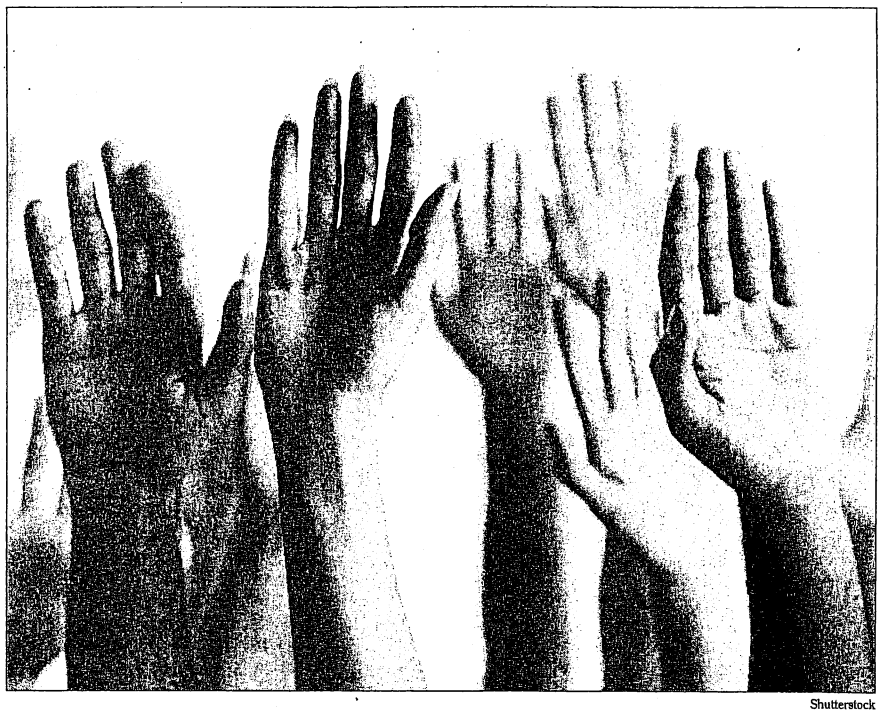
*Trust*able guidance on material participation?



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By Stefanie J. Lipson and Lora A. Cicconi

In a much awaited decision addressing whether a complex trust can "materially participate" for purposes of the passive activity loss rules of Internal Revenue Code Section 469 (and, by extension, the 3.8 percent "Medicare" tax under Section 1411), the Tax Court in *Frank Aragona Trust v. Commissioner* (142 T.C. No. 9, March 27, 2014) has confirmed that services performed by individual trustees *on behalf of* a trust can be considered personal services performed *by* the trust for purposes of determining whether a trust materially participated in a real estate trade or business.

The passive activity loss rules in Section 469 limit the ability of certain taxpayers, including trusts, to deduct net passive losses for the year. A passive activity is any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate. These rules are imported into Section 1411 and exclude income from an active trade or business in which the taxpayer materially participates from the 3.8 percent Medicare tax. For purposes of Section 1411, the determination of whether an activity is a "trade or business" is made *at the entity level*, while the determination of whether a taxpayer is active with respect to a trade or business is made *at the taxpayer level* by applying material participation test.

But who "participates" in the case of a trust? Prior to *Aragona Trust*, the guidance was minimal as to how (or if) a trust could materially participate in a business. The primary authority on the issue was the district court decision *Mattie V. Carter v. United States* (256 F. Supp 2d. 536, N.D. Tex. (2003)), in which the court found that a trust materially participated in the operations of a cattle ranch by looking to the participation of all persons who conducted business on behalf of the trust, both trustee fiduciaries and non-trustee employees. However, the IRS rejected this rationale in at least two subsequent Technical Advice Memoranda, in one finding that the appointment of "special trustees" involved in the daily operations of the business was insufficient to establish that the trust materially participated because they lacked sufficient decision making authority to qualify as fiduciaries (TAM 200733023) and, in another, finding that a special trustee's actions as trust fiduciary, limited to voting and selling stock, were the only activities that would be considered for purposes of the material participation test, notwithstanding his multiple roles as owner, beneficiary, president and trustee (TAM 201317010).

In the first direct Tax Court ruling on the issue of a trust's material participation, *Aragona Trust* concentrated on the narrow question of whether a trust can qualify for the "real estate professional" exception to the passive loss rules. Under this exception, a taxpayer's rental real estate income is *not* considered passive if (1) more than one-half of the personal services performed in the taxpayer's trades or businesses during the year are performed in real property businesses in which the taxpayer materially participates, *and* (2) the taxpayer performs more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates. The material participation test is met if the taxpayer participates in the trade or business on a regular, continuous and substantial basis.

In *Aragona Trust*, the taxpayer was a Michigan complex trust that owned and managed the trust's rental real estate properties through a wholly owned LLC. Three of the six trustees worked full time for the LLC, two of whom also separately held minority interests in the trust's real estate. Consistent with *Mattie Carter* and contrary to the IRS's argument, the Tax Court found that work performed by the trustees as part of their trustee duties could be considered personal services performed by the trust. Further, the Tax Court allowed the actions of the trustees as employees of the LLC to be considered in applying the material participation test, reasoning that they retained their fiduciary duties of loyalty to the trust even while acting in their capacities as employees of the LLC. In reaching this result, the Tax Court cited a Michigan state case which held that the trustees of a trust that wholly owned a corporation were not relieved of their fiduciary trustee obligations in carrying out their duties as directors of the corporation.

While the Tax Court ultimately concluded that the trust had materially participated and qualified for the real estate professional exception, a number of questions remain unanswered. The Tax Court purposefully declined to address whether the activities of the trust's non-trustee employees would be considered in the material participation test, leaving open the ambiguity surrounding the existing *Mattie Carter* and TAM decisions. In addition, the opinion stops short of addressing whether the trust in fact met the two-prong objective hours test because the IRS failed to put forth that argument. Further, it has already been suggested that the IRS may appeal the decision, provide notice of nonacquiescence or promulgate contrary regulations. Thus, until further guidance is issued, tax advisors should consider these additional open questions when applying the material participation test in the case of a trust:

Trustee Activity: How should a trustee's hours be counted to meet the various material participation "safe harbor" tests based upon hours? While a majority of trustees were not required to materially participate in *Aragona Trust*, what threshold is sufficient where there are multiple trustees?

Duty of Loyalty: The Tax Court's decision to consider the trustees' activities as employees of the LLC turned squarely on a state law analysis that the trustees' duty of loyalty to the trust beneficiaries carried through to their actions as employees of the wholly-owned LLC. Would the analysis be different had the employer not been wholly owned by the trust?

Corporate Trustee: Can a corporate trustee perform personal services *on behalf of* a trust where the Tax Court's analysis, relying on the Section 469 regulations, focused on the personal services provided by *individual* trustees? If a corporate trustee is serving, will the actions of an individual trust officer or other employee of the corporate trustee be treated the same as an individual trustee?

Medicare Tax: Because the material participation test is now crucial to determining whether the Medicare tax will apply to certain income, practitioners are looking to *Aragona Trust* to plan around this tax at the trust level. Under recent oral guidance from the IRS, the character of income at the trust level will control in determining the imposition of the Medicare tax, even when the income is distributed from the trust to a beneficiary. Assuming this guidance is observed, *Aragona Trust* suggests that properly designating active trustees may allow a trust to avoid characterization of its income as passive for purposes of the Medicare tax even where the income is distributed to a non-active beneficiary. But does this comport with general principles of taxation of trusts under subchapter J?

Because of the gaps in the *Aragona Trust* decision and the contradictions with existing IRS rulings, we should expect further comment from the IRS, leaving practitioners awaiting guidance once again.

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