities.

The Tax Court's decision in *Aragona Trust* is a victory for taxpayers under the passive loss rules, however, the court's ruling is of even greater significance in light of the new 3.8% Medicare surtax on net investment income (the "NII Tax") under the Affordable Care Act of 2010. With scant time remaining until the September 15th deadline to file partnership tax returns on extension for 2013, taxpayers and advisors are now tasked with interpreting the court's decision to determine its application to other trust arrangements.

I. Background: The NII Tax and Material Participation

Effective January 1, 2013, Internal Revenue Code Section 1411 imposes a 3.8% tax on net investment income of certain high-income individuals, estates, and trusts. Net investment income is generally comprised of interest, dividends, annuities, royalties, rents, income derived from a trade or business, gains derived from the disposition of property, and other non-passive income, less properly allocable expenses. The NII Tax is imposed on estates and trusts with undistributed net investment income and adjusted gross income at a very low threshold.[2] With many trusts owning interests in businesses that produce trade or business income each year, the application of the NII Tax requires that taxpayers and fiduciaries engage in proper planning in light of this new surtax.

The NII Tax does not apply where the taxpayer "materially participates" in the activity producing the net investment income. Section 1411 looks to the passive loss rules to determine what constitutes material participation. Under the passive loss rules, a taxpayer is treated as materially participating in an activity if the taxpayer is involved in the operations of the activity on a "regular, continuous, and substantial basis."

While individuals may use one of seven clearly defined quantitative tests outlined in the

1 142 T.C. No. 9 (March 27, 2014).

2 US$11,950 for 2013 and US$12,150 for 2014.

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Treasury Regulations (for example, the widely known 500-hour test) to establish material participation, no legislative or regulatory guidance is currently available in the context of a trust. There is but one statement regarding trusts in the legislative history surrounding the passive loss rules, which states that a trust "is treated as materially participating in an activity… if an executor or fiduciary, in his capacity as such, is so participating."[3] Determining which activities qualify for purposes of material participation has been a source of contention between the Internal Revenue Service (IRS) and taxpayers for over a decade.

Relying on the legislative history, the IRS asserts that only the activities of the trustee acting in a fiduciary capacity should count in establishing material participation by a trust. This "fiduciary capacity" argument was first tested by the IRS in *Mattie K. Carter Trust v. U.S.*,[4] in which a federal district court rejected the IRS's narrow position on the issue. In *Carter Trust*, the trust operated a ranch, the day-to-day operations of which were overseen by a non-trustee ranch manager and conducted by ranch employees. The trustee of the trust reviewed financial materials and made financial decisions on behalf of the trust, but did not participate in the daily operations of the ranch. The taxpayer in that case sought to include the activities of the trustee as well as the activities of the non-trustee ranch manager and all ranch employees in determining whether the trust materially participated in the ranch business. By contrast, the IRS argued that only the limited financial activities of the trustee should be taken into account. The court rejected the IRS's argument, stating that it had studied the "snippet of legislative history [the] IRS supplied" and found the contention that only the trustee's activities should be considered "is arbitrary, subverts common sense, and attempts to create ambiguity where there is none." As a result, the activities of all those acting on behalf of the trust were included in the determination that the trust materially participated in the ranch business.

Following the IRS's loss in *Carter Trust*, the IRS issued two Technical Advice Memoranda and a Private Letter Ruling[5] in which the IRS rejected the district court's opinion in *Carter Trust* and further expounded upon its fiduciary capacity argument in light of various planning techniques. In Technical Advice Memorandum 200733023, the IRS concluded that merely labeling an employee of a trust-owned business as "Special Trustee" would not count for purposes of establishing material participation by the trust unless the Special Trustee retained final decision-making authority with respect to the trust-owned business. Further, in Technical Advice Memorandum 201317010, the IRS held that where an individual serves in a dual role as both trustee and officer or trustee and shareholder, work performed in the individual's non-fiduciary role as officer or shareholder must be separated out and should not be considered in establishing material participation by a trust.

II. The Decision: *Aragona Trust*

The Frank Aragona Trust (the "Trust") owned rental real estate properties and invested in developed real estate. For liability reasons, some of the Trust's real estate activities were operated through a wholly-owned limited liability company (the "LLC"). Following the settlor's death, the settlor's five children and a non-family member were appointed as co-trustees of the trust. Three of the children-trustees were employed full time by the LLC. The Trust incurred losses in 2005 and 2006, which the Trust sought to carry back to prior years. The issues before the court were: (1) whether the Trust could qualify for treatment as a "real estate professional" and (2) whether the Trust materially participated in its real estate businesses through the activities of its trustees and/or employees.

With respect to the real estate professional exception, the IRS argued that a trust could never meet this exception to passive loss treatment because, as a threshold matter, a trust does not meet the definition of "individual" under the Regulations and therefore is incapable of performing "personal services," which are required to meet the exception. The court rejected the IRS's argument, reasoning 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.'" Therefore, the Tax Court concluded that a trust can satisfy the requirements of the real estate professional exception.

As to the issue of material participation in the context of a trust, the Tax Court further held that the Trust materially participated in its real estate business. In so holding, the court disregarded the IRS's fiduciary capacity argument and found that the activities of the trustees, including the activities of three of the trustees acting as employees of the LLC, should be considered in the determination of material participation. The Tax Court reasoned that all the activities of the three trustee-employees

3 S. Rept. No 99-313, at 735 (1986), 1986-3 C.B. 1.

4 256 F. Supp.2d 536 (N.D. Tex. 2003).

5 T.A.M. 200733023; T.A.M. 201317010; P.L.R. 201029014.

should count toward the Trust's material participation because state law required the trustees to administer the trust solely in the interests of the beneficiaries, and the trustees were not relieved of this duty of loyalty merely by conducting the real estate activities through a wholly-owned LLC.

III. Analysis and Key Guidance

The Tax Court's decision in *Aragona Trust* is the second published opinion to reject the IRS's fiduciary capacity argument with respect to material participation by a trust. While the IRS may seek to appeal the Tax Court's decision, the *Aragona Trust* case provides taxpayers and fiduciaries with a more clearly defined framework for establishing material participation in the context of a trust. The key guidance gleaned from the Tax Court's decision in *Aragona Trust* can be summarized as follows:

- Reliance on State Law. The Tax Court turned to state law in finding the activities of the trustees as employees of the trust-owned LLC should be considered in determining whether the trust materially participated in the real estate business. Under the law of every state, trustees owe a duty of loyalty to trust beneficiaries. Therefore, the Tax Court's decision in *Aragona Trust* highlights the importance of state trust law as support for establishing material participation when a fiduciary holds dual roles.
- Structural Arrangement. *Aragona Trust* involved an LLC wholly owned by the Trust. In analyzing this arrangement, the court held that the actions of the trustees employed by the LLC should be considered in determining if the Trust materially participated in the real estate business. The Tax Court reasoned that the duty of loyalty imposed by state law was not diminished merely because the business activities of the Trust were conducted through a wholly-owned LLC. The Tax Court did not indicate that its holding was limited to the LLC arrangement used by the Trust in *Aragona Trust*, and the court's rationale would seem equally as applicable in an array of other structural arrangements given the nature of a trustee's duty of loyalty. Until further guidance is available on this issue, however, it is advisable to follow the LLC arrangement in *Aragona Trust* as a model in structuring the business activities of a trust.
- Material Participation Among Co-Trustees. Many questions with respect to satisfying the material participation requirements have arisen when multiple trustees act on behalf of a trust. There is currently no guidance as to whether all, a majority, or only one co-trustee must participate in a trust's business activities to meet the material participation requirements. While the Tax Court does not explicitly address this question, the Tax Court nevertheless found the Trust in *Aragona Trust* materially participated when only three of the six co-trustees (i.e., not a majority) were participating. Therefore, taxpayers may point to *Aragona Trust* as support where not all co-trustees are active in a trust's business.
- Activities of Non-Trustee Employees. With respect to activities of non-trustee employees of a trust, the Tax Court in *Aragona Trust* did not go as far as the district court in *Carter Trust*. While in *Carter Trust*, the district court found that the actions of all individuals acting on behalf of a trust, including agents and employees, could be considered for purposes of material participation the Tax Court noted in Footnote 15 of the *Aragona Trust* decision that under the issues raised by the parties, it was not necessary for the Tax Court to decide whether the activities of non-trustee agents or employees should be disregarded. Nevertheless, contrary to the IRS's strict fiduciary capacity approach to material participation of trusts, the Tax Court explicitly found that all of the activities of the three trustee-employees, including their activities as employees of the trust-owned LLC, should be considered in determining whether the Trust materially participated in the real estate business. Therefore, while there is still limited precedent on whether the activities of non-trustee employees and agents should count toward the material participation of a trust, the Tax Court's decision in *Aragona Trust* supports the proposition that all activities performed by a trustee should be considered for purposes of meeting the material participation requirements.

As with any court decision, extreme care and consideration must be given to distinguishing factors between the facts in a given case and another taxpayer's situation. Nonetheless, the Tax Court's decision in *Aragona Trust* establishes additional precedent that challenges the IRS's position and lends support to positions many taxpayers and advisors will undoubtedly wish to take on those 2013 partnership returns currently on extension.