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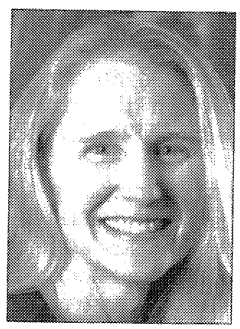
Material Participation in the Context of Trusts and Estates

Section 469 of the Internal Revenue Code was designed to stop taxpayers, including trusts and estates, from taking losses for passive activity against non-passive income like investment income and salary.[1] Passive activity occurs when the taxpayer does not "materially participate" in a trade, business, or rental activity, except in the case of a real estate professional.[2]

The imposition of the Net Investment Income Tax exacerbated the importance of understanding the impact of material participation in the context of trusts and estates.[3] Section 1411(a)(2) of the Internal Revenue Code imposes a tax of 3.8% on estates and trusts on the lesser of their undistributed net investment income or the excess of their adjusted gross income over the dollar amount at which the highest bracket begins. Since Section 1411(c)(1)(A) defines net investment income in part by reference to trades and businesses described in Section 1411(c)(2) which includes passive activities within the meaning of Section 469, an important exemption from the 3.8% tax is for trade or business income derived from a business in which a taxpayer materially participates.[4]

Section 469(h)(1) of the Internal Revenue Code provides that a taxpayer shall be treated as "materially participating" in an activity only if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. The Treasury Department reserved but never issued regulations addressing material participation as it relates to trusts, estates, and beneficiaries.[5] For this reason, the IRS has relied extensively on the legislative history of Section 469 to provide that "an estate or trust is treated as materially participating in an activity if the executor or fiduciary, in his capacity as such, is so participating."[6] This reliance directly conflicts with the two judicial decisions involving material participation in the context of trusts which applied the methodology outlined in Section 2032A of the Regulations.



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In *Mattie K. Carter Trust v. United States*, the trust operated a 15,000-acre

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cattle ranch.[7] The Trustee spent a significant amount of time reviewing financial information and making financial decisions for the trust and ranch, while the day-to-day operations were carried out by a full time ranch manager and part time employees. The manager and employees performed essentially all the acts of the ranch under the Trustee's supervision. Finding that the statutory language of Section 469 clearly identifies a trust as a taxpayer and that a taxpayer is treated as materially participating in a business if its activities in pursuit of that business are regular, continuous, and substantial, "common sense dictates that the participation of Carter Trust in the ranch operations should be scrutinized by reference to the trust itself, which necessarily entails an assessment of the activities of those who labor on the ranch, or otherwise, in furtherance of the ranch business on behalf of the Carter Trust."

Later in 2014, the decision in *Frank Aragona Trust v Commissioner* was issued.[10] In *Aragona*, the Decedent operated numerous rental apartment buildings and real estate businesses. After he died, his five children and his attorney, as co-trustees, became the operators of the real estate activities and businesses held in trust. Three family member trustees, who were also employees of the business, became managers of the LLC. The trust wholly owned the LLC and the trust owned the rental real estate.

After determining that a trust could qualify as a real estate professional, the court analyzed whether the trust was materially participating in the rental activities of the LLC. Noting that three of the trustees participated in the trust's real estate operations full-time, that the trust's real estate operations were substantial, and the trust had practically no other operations, the court concluded that the trust materially participated in the real property trades and businesses "considering the activities of all six trustees in their roles as trustees and employees of the LLC." The court concluded that the activities of the trustees as employees of the trade and business activity should be taken into account in determining whether a trust materially participates in a trade or business activity.

The IRS issued Technical Advice Memorandum 200733023 and 201317010 as well as Letter Ruling 2010029014, which reiterates its position to disregard *Carter* and *Aragona* and focus solely on the trustee's involvement in the operations of a business's activities on a regular, continuous, and substantial basis. However, these documents may not be cited as precedent. Further, the Senate Report to Section 469 provides "the taxpayer must be involved in the operations of the activity on a regular, continuous and substantial basis. This standard is based on the material participation standards under ... Section 2032A (relating to valuation of farm property for purposes of the estate tax)."[17] Section 2032A Regulations address the manner in which a trust establishes material participation.[18] Specifically, material participation under 2032A focused on the actual activities performed rather than the title or capacity of the decedent or family participant.

Regulations Section 20.2032A-3(f)(2) states that material participation is determined by looking at the activities performed by a participant in whatever capacity rendered. Section 20.2032A-3(f)(1) states that where property is owned by a trust, an arrangement called material participation is generally found where the participating individual is the trustee or in an employment relationship such that the participating individual is employed by the business owned by the trust . It is apparent that when addressing the issue of material participation in *Aragona*, the court considered the activities of the trustees as employees of the real property trade or business. And in *Carter*, the court examined all the trust activities and the fiduciaries activities, to include agents and employees to resolve the issue of material participation.

Addressing the issue of material participation requires a taxpayer to participate in activity beyond that of a normal investor so that limitations on passive activity losses or the net investment income tax can be avoided. By applying the methodology outlined in Section 2032A when addressing the question of material participation in the context of trusts and estate, the focus becomes the multiple means by which a fiduciary may materially participate. Both *Aragona* and *Carter* provide a script of the manner and level of activity necessary to distinguish conduct of an active business from mere passive ownership of income producing assets.

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1. IRC §469(d).
2. IRC §469(c)(2).
3. IRC §1411.
4. IRC §1411(c)(1)(A).
5. IRC §469(l)(l).
6. Senate Report No. 99-313.
7. 256 F.Supp.2d 536 (N.D. Tex 2003).
10. 142 T.C. No. 9 (Mar. 27, 2014).
17. Senate Report No. 99-313.
18. IRC §2032A.