March 6, 2014

CC:PA:LPD:PR (REG-130843-13)
Internal Revenue Service
Room 5205, PO Box 7604
Ben Franklin Station, Washington, DC 20044

Submitted Electronically at http://www.regulations.gov (IRS-REG-130843-13)

RE: Material Participation of Trusts and Estates

Dear Ladies and Gentlemen:

The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law (“RPTE Section”). They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

Lisa M. Rico, Chair of the Business Planning Group, and Sasha A. Klein, Vice-Chair of the Individual and Fiduciary Income Tax Committee, supervised the preparation of these comments and participated in their preparation. The following individuals contributed to the drafting of these comments: Richard L. Dees, Hugh F. Drake, Dana M. Foley, Steven B. Gorin, Kristen F. Hager, Elizabeth Lindsay-Ochoa, Daniel H. McCarthy, Christine Quigley, Adam D. Reid, William I. Sanderson, Karen Sandler Steinert, and Brian Tsu. These comments were reviewed by Edward F. Koren on behalf of the RPTE Section’s Committee on Governmental Submissions (“COGS”).

Although members of the RPTE Section who participated in preparing these comments and recommendations have clients who would be affected by the Federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or to otherwise influence the development or the outcome of, the specific subject matter of these comments.
We thank you for your consideration and are available to discuss any matters relating to this project. Any questions should be addressed to Lisa M. Rico, (781) 328-6140, at lrico@sdr-law.com.

Sincerely,

Susan G. Talley
Section Chair

cc:  Cara Lee T. Neville, Secretary, American Bar Association
     Thomas M. Susman, Governmental Affairs, American Bar Association
EXECUTIVE SUMMARY

Internal Revenue Code section 1411(a)(2) imposes a net investment income tax on estates and trusts. Net investment income includes gross income derived from a trade or business if such trade or business is a passive activity, as determined under Internal Revenue Code section 469. An activity that involves the conduct of a trade or business in which the taxpayer does not materially participate is a passive activity.¹ The Treasury Department and the Internal Revenue Service issued final regulations on Internal Revenue Code section 1411 on December 2, 2013. The preamble to the final regulations indicated that guidance on whether an estate or trust materially participates in an activity would be appropriately addressed in the section 469 regulations.² We agree, and note that Treasury regulations section 1.469-5T(g) has been reserved for "Material participation of estates and trusts." Furthermore, the only published case on this issue is the Mattie Carter Trust v. United States, a Fifth Circuit District Court case.³ While Mattie Carter may provide an appropriate starting point for analysis, it considered only the specific facts at issue and therefore does not provide sufficient guidance for global application. We, therefore, respectfully request that the Treasury Department and the Internal Revenue Service open a regulation project under Internal Revenue Code section 469 to provide guidance on material participation of trusts and estates.

COMMENT AND REQUEST FOR TREASURY REGULATIONS

I. Current Law

Internal Revenue Code section 1411(a)(2) imposes the net investment income tax on the lesser of (A) an estate or non-grantor trust's ⁴ undistributed net investment income, or (B) the excess of:

(i) the estate's or trust's adjusted gross income over
(ii) the dollar amount at which the highest tax bracket begins for the taxable year.

Net investment income includes income derived in the ordinary course of a trade or business if that business is a passive activity (within the meaning of Internal Revenue Code section 469) with respect to the taxpayer.⁵

¹ I.R.C. § 469(a)(2)(A), (c)(1); emphasis added.
² TD 9644, December 2, 2013. Treasury Regulations § 1.469-5T(a) addresses material participation by individuals.
⁴ The NII of a grantor trust will be determined by the activity of the grantor and taxable to her individually.
⁵ Treasury Regulations § 1.1411-4(b).
Treasury regulations section 1.469-5T(a) provides seven separate tests by which an individual may be considered to meet requisite requirements for "material participation." If the taxpayer is an individual, his or her identity is easily determined. If the taxpayer is a C Corporation subject to section 469, regulations govern which owners' actions are counted towards material participation. Where the taxpayer is an estate or trust, however, the law is uncertain. As noted above, the regulations section 1.469-5T(g) regarding the material participation of trusts and estates is reserved.

The Senate Report accompanying the Tax Reform Act of 1986 suggests that an estate or trust materially participates in an activity if the fiduciary "in its capacity as such" participates. Neither the Code nor its regulations adopt this as a requirement, although the Service appears to view it as such. Given that a trust is not a legal entity but rather a relationship between the person(s) holding title and managing assets and the person(s) benefitting from such ownership, we respectfully request further exploration regarding the trustee’s role.

The *Mattie Carter Trust* case considered the activities of both the trustee and its employees and agents, including a beneficiary. In that case, the single, individual trustee was engaged directly in a business (rather than through an entity). The case did not, however, analyze the actions of corporate trustees, private trust companies, or beneficiaries in general. Therefore, we respectfully suggest that further exploration regarding actions regarding trusts would be appropriate.

II. Scope of Regulations Request

As a result, we respectfully request that the Treasury Department open a project to implement regulations under the reserved section 1.469-5T(g), "Material Participation of Estates and Trusts". New regulations might answer the following questions:

A. Whose participation is relevant to a determination of whether the estate or trust materially participates in the activity?

B. What are the relevant actions of those persons toward material participation?

C. What level of action is required to constitute material participation?

---

6 Treas. Reg. § 1.469-1T(g).
7 S. Rep. No. 99-313 (1986), at 735 and n.87; the Senate Report also notes that, in the case of a grantor trust, material participation is determined by the activity of the grantor.
8 We believe that the answers to these questions will necessarily provide guidance as to the application of the grouping rules under regulation 1.469-4. Depending on the regulations provided, however, some level of guidance may also be required with respect to how an estate or trust may group its activities, and, specifically, whose participation may be counted towards grouped activities.
III. Items for Consideration in Regulations Project

A. Whose activities should be considered for purposes of determining material participation?

A passive activity is any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate.9 There is no guidance on what constitutes material participation where the taxpayer is an estate or trust.

A determination of material participation based on the "owner" of an estate or trust is frustrated by the nature of the fiduciary relationship which bifurcates legal and beneficial ownership. This commentary presumes that there should be neither a tax benefit nor a tax detriment to holding an activity in an estate or trust rather than individually. We request, therefore, that regulations address the extent to which the activities of the following persons should be counted in determining the material participation of an estate or trust:

1. Individual Fiduciaries. Such fiduciaries may include (a) individual executors and trustees, (b) so-called investment trustees or special trustees whose fiduciary duties are limited to management of specific or all trust assets (where permitted by state law), and (c) where either state law or the trust instrument do not allow for such a limited-scope fiduciary, investment advisors acting in a fiduciary capacity.

2. Corporate Fiduciaries, including Private Trust Companies. If a corporate fiduciary is engaged in the operation of an estate- or trust-owned business, will the activities of the corporate fiduciary’s employees, agents, or a combination thereof be counted towards material participation?

3. Non-Fiduciary Agents. To the extent that, pursuant to state law or the governing instrument, the fiduciary exercises the authority to delegate management of an activity to an agent, such as an investment advisor, protector or Direction Advisor (as defined under Delaware law (12 Del. C. §3313), while retaining any level of fiduciary liability for that agent's actions, will that agent's activities be counted in determining material participation?

4. Beneficiaries. Should a beneficiary’s activities count towards the determination of material participation? If there are multiple beneficiaries, should their activities be aggregated?

5. The Grantor or Decedent. If a grantor or decedent materially participated in an activity during life, there is often a post-death transition period in which direct, active involvement in the business (either by the fiduciaries or beneficiaries) may be inconsistent or unclear. In an effort not to unfairly penalize family businesses, we request that regulations as address the issue of whether in the case of a decedent, the decedent’s activity should be counted.

---

9 I.R.C. § 469(c)(1) (emphasis added).
B. What are the relevant actions that count towards material participation?

Once it is determined whose activities count towards material participation, the next relevant analysis would be which activities of those persons should be counted. This analysis might include:

1. In what capacity must those activities be performed, in a fiduciary capacity or non-fiduciary capacity?

2. How do you separate activities performed in a fiduciary capacity from those performed in a non-fiduciary capacity?

C. What level of relevant action is required for the trust to materially participate?

To the extent that the activities of one or more individuals may be counted towards the material participation by an estate or trust, we request that the regulations set a threshold level of required action. In addition, if there are co-fiduciaries, agents of fiduciaries or beneficiaries materially participating can the activities of the multiple parties be aggregated?

In the interim, just as the Service has allowed taxpayers to choose between proposed and final regulations for tax years beginning before January 1, 2014 for the purpose of applying the net investment income tax, we request that taxpayers be allowed to rely upon any reasonable method to demonstrate the regular, continuous and substantial involvement in an estate- or trust-owned business prior to the promulgation of regulations.

CONCLUSION

We respectfully request that the Treasury open a regulations project to provide guidance as to the material participation of an estate or trust under Internal Revenue Code section 469. In the absence of further regulations, sections 469 and 1411 may be inconsistently applied in the estate and trust context, with the distinct possibility that family-owned businesses and less sophisticated taxpayers would be unfairly disadvantaged. We believe that implementation of regulations consistent with the foregoing recommendations would minimize these risks and provide a framework to implement the legislative intent of both Code sections.

We plan to submit detailed recommendations analyzing ideas that we respectfully suggest that the government consider in the next few months.