January 20, 2015

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Material Participation by a Trust or Estate Under Section 469.

Dear Commissioner Koskinen:

Enclosed please find comments on proposed guidance regarding material participation by a trust or estate under Internal Revenue Code section 469 (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

Armando Gomez
Chair, Section of Taxation

Enclosure

cc: Hon. Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
    Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
    Hon. William J. Wilkins, Chief Counsel, Internal Revenue Service
    Thomas C. West, Tax Legislative Counsel, Department of the Treasury
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON MATERIAL PARTICIPATION BY A TRUST OR ESTATE UNDER INTERNAL REVENUE CODE SECTION 469

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by David A. Berek, Richard L. Dees, Irene C. Estrada, Steven B. Gorin, and Lisa M. Rico of the Section's Committee on Fiduciary Income Tax, and C. Wells Hall III and Laura D. Howell-Smith of the Section's Committee on S Corporations. These Comments were reviewed by Kevin D. Anderson of the Section's Committee on Government Submissions, Kurt L. P. Lawson, the Section’s Council Director for the Committee on Fiduciary Income Tax, John O. Tannenbaum, the Section’s Council Director for the Committee on S Corporations, and Peter H. Blessing, the Section’s Vice Chair (Government Relations).

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal income tax principles addressed by these Comments, or have advised clients on the application of such rules, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: January 20, 2015
EXECUTIVE SUMMARY

The following Comments are submitted in response to the request for comments made by the Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) in the preamble to the Regulations under section 1411 issued on December 2, 2013, with respect to guidance as to material participation of estates and trusts to be issued under Regulations section 1.469-5T(g), presently reserved for rules on the “Material participation of estates and trusts.” The 2014-2015 Priority Guidance Plan includes “Guidance regarding material participation by trusts and estates for purposes of §469” for the first time.

Section 469 prevents certain taxpayers, including estates and trusts, from deducting losses from passive activities (“passive losses”) against non-passive or portfolio income, such as salary and investment income. Under section 469, a passive activity is a trade or business in which the taxpayer does not materially participate, or a rental activity, except in the case of a real estate professional. To date, only a snippet of legislative history and two published cases, Frank Aragona Trust v. Commissioner and Mattie Carter Trust v. United States, provide any guidance on material participation by a fiduciary for purposes of section 469.

The need for guidance on this issue has increased with the enactment of the 3.8% tax (the “NII Tax”) on individuals, trusts and estates under section 1411. The NII Tax applies to the taxpayer’s “net investment income,” including income from a passive activity above an adjusted gross income threshold. The open issues and our recommendations are summarized below:

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1 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
4 I.R.C. § 469(c)(1).
5 I.R.C. § 469(c)(2).
7 142 T.C. No. 9 (Mar. 27, 2014) (“Aragon Trust”).
9 But see Section II.A.3.c of these comments discussing the significance of the Regulations under section 2032A in determining fiduciary material participation in the absence of applicable Regulations under section 469.
10 I.R.C. § 1411(c)(1).
11 Actually modified adjusted gross income for an individual, which includes certain net foreign personal service income. I.R.C. § 1411(d).
12 I.R.C. § 1411(b). The threshold amount for a single individual is $200,000 and for a married individual is $250,000. In the case of an estate or trust, section 1411(a)(2) provides that the threshold amount is the minimum income level at which the top marginal rate applies ($12,150 in
We recommend that Regulations provide that:

A. With respect to the question of whose participation is relevant as to whether a trust or estate materially participates in the trade or business or rental activity owned by a trust or estate, it is the participation of each person owing fiduciary duties to the beneficiaries of the trust or estate (the “fiduciary”) with decision making authority and the power to act on behalf of the trust or estate.

B. In determining whether a trust or estate materially participates in a trade or business or rental activity it owns under the general Facts and Circumstances Test described below, the trust or estate may consider the actions of its fiduciary undertaken in any capacity in the trade or business or rental activity if undertaken while owing fiduciary duties to the beneficiaries of the trust or estate.

C. A fiduciary’s participation in a trade or business or rental activity owned by a trust or estate shall constitute material participation by the trust or estate when the fiduciary satisfies either of two alternative tests: (1) an objective hours based test known as the “Parity Test” or (2) a subjective test known as the “Facts and Circumstances Test.” Because the Parity Test is intended to provide parallel treatment whether the trade or business or rental activity is owned in a trust or estate, or outright, the Parity Test applies the seven individual hours tests prescribed by the Regulations for determining whether an individual materially participated in a trade or business or rental activity (the “Individual Hours Tests”) to a fiduciary. Under the Parity Test those individual fiduciaries should satisfy the Individual Hours Tests on the basis of owing fiduciary duties to the beneficiaries of the trust or estate and have decision making authority and the power to act on behalf of the trust or estate with respect to the trade or business or rental activity. The Facts and Circumstances Test, on the other hand, aggregates the participation of all of the fiduciaries of the trust or estate and all their employees and agents. The real estate professional exception, the significant participation passive activity (“SPPA”) recharacterization and any other test under section 469 based on hours other than determining material participation (each a “Special Individual Hours Test”) also should apply to trusts and estates, counting fiduciary hours in the same manner as under the Facts and Circumstances Test.

2014), and the threshold applies to adjusted gross income, an amount which has been reduced by deductions for distributions. Interestingly the threshold for individuals is not adjusted for inflation, but the threshold for trusts and estates is inflation adjusted.

13 Like individual limited partners, a trust or estate that is a limited partner may only avail itself of the material participation tests under Regulations section 1.469-5T(a)(1), (5), and (6).

14 Regulation section 1.469-5T(b)(2)(iii) provides that for purposes of the seventh individual material participation test (the facts and circumstances test), an individual must participate in the activity for more than 100 hours.
D. If a fiduciary who has authority to participate in the trade or business or rental activity on behalf of the trust or estate is a corporate trustee or trust company, including a private trust company (“PTC”), the actions of the employees and agents of the corporate trustee or trust company should be considered in determining whether the trust or estate materially participates in the trade or business or rental activity under the Facts and Circumstances Test.

E. The members of the Section who participated in drafting of these Comments were unable to reach a consensus favoring whether the material participation of the trustee of a trust or executor of an estate (the “Fiduciary Participation Test”), or the material participation of the taxpayer (either the trust or estate or the beneficiary, depending on whether gain or income from a trade or business or rental activity is distributed to the beneficiary) (the “Taxpayer Participation Test”) should be determinative of whether income or loss of a trust or estate is active or passive. However, we offer these Comments showing the merits of and justifications for each approach.

With respect to determining whether income or loss retained in a non-grantor trust or estate is active or passive, proponents of both the Fiduciary Participation Test and the Taxpayer Participation Test agree that the material participation of the fiduciary, not the beneficiary, is relevant. In this case, the trust or estate is the taxpayer – therefore, the fiduciary’s participation should determine whether the trust or estate materially participates in the trade or business or rental activity of the trust or estate. Proponents of the Fiduciary Participation Test further recommend that a recharacterization rule (the “Beneficiary Recharacterization Rule”) apply when income is distributed to a beneficiary who materially participates in the trade or business or rental activity generating the income. Proponents of the Fiduciary Participation Test believe that the Beneficiary Recharacterization Rule is good tax policy consistent with the legislative history of section 469.

Proponents of the Taxpayer Participation Test believe that the material participation of the fiduciary should determine whether gain or income or loss of a trade or business or rental activity retained in a non-grantor trust or estate is active or passive, and the material participation of the beneficiary, or lack thereof, should determine whether gain or income or loss of a trade or business or rental activity distributed by a trust or estate to the beneficiary is active or passive. Proponents of the Taxpayer Participation Test cite as authority the language of section 1411(c)(2)(A) and Regulation section 1.1411-5(b), both of which define a passive activity as a trade or business which is a passive activity with respect to the taxpayer within the meaning of section 469. Proponents of the Taxpayer Participation Test believe that this result is consistent with the rules under subchapter J dealing with the determination of the character of income distributed to beneficiaries (the Subchapter J Character Rule) (in that the character of the income from a trade or business or rental activity is determined at the trust or estate level under Subchapter J, but not whether the income is active or passive with respect to the beneficiary), and the purposes of the net investment income tax
under section 1411 (which attaches based on whether the taxpayer subject to tax on the income from a trade or business or rental activity materially participates in the trade or business or rental activity).

Both the Fiduciary Participation Test, coupled with the Beneficiary Recharacterization Rule, and the Taxpayer Participation Test, get to the same result with respect to income currently distributed to a beneficiary who materially participates in the trade or business or rental activity, on a basis consistent with the purposes of section 469 and section 1411, but get to different results with respect to a beneficiary who does not materially participate in such activity.

F. Certain transitory events involving trusts and estates require special material participation rules:

1. We recommend that the fiduciary material participation Regulations provide that any gain or loss recognized by a qualified subchapter S trust (QSST) upon the sale of S corporation stock be characterized as active or passive according to the material participation of the beneficiary of the QSST, the deemed owner of the S corporation stock prior to the sale of the stock.

2. When an event causes a realization of a gain or loss, such as a trust converting from a grantor trust to a non-grantor trust, for purposes of section 469, we recommend that the material participation of the person owning the trade or business immediately before the event should determine whether the income or loss is active or passive, rather than the actual taxpayer who owned the property only for the transitory event.

3. A charitable remainder trust (“CRT”) does not pay taxes and is not subject to section 469. Income accumulated by the CRT is taxed to the CRT beneficiary when distributed under a “tier” system. Because unrelated business income earned by the CRT is subject to penalty taxes, we recommend that all income accrued during the term of the CRT should be deemed passive income. However, pre-contribution gain for purposes of section 469 should be classified as active or passive at the time the property is contributed as if sold on the date of the contribution for fair market value.

4. Because death is an unpredictable event, we recommend that an estate or other testamentary successor to the deceased should be able to qualify under any Individual Hours Test that would have applied if the decedent would have lived without the decedent actually materially participating. Two of the Individual Hours Tests could be satisfied: the “five years out of ten” rule and the three years rule for a personal service business.
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DISCUSSION

I. BACKGROUND

In the preamble to the Final Regulations under section 1411, Treasury and the Service observed:

Several commentators noted that the enactment of section 1411 has created an additional and compelling reason for the need to determine how an estate or a trust materially participates in an activity. An estate’s or a trust’s income or gain from a trade or business activity in which the entity materially participates does not constitute income from a passive activity under section 469 or section 1411. One commentator noted that, in the case of estates or trusts that have not incurred losses from a passive activity, those estates and trusts previously have not had to characterize either losses or income under section 469.

Commentators stated that the legislative history of section 469 suggests that only a fiduciary’s participation should control in determining whether an estate or a trust materially participates in a trade or business activity. In certain situations, case law has concluded that the participation of beneficiaries and employees also should be considered. One commentator noted that case law and Service guidance conflict, leaving taxpayers with uncertainty in determining the material participation of a trust.

A number of commentators requested that the Treasury Department and the IRS provide guidance on material participation of estates and trusts. However, the commentators acknowledged that guidance on material participation would apply under both sections 469 and 1411, and consequently suggested the initiation of a guidance project to propose the rules for which § 1.469-5T(g) has been reserved.

The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to include guidance on material participation of estates and trusts. The Treasury Department and the IRS, however, believe
that this guidance would be addressed more appropriately in the section 469 regulations.15

These Comments were developed with five goals and objectives. First, we have prepared these Comments to assist Treasury and the Service in promulgating Regulations under reserved Regulation section 1.469-5T(g) addressing material participation by a trust or estate. Second, although the Regulations will be proposed under section 469, we believe the Regulations should be consistent with the purposes of section 1411. Third, we have attempted to provide understandable, neutral rules that neither penalize nor incentivize the use of trusts. Fourth, we have tried to preserve existing law, while providing simpler and more certain rules. Finally, we believe that the Regulations should appropriately reflect the unique nature of fiduciary arrangements, such as trusts and estates, under state law.

II. CURRENT LAW

A. Relevant Tax Law Authorities

1. Statutory Law

Section 469 limits the deductibility of certain losses against non-passive or portfolio income, such as salary and net earnings from self-employment, and investment income, such as dividends, interest and capital gains. Congress intended that losses from activities in which the taxpayer does not materially participate (“passive activities”) would be deductible only against the taxpayer’s income from other passive activities,16 until the complete disposition of the passive activity. Generally, for purposes of the passive activity loss limitations, all rental activities are deemed to be passive.17 While Congress borrowed the concept of material participation from sections 1402 and 2032A, it also granted Treasury authority to promulgate Regulations defining material participation for purposes of section 469.18

Congress subjected trusts and estates to section 469, without providing any statutory guidance on determining whether the losses under these fiduciary arrangements are active or passive. This silence has left a void for the Treasury to fill. We understand that Treasury now anticipates filling this void with Regulations defining material participation for trusts and estates.

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16 I.R.C. § 469(d).
17 I.R.C. § 469(c)(2). However, Congress later provided an exception for the rental activities of certain real estate professionals in section 469(c)(7). Further, Regulation section 1.469-1T(e)(3)(ii) provides for a number of limited exceptions for treating an activity involving the use of tangible property as not a rental activity for a taxable year.
18 I.R.C. § 469(l)(1).
Section 1411, enacted by the Health Care and Education Reconciliation Act of 2010, provides for a 3.8% tax (the “NII Tax”) on a taxpayer’s “net investment income” in excess of certain statutorily defined modified adjusted gross income (“MAGI”) thresholds for taxable years beginning after December 31, 2012. Proposed Regulations under section 1411 were published on December 5, 2012, with a proposed effective date for taxable years beginning after December 31, 2013. Final Regulations under section 1411 were published on December 2, 2013, and apply to taxable years beginning after December 31, 2013, except that Regulations section 1.1411-3(d) (rules for charitable remainder trusts) applies to taxable years beginning after December 31, 2012. Certain Regulations originally proposed in 2012 were revised and reproposed.

The NII Tax is imposed on individuals, trusts and estates. Included in the definition of net investment income is income from trades or businesses that are passive activities within the meaning of section 469. The Regulations under section 1411 tie the definition of a passive activity to the Regulations under section 469, which generally is intended to promote simplicity of the tax system.

2. Material Participation by Individuals under Section 469

The Regulations provide certain quantifiable, objective tests based on the number of hours worked during the taxable year to determine whether an individual “materially participates” in a particular activity in a taxable year. Pursuant to these Regulations, an individual will be found to “materially participate” in an activity in which the individual owns an interest at the time the work is done for purposes of section 469 if the individual meets one of the following seven tests, each involving a minimum number of hours of participation in the activity (“Individual Hours Tests”).

1. The individual participates in the activity for more than 500 hours during the year.

2. The individual’s participation for the taxable year constitutes “substantially all” of the participation in such activity of all

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23 If an activity does not rise to the level of a trade or business, under section 1411(c)(1)(A)(i) its income is taxable if it is “interest, dividends, annuities, royalties, and rents . . .”
24 Reg. § 1.469-5(f).
25 The italicized language appears in Regulation section 1.469-5(f), but not Temporary Regulation section 1.469-5T(a).
26 Temp. Reg. § 1.469-5T(a).
individuals (including individuals who are not owners of interests in the activity) for such year.

3. The individual participates in the activity for more than 100 hours during the taxable year, and such individual’s participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year.

4. The activity is a “significant participation activity” and the individual’s aggregate participation in all significant participation activities during such year exceeds 500 hours.

5. The individual materially participated in the activity for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year.

6. The activity is a “personal service activity” and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.

7. Based on “all of the facts and circumstances” the individual participates in the activity on a “regular, continuous, and substantial” basis during such year, provided the individual participates for more than 100 hours during the year in such activity.\(^\text{27}\)

If the individual only holds a limited partner interest in the activity, the individual must establish material participation in the activity for the taxable year by satisfying test #1, 5 or 6.\(^\text{28}\)

Section 469(h)(5) states: “In determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer shall be taken into account.” The Regulations further elaborate that with respect to any married person, any participation by such person’s spouse in the activity during the taxable year (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) shall be treated, for purposes of applying section 469 and the Regulations

\(^{27}\) The 100 hour minimum for the “facts and circumstances” test #7 is set forth in Temporary Regulation section 1.469-5T(b)(2)(iii) (“If an individual participates in an activity for 100 hours or less during the taxable year, such individual will not be treated as materially participating in such activity for the taxable year under section (a)(7) of this section.”)

\(^{28}\) Temp. Reg. § 1.469-5T(e)(2).
thereunder to such person, as participation by such person in the activity during the taxable year.  

The Regulations generally provide that any work done by an individual, without regard to the capacity in which the individual does the work, in connection with an activity in which the individual owns an interest at the time the work is done is treated as participation by the individual in the activity. However, work done for a principal purpose of avoiding the application of the passive activity loss limitations under section 469 is not treated as participation in an activity and any work done by an individual in the individual’s capacity as an investor in an activity (e.g., studying and reviewing financial statements or reports on activity operations, preparing or compiling summaries or analyses of the finances or operations of the activity for the individual’s own use, and monitoring the finances or operations of the activity in a non-managerial capacity) is not treated as participation in the activity, unless the individual also is directly involved in the day-to-day management or operations of the activity. 

The Regulations further provide that an individual who satisfies the requirements of any participation standard (whether or not referred to as “material participation”) under any provision (including sections 1402 and 2032A and the Regulations thereunder) other than section 469 and the Regulations thereunder is not taken into account in determining whether such individual materially participates in any activity for any taxable year for purposes of section 469 and the Regulations thereunder.

3. Material Participation by Non-Grantor Trusts and Estates under Section 469

The Code and the Regulations do not describe how material participation by a trust or estate is to be determined for purposes of section 469. Although the limited tax guidance in this area can be read consistently, the post-2012 sources of Service guidance in this area diverge from the earlier Service guidance. Regulations section 1.469-5T(g) has been reserved for Regulations applying the material participation requirements to trusts and estates. Until Regulations are promulgated, the “regular, continuous, and substantial” standard under section 469(h)(1) applies for purposes of determining whether a trust or estate satisfies the material participation requirement of section 469.

29 Temp. Reg. § 1.469-5T(f)(3). This Regulation allows the hours worked by spouses to be aggregated for purposes of determining material participation.
30 Reg. § 1.469-5(f)(1).
33 However, grantor trusts are ignored for purposes of sections 469 and 1411. Reg. § 1.1411-3(b)(1)(v). Therefore, unless otherwise qualified, any reference to a trust under these Comments excludes a grantor trust or any portion of a trust that is treated as a grantor trust.
a. The Legislative History of Section 469

The most broadly accepted guidance on how a trust or estate can materially participate for purposes of section 469 is the legislative history of the Tax Reform Act of 1986 (the “1986 Tax Reform Act”). The Senate Report accompanying the 1986 Tax Reform Act, which included section 469, treats an estate or trust as materially participating in an activity “if an executor or fiduciary, in his capacity as such, is so participating . . .” The Senate Report further provides that “[i]n the case of a grantor trust . . . material participation is determined at the grantor rather than the entity level.”

b. Case Law under Section 469

The only precedential authorities specifically applying section 459 to determine whether a trust is materially participating include the recently decided Tax Court case, Aragona Trust, and an older federal district court case, Carter Trust. The two cases take different approaches when analyzing whether a trust is materially participating in an activity. Aragona Trust, decided March 27, 2014, considered only the actions of the trustees undertaken in multiple capacities to determine whether the trust materially participated in its real estate and rental activities. The Carter Trust decision, decided on April 11, 2003, considered the actions of the trust, through the agents and employees of the trust, as actions of the trust and attributed such actions to the trustee. Both cases demonstrate the willingness of the courts to find that a trust materially participated under appropriate facts, despite the absence of regulatory guidance.

(i) The Aragona Trust Decision

In Aragona Trust, the decedent had operated numerous rental apartment buildings and real estate businesses. After he died, his five children and an attorney, as co-trustees, became the operators of the real estate activities and businesses held in trust. Because of a concern that a liability from the operation of the rental buildings could drain the other trust assets, the trustees, with probate court approval, transferred the rental buildings into a limited liability company (“LLC”) wholly owned by the trust. The three family member trustees, who had already been involved in the business with the decedent full-time, became the

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34 The Carter Trust case held that the trustee’s actions are not the exclusive method for a trust to establish material participation. Carter Trust, supra note 8, at 536. However, as discussed below, properly understood, the Carter Trust case holding does not reject relying on the trustee’s actions to determine material participation for a trust.
35 Senate Report, supra note 6, at 735.
36 Id.
37 The court indicated that it “need not and do[es] not decide whether the activities of the trust’s non-trustee employees should be disregarded.” Aragona Trust, supra note 7, at 23.
38 Although the court considered the work of the beneficiary in determining that the trust was active, the trustee had delegated to him the powers to manage the day to day operations of the business.
managers of the LLC. Because the LLC was wholly owned by the trust, and the trust had not made an entity classification election to treat the LLC as an association taxable as a corporation, the LLC was disregarded as a separate entity from the trust for federal tax purposes, although the court did not focus on the disregarded status in evaluating the issues described below.

Real estate rental activities are *per se* passive under section 469. However, Congress carved out an exception for “real estate professionals” in section 469(c)(7). The Service argued that a trust could not be a real estate professional, because a trust could not perform “personal services” as required by the statute. Rather than rely on just its real estate professional argument, however, the Service argued that the trustees’ actions as managers and employees of the wholly owned LLC could not be counted towards material participation by the trust.

The court concluded that a trust could be a real estate professional, contrary to the Service’s position in the case. The court reasoned that services performed by individual trustees on behalf of the trust may be considered personal services performed by the trust. A real estate professional must satisfy a two-part Special Individual Hours Test: (i) the taxpayer must spend at least 750 hours working in real estate trades or businesses, and (ii) those hours must be more than half the taxpayer’s hours in all trades or businesses. The court stated that it did not have to address how a trust would satisfy the Special Individual Hours Tests, because the Service only argued the trust could not be a real estate professional, not whether the trust may have satisfied the Special Individual Hours Tests.

After first 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. The heart of the court’s ruling on this issue was its analysis of state fiduciary law, rather than federal tax law. The court accepted the Service’s argument that in this case only the trustee’s activities were relevant in determining whether the trust materially participated. The Service argued that the trustees’ actions were undertaken as employees, not as trustees, and could not be considered in determining whether the trust materially participated. The court rejected the “election” theory that the trustee should have to elect in which capacity its hours should be counted, stating:

Even if the activities of the trust’s non-trustee employees should be disregarded, the activities of the trustees—

39 While *Aragona Trust* was pending in Tax Court, the Service issued CCA 201244017 (Nov. 12, 2012), which reflects the Chief Counsel’s advice that a trust cannot qualify for the real estate professional exception under section 469(c)(7)(B). The CCA concludes that Congress did not intend that a trust could qualify as a real estate professional citing the statute, regulations (which, of course, do not address trusts) and legislative history, which the Chief Counsel contends “explicitly states that this provision is intended to apply to individuals and closely-held C corporations.”
including their activities as employees of Holiday Enterprises, LLC—should be considered in determining whether the trust materially participated in its real-estate operations. The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary.

Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. Cf. In re Estate of Butterfield, 341 N.W.2d [453,] 457 (“Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy.”). Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.40

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 or businesses “considering the activities of all six trustees in their roles as trustees and employees of the LLC.” Thus, based primarily on the fact that the trustees remained subject to state law fiduciary duties as trustees of the trust even when acting as employees of the entities through which the trust conducted real estate activities, the court concluded that the activities of the trustees as employees of the trade or business activity should be taken into account in determining whether a trust materially participates in a trade or business activity.

(ii) The Carter Trust Decision

In Carter Trust, the U. S. District Court for the Northern District of Texas concluded that material participation by a trust in an activity (here, the operation of a ranch with no intervening entity) is to be determined by the aggregate participation of the fiduciaries and the employees and agents of the trust. The District Court held that a testamentary trust satisfied the section 469 material participation standard as a result of the activities of its fiduciaries, employees and agents. The testamentary trust owned a cattle ranch and, during the taxable years at issue, hired a full-time ranch manager and other full- and part-time employees

40 Aragona Trust, supra note 7, at 23-34 (citations and footnotes omitted).
to operate the ranch. Fortson, the individual trustee, managed the assets of the trust, including a 15,000 acre ranch used for cattle ranching operations and oil and gas interests.

The Service asserted that, based on the legislative history underlying section 469, material participation should be determined based solely on the activities of the trustee of the trust. Accordingly, the Service argued that if one only considers the trustee’s participation in the ranching activities, the trust did not materially participate.

The court was dismissive of the Service’s citation to the Senate Report (discussed above) accompanying the 1986 Tax Reform Act:

IRS’ contention that Carter Trust’s participation in the ranch operations should be measured by reference to Fortson [the trustee] finds no support within the plain meaning of the statute. Such a contention is arbitrary, subverts common sense, and attempts to create ambiguity where there is none.\(^{41}\)

Recognizing that no Regulations had been issued yet under section 469 regarding trust material participation, the court nevertheless rejected the Service’s argument, relying primarily on its determination that the statutory language of section 469—rather than the underlying legislative history—should apply to determine material participation. Under section 469, the material participation test is applied to the “taxpayer.” Because, under section 469(a)(2)(A), trusts are defined as “taxpayers,” the court concluded that the material participation standard applies to the trust, as opposed to the trustee. In that regard, the court stated that:

It is undisputed that Carter Trust, not [the trustee], is the taxpayer. 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 Carter Trust.\(^{42}\)

Because the material participation standard applied at the trust level, and also because “legal entities” such as trusts (as the Carter Trust identified itself)\(^{43}\) can only act through their fiduciaries, employees and agents, the court concluded that the activities of the trust’s fiduciaries, employees and agents should be considered in applying the material participation standard to the Carter Trust.

\(^{41}\) Carter Trust, supra note 8, at 541.

\(^{42}\) Id.

\(^{43}\) This likely contributed to the Court’s apparent belief that the Senate Report was inconsistent with its holding, whereas in reality under state law a trust is not an entity.
While concluding that it did not need to resort to the statute and section 469 Regulations applicable to closely-held corporations to rule in favor of the Carter Trust, the court was sympathetic to the taxpayer’s analogy to how a closely-held C corporation conducts business as a practical matter. Because the activities of all of these persons acting on behalf of the trust were regular, continuous, and substantial, the court held that the Carter Trust satisfied the section 469 material participation standard.\textsuperscript{44}

c. Section 2032A Regulations and Their Relevance to Section 469

Material participation was not a new concept in tax law when Congress adopted it for purposes of section 469. Material participation first was used under section 1402(a) to determine when a farmland owner who rented land under a crop share lease was sufficiently active to treat the rental income as self-employment income. For a landowner to materially participate, the owner had to be involved in management of the farming operation, in the management of production or in providing actual physical labor.

Congress later borrowed the concept for section 2032A to identify those decedents who should be allowed to reduce the value of their farmland for estate tax purposes. Only a decedent who had materially participated in farming (or who had family members who materially participated) could qualify to value farmland at its special use value (rather than its higher fair market value) for federal estate tax purposes.\textsuperscript{45} The relationship between sections 469 and 2032A can be seen in the Senate Report to section 469 stating:

In order to be treated as materially participating for purposes of the provision [section 469], 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 Code sections 1402(a) (relating to the self-employment tax) and 2032A (relating to valuation of farm property for purposes of the estate tax). However, the standard is modified consistently with the purposes of the passive loss provision.

Thus, precedents regarding the application of those

\textsuperscript{44} The court also noted that the trustee’s activities with regard to the ranch operations, standing alone, were regular, continuous, and substantial so as to constitute material participation by him, as trustee, during the relevant time periods. \textit{Carter Trust, supra} note 8, at 536. As a result, even if the court had accepted the legal standard promoted by the Service, the Carter Trust would have prevailed under section 469.

\textsuperscript{45} I.R.C. § 2032A. Sections 263A(d)(2) (determining whether certain farm expenses must be capitalized) and 2057 (providing whether part of the value of a family business may be excluded from the gross estate) use the same definition of material participation as section 2032A.
preexisting legal standards, whether set forth in regulations, rulings, or cases, are not intended to be controlling with regard to the passive loss rule. For example, whether or not, under existing authorities interpreting sections 1402(a) and 2032A, it could be argued that the material participation requirement (for purposes of those sections) is in certain circumstances satisfied by periodic consultation with respect to general management decisions, the standard under this provision is not satisfied thereby in the absence of regular, continuous, and substantial involvement in operations.{}

The Regulations under section 469 stress that the rules under section 2032A are not to be considered for purposes of individual material participation under section 469.{}

On the other hand, when determining how to apply the material participation test to a trust or estate under section 469, the section 2032A Regulations should be instructive, because the section 469 legislative history explicitly states that the section 469 “[material participation standard] is based on the material participation standards under [section] . . . 2032A.”

The section 2032A Regulations specifically address the manner in which a trust establishes material participation. As under the section 469 Regulations for individuals, material participation under section 2032A focuses on the actual activities performed, rather than the title or capacity of the decedent or family participant. Regulations section 20.2032A-3(f)(2) provides that material participation is determined by looking at the activities performed by a participant in whatever capacity rendered. Further, Regulations section 20.2032A-3(f)(1) specifically states that where property is owned by a trust, an arrangement calling for material participation is generally found where the participating individual is appointed as trustee, or under an “employer-employee relationship in which the participant is employed by a qualified closely-held business owned by the trust in a position requiring his material participation in the activities.”

In summary, in the absence of Regulations on fiduciary material participation under section 469, the section 2032A Regulations should be instructive as to the method for applying the material participation test to fiduciaries. Those Regulations provide that in determining whether a trustee materially participates, one should consider the actions of the trustee in whatever capacity the actions are undertaken. The two decided cases on fiduciary material participation are consistent with approach taken in the section 2032A Regulations. In determining the material participation of the trust in Aragona Trust, the court considered the activities of the trustees as employees of the real property trade or

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46 Senate Report, supra note 6, at 732.
business. In *Carter Trust* the court considered all activities of the trust and its fiduciaries, including those agents and employees acting on behalf of the trust,\(^{48}\) in determining the material participation of the trust.

By considering all of the activities of the fiduciary for purposes of section 469, the courts further align the determination of the material participation of trusts under section 469 with the determination of material participation by fiduciaries under section 2032A.

d. **Summary of Tax Authorities**

Although the *Aragona Trust* and *Carter Trust* cases were decided on different legal grounds, in both cases the involvement of the trusts, as such, in their respective ranching and real estate businesses was clear. The trusts had not acquired these businesses to shelter positive income. The trusts quite clearly were established to provide a continuum of management and ownership to these businesses following the death of the trust grantor. The courts rejected the idea that their facts showed a passive investment. We believe that Regulations addressing material participation by trusts and estates should reflect the principles of section 469 contained in these two decisions.

The Code defines the term “fiduciary” as a “guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.”\(^{49}\) The term is applied:

> to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another” and also includes a “committee or guardian of the property of an incompetent person.”\(^{50}\)

A mere agent is not a fiduciary; for example, an “agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary” under this definition.\(^{51}\)

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\(^{48}\) Because section 2032A qualification depends on family member material participation, however, Regulation section 20.2032A-3(e)(2) prohibits another person’s actions from being attributed to the material participant.

\(^{49}\) I.R.C. § 7701(a)(6).

\(^{50}\) Reg. § 301.7701-6(b)(1).

\(^{51}\) Reg. § 301.7701-6(b)(2).
B. Non-Tax Authorities Relevant to Fiduciary Material Participation and the Service Response

The Senate Report treats an estate or trust as materially participating in an activity “if an executor or fiduciary, in his capacity as such, is so participating.” “Fiduciary capacity” is not a tax term, but rather is a state trust law concept. The Senate Report fittingly ties the federal income tax consequences to the unique nature of a trust under state fiduciary law. The Code, practitioners, and these Comments, too, at times refer to a trust taking some action or another, owning an asset or disposing of an asset as if a trust were a legal entity. However, as discussed herein, under applicable state law and its common law antecedents, a trust predates the development of the law governing other modern legal entities.

A trust is a fiduciary relationship where the legal owner of the trust assets, the trustee, manages those assets for the benefit of the trust beneficiaries, the beneficial owners of the trust assets. The obligations that the trustee owes the beneficiaries are called “fiduciary” duties. The word “trust” generally is used colloquially to convey that an action the trustee is taking involves the property subject to its fiduciary duties and is, thus, for the benefit of the trust beneficiaries. The common understanding of acting in a fiduciary capacity is acting while subject to fiduciary duties.

1. The Service’s Interpretation of “Fiduciary Capacity”

Prior to 2012, all of the rulings by the Service with respect to fiduciary material participation under section 469 were consistent with this state law meaning of fiduciary capacity. The Service disagreed with the court’s holding in Carter Trust, because the actions of persons other than the trustee were attributed to the trust. The Service’s position, however, was not contrary to this state law meaning of acting in a fiduciary capacity.

In PLR 201029014, a trust owned an interest in a partnership that owned an interest in another entity (“Sub 1”). Sub 1, in turn, owned an interest in another entity (“Sub 2”). The taxpayer asked the Service to rule that the trust could materially participate in Sub 2. The purpose of the ruling is somewhat obscure: the Service did not rule on what actual activities by the trustee in Sub 2’s business would constitute material participation by the trust. Nonetheless, the Service ruled that the trust could materially participate in Sub 2 through the trustee’s regular, continuous, and substantial involvement in Sub 2’s operations, which it owned only indirectly.

The taxpayer apparently was concerned that the Service might interpret the “in such capacity” language as meaning only the exercise of those legal powers that the trustee had as the legal owner of the trust assets. Because the trust

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52 Senate Report, supra note 6, at 735.
53 PLR 201029014 (July 23, 2010).
only owned Sub 1, its legal powers were over Sub 1, not Sub 2. Although the ruling cited the Senate Report, the Service did not interpret that language as limiting the activities of the trustee that would count towards the trust’s material participation to those undertaken by the trustee as the legal owner of Sub 1. The taxpayer requesting PLR 201029014 appeared to be concerned about a cramped interpretation of the legislative history, limiting the trustee’s activities to those undertaken as the legal owner of Sub 1, and the Service agreed with the taxpayer: the trustee could count its activities undertaken as legal owner of both Sub 1 and Sub 2.\(^\text{54}\)

After 2012, the Service interpreted fiduciary capacity in its litigation position and arguments in the *Aragona Trust* litigation and in a technical advice memorandum. In TAM 201317010, the Service considered whether a trust materially participated in the activities of an S corporation for purposes of section 56(b)(2)(D).\(^\text{55}\) In TAM 201317010,\(^\text{56}\) two trusts owned an interest in an S corporation that owned a qualified subchapter S subsidiary. Each of the trusts had identical governing provisions whereby an individual, his spouse, his children and grandchildren were the beneficiaries of the trusts and another unrelated person served as the sole trustee of the trusts.

The individual beneficiary was appointed as a special trustee of the trusts, which authorized the individual beneficiary to control all decisions regarding the sale or retention of the S corporation stock. The individual beneficiary also served as the president of the qualified subchapter S subsidiary and was therefore directly involved in the day-to-day operations of the qualified subchapter S subsidiary. The sole (non-special) trustee of the trusts was not otherwise involved in the operations of the S corporation or the qualified subchapter S subsidiary.

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\(^{54}\) PLR 201029014 also reaffirmed the Service’s continuing opposition to the court’s holding in *Carter Trust*:

The focus on a trustee’s activities for purposes of section 469 accords with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner’s employees to satisfy the material participation requirement. *See* S. Rep. No. 99-313, at 735 (1986) (“the activities of [employees] . . . are not attributed to the taxpayer.”). Indeed, because an owner’s trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of other business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee. Thus, the sole means for a trust to establish material participation is if its fiduciary is involved in the operations of the activity on a regular, continuous, and substantial basis.

\(^{55}\) Section 56(b)(2)(D), dealing with adjustments in computing alternative minimum taxable income, provides an exception from the requirement that research and experimental expenditures be capitalized when “the taxpayer materially participates (within the meaning of section 469(h)) in an activity . . .”

\(^{56}\) TAM 201317010 (Apr. 26, 2013).
TAM 201317010 interpreted “fiduciary capacity” in the Senate Report as limited to the exercise of the legal rights of the trustee. In TAM 201317010, the trust asset was corporate stock, therefore, the Service concludes that only the “sale or retention of such stock and all voting of such stock” could be undertaken in a fiduciary capacity. Had the stock been individually owned by the president, his powers to manage the S corporation and its subsidiary would have been identical. If he had the power to vote, he might have elected himself as a director. The board may have elected him as an officer. He might have been hired as a janitor. His actions undertaken in any of those capacities would count towards satisfying the Individual Hours Tests. Nevertheless, in TAM 201317010, the Service determined to apply the material participation test for fiduciaries on the basis of its view of what could be done in a “fiduciary capacity”.

In the Aragona Trust case, the Service made a slightly different argument than in TAM 201317010. The Service could have argued that, as the owner of the LLC managed by managers, the trustees had no more legal power over the real estate businesses than the special trustee in TAM 201317010. Instead, it contended that the trustees’ hours worked in the real estate businesses could not be counted towards material participation by the trust because the trustees had instead “elected” to be treated as employees. The problem with this argument is that it is directly contradicted by the state law that applied to the trust. For the Service’s election argument to succeed, state fiduciary law would have to permit a trustee to remove the trustee “hat” and put on an employee “hat” when working in a trust-owned business. The Aragona Trust court ruled that Michigan state law did not allow a trustee to avoid fiduciary duties when the trust-owned business was an instrumentality through which the trust controlled various business activities.

The court relied on the state law meaning of “acting as a fiduciary”: acting while owing fiduciary duties to beneficiaries. The Service offered a narrow interpretation of “acting as a fiduciary”: exercising the powers held by the fiduciary as the legal owner of the trust assets. In TAM 201317010, this interpretation was explicit. In its arguments in Aragona Trust, the Service varied the argument slightly by asserting that actions undertaken in another capacity, for example, as an employee, necessarily could not have been undertaken as a fiduciary. The Aragona court rejected this assertion.

2. Fiduciary Duties Owed by a Trustee to the Trust and the Beneficiaries When Acting in a Capacity Other Than Trustee

The United States Supreme Court discussed the importance of state law in shaping the federal revenue law in that state law “creates no property rights but

\[57\] The analysis of whether an individual materially participates in an S corporation is the same whether the stock is voting or non-voting.
merely attaches consequences, federally defined, to rights created under state law."

Under the trust law of nearly all states, if a trustee acts in a potentially conflicting managerial role (e.g., for an entity the interests of which comprise a trust asset), the trustee’s fiduciary duties also extend to the fiduciary’s managerial activities. An individual who is a trustee cannot disregard the fiduciary obligations to the beneficiaries when the individual acts in another capacity, for example, employee or director, in a business owned by the trust. As discussed below, the states are nearly unanimous that a trustee continues to owe fiduciary duties to the beneficiaries when acting in another capacity in a trust-owned business.

The Michigan fiduciary law was crucial to the holding in Aragona Trust. The fiduciary law in New York is similarly robust. The New York Court of Appeals summarized the duties and obligations of a trustee as follows:

Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

Under this heightened standard of behavior, the Second Circuit Court of Appeals confirmed that “[a]lthough a trustee, in the course of his administration, may become an officer of a corporation, his duties as a corporate officer do not supplant or mitigate the duties he owes the trust beneficiaries.”

Thus, all of the actions undertaken by an individual trustee with respect to any activity are relevant to determine whether the trust is active. Moreover, this rule is nearly universal. See, for example, the following:

A decision on behalf of the trust to have a trustee assume a role in the corporation or other enterprise . . . necessarily carries with it an acceptance on behalf of the

58 See Saltzman v. Commissioner, 131 F.3d 87, 89 (2d Cir. 1997) (citations omitted).
60 See Saltzman, supra note 58, at 90 (citations omitted).
trust that the trustee’s duties to it will be subordinated to any legal duties to which the trustee is subject when acting in the role of director, officer, manager, or the like. A trustee’s election to a role of this type is a matter of which beneficiaries should ordinarily be informed. That duties of prudence, loyalty, impartiality (including re: income productivity), and other fiduciary duties apply to the trustee’s decisions and conduct in, e.g., incorporating business or investment activities of the trust. 61

Both the Restatements of Trusts, Second and Third, are consistent in this respect.

One of the leading commentators on the law of trusts and estates is able to state authoritatively when considering the law of all states that:

Where a trust holds all or a part of the stock of a corporation and the trustee either personally owns the balance of the stock or, by reason of the trust’s stock ownership, becomes an officer and director of the corporation, the trustee may occupy one or more conflict of interest positions. His duty of undivided loyalty to the trust may be impaired by his personal interest as an individual stockholder or by his personal interest as an officer and director, or by both such personal interests. In such a case the trustee must be careful not to favor his individual interests or the interests of the corporation (or its other stockholders) at the expense of the trust and its beneficiaries. A number of court decisions illustrate the application of both trust and corporate standards towards the resolution of these conflict of interest problems. 62

Fiduciary capacity is a state law concept, and state law is remarkably uniform in providing that when a fiduciary acts in another capacity in a trust-owned business, the fiduciary continues to owe fiduciary duties to the beneficiaries. 63

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61 Restatement (Third) of Trusts § 78 (2013 ed.); see also id. § 86 cmt. e.
62 George G. Bogert, Bogert Trust and Trustees § 542 (Westlaw 2012).
63 A few cases, such as Estate of George S. Halas v. McCaskey, 209 Ill. App.3d 333, 568 N.E.2d 170 (1st Dist. 1991) (“Halas”) and Rollins v. Rollins, Slip Op. S13G1162 (Ga. Sup. Ct. 2014) (“Rollins”), found from the circumstances of the settlor’s creation of trusts and funding them with business assets that the grantor did not intend that strict fiduciary duty standards to apply when the fiduciary exercised powers as an officer, director or manager of a corporation or partnership. Neither decision held that the fiduciary could act to intentionally harm the beneficiaries of the trust owning the business interests. See, e.g., Halas at 178-79:

Where a conflict of interest is approved or created by the testator, the fiduciary will not be held liable for his conduct unless the fiduciary has acted dishonestly or in bad faith, or has abused his discretion. Further, where the will approves
The language of both restatements, and the uniformity of state law, suggest that fiduciary duties cannot be fully negated. Accordingly, it is difficult to determine when a fiduciary acting in another capacity in a trust-owned business ceases to act for the benefit of the trust fiduciaries. First, if actions were undertaken in the best interests of the trust-owned business, those actions would generally be in the best interests of the beneficiaries. Second, if one ignored that indirect benefit, in those rare cases that the fiduciary may have stopped acting in the best interests of the beneficiaries, drawing that line would be extremely difficult.

3. **Duties Owed by an Employee or Officer of a Corporate Trustee or Trust Company Acting as Trustee**

With respect to the determination of material participation of a trust or estate having a corporate fiduciary, \(^64\) whether an employee, officer or manager of the trust company owes fiduciary duties to the trust beneficiaries is quite relevant. State law generally recognizes that individuals retained or employed by a corporate trustee directly owe fiduciary duties to trust beneficiaries. \(^65\) the conflict of interest, the burden of proof remains on the party challenging the fiduciary's conduct as there is no presumption against the fiduciary despite the divided loyalty. Whether George Halas, Sr., abused his discretion or acted in bad faith is a question of fact, and the trial court's findings cannot be reversed unless they are against the manifest weight of the evidence. After the trial below, the trial judge made findings of fact pertaining to the conflicting interests of George Halas, Sr., without considering that his duty of undivided loyalty had been waived in his son's will. Nevertheless, the trial judge indicated that he found that George Halas, Sr.'s participation in the reorganization was motivated by "benevolent intentions." [Citations omitted] [Emphasis added]

In *Rollins* the court overruled the appellate court's decision that the trustees who also were directors would have to provide trust-like accountings for all the trust-owned entities. The Georgia Supreme Court held that business accountings were sufficient. The court also held: While other courts may have held otherwise, we hold that where, under the terms of a trust, the trustee is put in control of a corporate entity in which the trust owns a minority interest, the trustee should be held to a corporate level fiduciary standard when it comes to his or her corporate duties and actions. Our holding in this regard is buttressed by the legislature's 2010 amendment to the Trust Code which expressly recognizes that trustees may act in a dual role where the trust estate owns an interest in a corporation or business enterprise, as long as it is "fair to the beneficiaries." [Emphasis added]

Thus, by citing the Georgia statute approvingly, the *Rollins* court recognized that the fiduciary continued to owe fiduciary duties to the beneficiaries, although not the strict standard under common law.

\(^64\) "Corporate trustee" and "trust company" are used interchangeably in these Comments, although not interchangeable for all tax purposes.

\(^65\) We do not address in these Comments whether an independent contractor engaged by a trustee owes fiduciary duties to trust beneficiaries. In some cases, fiduciary responsibilities may attach to an independent contractor. Thus, we believe that the activities of the independent contractor with respect to an activity owned by the trust should not be attributed to the trustee for purposes of determining material participation by the trustee; however, if the independent contractor owes
In *In re Estate of Daniel Swieckiki*, a bank, while acting as guardian of its minor ward, invested some of the ward’s assets in a savings account at the bank, from which the bank profited. The ward’s successor guardian sued the bank for breach of its fiduciary duties to the ward. The court stated that a guardian’s fiduciary duties to its ward are equivalent to a trustee’s fiduciary duties to its beneficiaries, and even though the trust department of a bank is separate from the commercial department of a bank as depository, the bank was held to have breached its duty of loyalty to the ward for profiting from the investment of ward’s assets at the bank. “[T]here is nothing to suggest that, in reality, the bank here is anything other than one business entity, controlled by one board of directors and owned by a single set of stockholders . . . [W]e think it unrealistic to rigidly compartmentalize the bank’s business functions for purposes of analyzing its adherence to its fiduciary obligations.”

The *Swieckiki* court relies on other authority for the proposition that all of a bank’s departments are subject to its fiduciary duties.

The fact that the bank has two departments, a trust department and a commercial department, does not alter the fact that it is a single entity doing business under one charter, and the use of money in one department inures to the benefit of the other department, and constitutes a use in its general business. Many banking institutions are organized with several departments such as commercial, savings, trust, bond, loan and real estate. Interdepartmental transactions in such banks cannot be regarded as dealing at arm’s length, as between independent entities. Departmental banks, after all, are single corporate entities, managed by a single board of directors and owned by shareholders who participate in the combined profits and losses of the several departments. Transactions, therefore, between separate departments, affecting a trust for which the bank is trustee, do not create any immunity against self-dealing as between the bank and the trust, because such transactions, in fact, constitute self-dealing.  

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66 106 Ill. 2d 111 (1985).
67 Id. at 116-17.
68 Id. at 117.
69 Id. at 117-18 (“the relationship between a guardian and a ward is equivalent to the relationship between a trustee and a beneficiary”) (citing Parsons v. Estate of Wambaugh, 110 Ill. App. 3d 374 (1982)).
70 Id. at 121 (citing In re Estate of Swieckiki, 121 Ill. App. 3d 705, 708 (1984)).
71 Id. at 121-22.
72 Rose v. Bank of Wadesboro, 217 N.C. 600, 9 S.E.2d 2 (1940) (like Swieckiki, the Rose decision pertains to fiduciary duties in the context of a guardianship relationship).
A corporate trustee’s fiduciary duties extend to its directors and officers. In *Childs v. National Bank of Austin,* the court suggested that the chairman of the board of a trustee bank could be liable to the trust’s beneficiaries under the same standards as the bank. The court held there was a conflict of interest in breach of the trustee’s fiduciary duties when the chairman could not act in the bank’s best interests without harming the interests of the trust beneficiaries. “The fact that [the chairman] is only the agent of the trustee Bank is not material.”

4. **Summary of Non-Tax Authorities**

When acting in another capacity in a trust-owned business, the trustee’s continuing fiduciary duties to the beneficiaries of the trust have tax significance under section 469. However, those fiduciary duties also have substantial non-tax significance. If one sibling asks another sibling active in the family business to serve as trustee, the active sibling’s acceptance may dramatically curtail the fiduciary’s freedom to act when making ordinary business decisions. Frequently, a business decision will impact active and passive owners differently. If so, the active owner who becomes a trustee for the inactive siblings will be subject to fiduciary duties to the siblings with respect to all activities undertaken with respect to the trade or business or rental activity of the trust.

Although trusts often contain exculpatory language excusing certain potential conflicts, for example, setting the employee’s salary, those provisions are usually focused on waiving the strict liability that resulted at common law from self-dealing that meant the trustee had to forfeit any resulting profits, despite the transaction being fair to the trust beneficiaries. Exculpatory provisions might alter the standard applicable to the fiduciary’s actions, for example, substituting “business judgment” for the strict standard typically applied to a fiduciary. State law is clear that a trust instrument’s attempt to exculpate the trustee is valid, “except to the extent that it purports to relieve the trustee of liability for a breach of trust committed in bad faith or with indifference to the fiduciary duties of the trustee, the terms or purposes of the trust, or the interests of the beneficiaries.” In other words, an exculpatory provision is void as against public policy if it purports to allow the trustee to act in bad faith or contrary to the beneficiaries’ best interests or the purposes of the trust, or otherwise disregard the fiduciary duties the trustee owes the beneficiaries.

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75 Id. at 1102.
76 Id. (citing *People ex rel. Barrett v. Central Republic Trust Co.*, 300 Ill. App. 297, 310 (Ill. App. Ct. 1939) (“And the trustee’s duty not to place himself in a position where his personal interests conflict with those of his beneficiary, likewise applies to the officers of corporate trustees”)) (citation omitted), rev’d on other grounds.
77 Restatement (Third) of Trusts § 96 (2003).
III. QUESTIONS AND ANSWERS TO BE ADDRESSED IN NEW FIDUCIARY MATERIAL PARTICIPATION REGULATIONS

A. Whose Participation Is Relevant to Determine Whether a Trust or Estate Materially Participates in a Trade or Business or Rental Activity?

Consistent with the legislative history, when a trust or estate is the taxpayer, the participation of the fiduciary or fiduciaries of the trust or estate should determine whether a trust or estate materially participates in a trade or business in the context of section 469. The determination of the identity of the fiduciary is determined under ordinary tax principles. Thus, the person’s actual title is irrelevant. The person acting in a fiduciary capacity on behalf of the beneficiaries with the actual discretionary decision-making power over the trade or business of the trust or estate is the relevant fiduciary.

When the income of the trust is distributed by the trust to a beneficiary, in which event the beneficiary is the taxpayer, it is not so clear that the fiduciary’s participation should be relevant to whether the income is active or passive to the beneficiary, as discussed further below. It appears that the beneficiary’s material participation should be relevant to the characterization (or recharacterization) of the distributed income as active or passive with respect to the beneficiary as a taxpayer for purposes of both sections 469 and 1411.

B. What Participation in the Trade or Business or Rental Activity by the Requisite Person Is to be Measured in Determining Whether the Trust or Estate Materially Participates?

We recommend that the Regulations clarify that when the trust or estate is the taxpayer, and the participation of the fiduciary is undertaken while subject to fiduciary duties owed the beneficiaries of the trust or estate, the fiduciary’s participation in the trade or business in whatever capacity should be considered participation by the trust or estate. Participation by the fiduciary while subject to fiduciary duties should count towards satisfying the Individual Hours Tests that apply to trusts and estates.

On the other hand, we recommend that when the beneficiary is the taxpayer, the beneficiary’s material participation should be relevant to the characterization (or recharacterization) of the distributed income as active or passive with respect to the beneficiary for purposes of both sections 469 and 1411.

C. What Measure of the Relevant Participation by the Requisite Person Is Required for the Trust or Estate to Materially Participate?

We recommend two alternative tests consistent with existing law for measuring fiduciary material participation for trusts and estates: one objective, the
“Parity Test,” and the other subjective, the “Facts and Circumstances Test.” The Parity Test, based on *Aragona Trust*, provides partial parity between a natural person, acting in an individual capacity or in a fiduciary capacity. Because the Individual Hours Tests are objective, the Parity Test is objective.

The Facts and Circumstances Test, based on *Carter Trust*, is subjective and based on all facts and circumstances with respect to the participation of the fiduciary or fiduciaries in the trade or business or rental activity, including attributing to a fiduciary the participation of that fiduciary’s agents and employees of the fiduciaries acting on behalf of the beneficiaries attributed to those fiduciaries, to determine whether the participation is “regular, continuous, and substantial.” If the fiduciary satisfies the Individual Hours Tests, either directly or through the participation of agents and employees of the trust, a rebuttable presumption should be created that the trust or estate materially participates. The employees, agents and managers of a disregarded entity owned by the fiduciary, trust or estate will be considered employees and agents of the fiduciary for purposes of this test.

Both of these tests reflect current case law. While we recognize that in exercising their rulemaking authority Treasury and the Service are not bound by the decisions of lower courts, we believe that the fiduciary material participation Regulations should follow existing law, rather than adopt an entirely new paradigm. The goal for any new Regulations should be to make the existing rules explicit and practical, while simplifying and clarifying the rules.

The individual fiduciaries who satisfy the Parity Test must owe fiduciary duties to the beneficiaries of the trust or estate and have decision making authority and the power to act on behalf of the trust or estate with respect to the trade or business or rental activity owned by the trust or estate. The Facts and Circumstances Test aggregates all of the actions of the fiduciaries and of their agents and employees, as long as their agents and employees do work customarily done by owners who run similarly situated businesses on a regular, continuous, and substantial basis.

In addition, we believe that any Special Individual Hours Tests that apply to individuals should apply to fiduciaries, including corporate trustees and trust companies, by counting their hours in the same manner as for purposes of the Facts and Circumstances Test.

D. How Do These Material Participation Rules Apply to a Trust or Estate With a Corporate Trustee or a Trust Company as Fiduciary?

We believe that a corporate trustee or trust company and any co-trustees should satisfy the Individual Hours Tests, or in the alternative, the Facts and
Circumstances Test, for the trust or estate to materially participate.\textsuperscript{78} Both tests should be applied after attributing any actions undertaken by the employees or agents of the trust, including, but not limited to, the corporate fiduciary’s actual individual decision makers, to the corporate trustee or trust company. In the case of a private trust company (“PTC”), we believe that the Service’s “look-through” rules should be applied in determining whether the Individual Hours Test or the Facts and Circumstances Test is satisfied.\textsuperscript{79}

E. When Is a Trust or Estate Beneficiary’s Material Participation Relevant?

When the trust or estate is the taxpayer, the material participation of the fiduciary should determine whether income or loss from a trade or business or rental activity owned by the trust or estate is active or passive. As discussed further below, it is the view of the proponents of the Fiduciary Participation Test that the material participation of the fiduciary should determine whether the income\textsuperscript{80} of a trade or business or rental activity held in trust and distributed to a beneficiary, or a depreciation, depletion or amortization deduction directly allocated to a beneficiary, is active or passive, provided that a recharacterization rule is available to apply to income distributed to a beneficiary when the beneficiary materially participates.

It is the view of the proponents of the Taxpayer Participation Test that the material participation of the beneficiary should determine whether gain or income of a trade or business or rental activity distributed by a trust or estate to the beneficiary is active or passive.

F. What Special Rules Should Apply When an Event Results in a Potential Change in the Tax Status or the Identity of the Taxpayer?

Whenever a change in the taxpayer with respect to income or loss from a business results in taxable gain or loss, whether the gain or loss is active or

\textsuperscript{78} If the individual trustees of the trust satisfy the Parity Test and they have decision making authority over the trade or business or rental activity, the trust company’s participation need not be considered.

\textsuperscript{79} Because of the Service’s look-through rules, if an individual decision maker satisfies the Parity Test, the trust or estate will materially participate.

\textsuperscript{80} Section 642(h) provides that losses of a trust may only be allocated to beneficiaries in the year the trust terminates. However, suspended passive losses cannot be distributed to beneficiaries. The Form 1041, Schedule K-1 instructions provide: “Upon termination of an estate or trust, any suspended passive activity losses (PALs) relating to an interest in a passive activity cannot be allocated to the beneficiary. Instead, the basis in such activity is increased by the amount of any PALs allocable to the interest, and no losses are allowed as a deduction on the estate’s or trust’s final Form 1041.” See I.R.C. § 469(j)(12). Thus, except for depreciation under section 167(d) or similar deductions for depletion and amortization directly allocable to a beneficiary, only income or gain can be allocated to a beneficiary.
passive, should depend on the material participation of the original taxpayer, rather than the material participation of the actual taxpayer. Mere transitory ownership should never define whether gain or loss is active or passive.

We recommend that the fiduciary material participation Regulations provide that any gain or loss recognized by a QSST upon the disposition of S corporation stock be characterized as active or passive according to the material participation of the beneficiary of the QSST, the deemed owner of the S corporation stock, prior to the sale of the stock.

Similarly, when an event causes a realization of a gain or loss, such as a trust going from being a grantor trust to a non-grantor trust, for purposes of section 469, we recommend that the material participation of the taxpayer owning the trade or business immediately before the event should determine whether the income or loss is active or passive, rather than the taxpayer who owned the property only at the time of the transitory event.

Although a charitable remainder trust or pooled income fund is not subject to section 469, we recommend that the new fiduciary material participation Regulations provide rules for determining whether a CRT's gain or income is active or passive. While a CRT is not subject to the NII Tax under section 1411, a CRT income beneficiary may be subject to tax when the accumulated gain or income is distributed to the beneficiary under the “tier rules” of section 664. These rules require the trustee to determine whether the accumulated gain or income will be subject to tax, here the NII Tax, when distributed. Because of the nature of the permitted investments in a CRT, we recommend a simple rule that any income or gain earned by the CRT and later distributed to a beneficiary be deemed passive. However, a different rule should apply to the pre-contribution gain of an appreciated interest in a trade or business or rental activity, held directly or through a pass though entity, and given to a CRT by a taxpayer who materially participated in the trade or business or rental activity, where the interest is later sold by the CRT. The pre-contribution gain should be active or passive depending on the amount and character of the gain had the appreciated property been sold for fair market value at the time given to the CRT. This treatment is similar to the treatment of the gain resulting from an installment sale, which remains active or passive depending on material participation on the day of the sale, despite the actual taxpayer’s participation thereafter.

An individual’s death changes the identity of the taxpayer with respect to business income or loss from the decedent to the probate estate or testamentary substitute. The Individual Hours Tests contain two tests that provide for an individual’s material participation in a business to carry over to subsequent years: a five out of ten year material participation test and permanent carryover for personal service businesses after three years of material participation. We believe that these carryover rules should not be arbitrarily terminated by death – a factor outside of the decedent’s control – simply because a new taxpayer owns the business interest, and recommend that an estate or other testamentary successor to
the deceased should be able to qualify under any Individual Hours Test that would have applied if the decedent would have lived without the decedent actually materially participating.

IV. DISCUSSION OF THE PROPOSED FIDUCIARY MATERIAL PARTICIPATION RULES.

We recommend that the rules for determining fiduciary material participation incorporate the law which has developed in the nearly thirty years since the enactment of section 469. While we seek to simplify and clarify current law, our recommendations neither significantly expand nor contract the number of those trusts and estates that will materially participate. Most importantly, our recommendation is consistent with the concept of state law fiduciary capacity from the Senate Report, rather than erase the difference between actions undertaken solely as an individual and those undertaken as a fiduciary.

Our analysis of current law includes considering not only the effect of section 469, but also section 1411. In particular, the Regulations under section 1411 prompt our recommendation with respect to whose material participation should determine whether distributed income is active or passive. We believe there should not be, and our recommendations attempt to minimize any incentives or disincentives for the use of trusts as compared with other forms of holding assets.

A. Whose Participation Is Relevant to Determine Whether a Trust or Estate Materially Participates in a Trade or Business or Rental Activity?

The Senate Report identifies the fiduciary, acting as such, as the appropriate person whose actions are to be considered when determining whether a trust or estate materially participates in a trade or business or rental activity, at least when section 469 is applied to the trust as a taxpayer. Neither the Aragona Trust case nor the Carter Trust case involved a fiduciary other than the trustee, because the trustees, in the aggregate, or trustee alone, made all the decisions with respect to the real estate business or ranching business in those cases.

The tax law clearly defines who is a “fiduciary.” Being named the “trustee” or actually being the trustee under state law is insufficient, absent actual decision-making power, to make one the fiduciary of a trust for tax purposes, including section 469. Section 7701(a)(6) defines a fiduciary as “a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.” Tax authorities emphasize the facts and the substance of the relationship, rather than title.81 In Rev. Rul. 1969-300, a court-
appointed bank served as custodian of shares in a land trust. The bank was granted the power to vote at any stockholders’ meeting, retain legal counsel, exercise or sell conversion or subscription rights, and petition the court to make any disposition concerning the property that it considered to be in the best interests of the owner. In holding that a trust was formed, the ruling notes that “where the bank or individual is vested with broad discretionary powers of administration and management, a fiduciary relationship exists within the meaning of section 7701(a)(6) of the Code.” In Rev. Rul. 1982-177\(^\text{83}\) (as modified by Rev. Rul. 1992-51),\(^\text{84}\) the Service ruled that a fiduciary relationship does not exist for purposes of section 7701(a)(6) where a bank merely holds money for an estate and pays interest on the account, but performs no administrative duties. In City Nat’l Bank & Trust Co.,\(^\text{85}\) the Seventh Circuit Court of Appeals held that no trust was formed where the settlor could override a bank’s investment decisions and other evidence of managerial power was lacking.

The only advice under section 469 from the Service is consistent with this interpretation of “fiduciary.” The Service held in a 2007 technical advice memorandum, TAM 200733023,\(^\text{86}\) that a person must have decision making authority and the capacity to legally bind the trust in order to be considered a fiduciary for purposes of satisfying the material participation requirements of section 469. In TAM 200733023, a testamentary trust acquired an interest in a state law LLC. Pursuant to the decedent’s will, the Trustees contracted with Special Trustees to perform a number of tasks related to the LLC’s business on behalf of the trust. The contract entered into between the trust and Special Trustees for Year 3 explicitly stated that the Special Trustees were being appointed as special trustees pursuant to the will and that their involvement in the LLC’s business was intended to satisfy the material participation standard of section 469(h)(1). The contract also provided that the Special Trustees “will not possess the capacity to legally bind or commit the trust to any transaction or activity” and that “[the trust] [sic] acknowledges that it retains all decision making responsibilities related to [the trust’s] financial, tax, or business matters.”

Although TAM 200733023 discussed the activities of the Special Trustees, its holding turned on the determination that the Special Trustees were not the “fiduciaries” of the Trust for tax purposes. Although the Trustees delegated management authority to the “Special Trustees,” the Service held that their involvement in the activity could not be counted toward the trust’s material participation. Because the Special Trustees were not vested with any degree of discretionary power to act on behalf of the trust, the Service concluded that the

\(^{82}\) 1969-1 C.B. 167.
\(^{83}\) 1982-2 C.B. 365.
\(^{85}\) City Nat’l Bank & Trust Co. v. United States, 109 F.2d 191 (7th Cir. 1940).
\(^{86}\) TAM 200733023 (Aug. 17, 2007).
Special Trustees were not “fiduciaries” under regulatory and administrative guidance. Therefore, “only the activities of [the non-special] trustees count toward the material participation requirement for [trust]”; and “[a]ccording to the time logs submitted by [trust], [the non-special] trustees” had not spent the number of hours sufficient to establish material participation under the Regulations.\(^8\)

TAM 201317010 also holds that the relevant fiduciary for purposes of the section 469 analysis need not be the named trustee under the trust. Rather, the Service considered the special trustee holding discretionary powers over the S corporation business as the appropriate fiduciary. The Service accepted the proposition that the president of the business who was designated as a special trustee was the relevant fiduciary, because he made all of the decisions for the trust with respect to the business.

Thus, the “fiduciary” of a trust for tax purposes is the person “vested with some degree of discretionary power to act on behalf of the trust.” For purposes of section 469 that means the fiduciary is the person who has the power to make discretionary decisions on behalf of a trust with respect to the trust-owned business or real estate. Although the fiduciary in each of those cases and Service guidance involved a person named a trustee or “special” trustee, the tax authorities quite clearly conclude that the title alone is immaterial.

Under some trust instruments, with respect to some decisions or assets, the relevant “fiduciary” may not be a trustee or a special trustee, but an investment advisor, trust director or protector under the trust instrument who is actually able to direct the trustee’s decisions with respect to the trust-owned business.\(^8\) If the person directing the business decisions for the trust does not owe fiduciary duties to the trust beneficiaries, calling the person a trustee would not make the person a “fiduciary” for tax purposes. On the other hand, if the person does owe such fiduciary duties, failing to call the person a trustee would not prevent the person from being the fiduciary.

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\(^8\) The Service was not applying the hours test applicable only to individuals, but rather cited hours as evidence that the trustee’s activities in the business were not “regular, continuous and substantial.” These comments propose a similar use of the Individual Hours Tests in the fiduciary context.

\(^8\) In another case, the Tax Court was forced to consider whether an individual could be the “fiduciary” for purposes of materially participating for a trust. See Estate of Roger Strangeland v. Comm’r, 100 T.C.M. (CCH) 156, 2010 T.C.M. (RIA) ¶ 2010-185. The Tax Court concluded that the taxpayer trust had failed to show what capacity, if any, a business advisor, Roger Henn, had with a trust. The court stated: “We need not address whether or how a trust may materially participate in an activity because we conclude that petitioners have failed to prove Henn’s relationship with the trusts.” Id. at 35.
B. What Participation in the Trade or Business or Rental Activity by the Requisite Person Is to be Counted Towards Determining Whether the Trust or Estate Materially Participates?

Having identified the fiduciary as an actual decision maker with respect to the trust-owned trade or business or rental activity as the requisite person for determining material participation, at least when the trust is the taxpayer, the next question is which actions of that person count towards establishing material participation for the trust or estate. The Senate Report provides that actions undertaken by the fiduciary in that capacity are to be counted towards the material participation by the trust or estate. All of the tax authorities agree that the trustee’s actions in any capacity in a trust-owned business count towards the trust’s material participation, although the Service has taken a different position in informal guidance and in litigation. The non-tax authorities under state law agree that a trustee does not completely remove the trustee “hat” when picking up the employee or manager “hat” in a trust-owned business. The state law meaning of acting in a fiduciary capacity means acting while subject to fiduciary duties to the beneficiaries of a trust. The meaning of fiduciary capacity for tax purposes, therefore, is not, nor has it ever been, an open issue under section 469, despite the lack of material participation Regulations.89

The Service presented an election theory in Aragona Trust essentially arguing that the individual trustee must choose whether the hours performed in the business counted towards the trust’s material participation or the material participation of the individual acting in another capacity. However, state fiduciary law is clearly to the contrary. The actions undertaken by the three trustees as employees of the LLC were undertaken as fiduciaries. Also, if the Frank Aragona Trust had been a separate trust for each child, rather than one trust for all the children, with the same six trustees, the three active trustees would have acted in exactly the same manner for each trust, and they should not need to distinguish or allocate their work for each separate trust.

Although not applicable to trusts and estates, the Regulations under section 469 generally allow an individual to consider all of the individual’s participation in an activity without regard to the capacity in which the actions are undertaken (subject to the limited exceptions discussed above).90 It is easy to see why Treasury adopted this rule. Tracing hours in each capacity in which an individual might be involved in a business is an administrative impossibility for both Treasury and the taxpayer.91 By choosing to act in more than one capacity, a

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89 Despite the contrary authority and Treasury’s failure to issue Regulations on material participation with respect to trusts, the Service assessed an accuracy related penalty in its deficiency notice in Aragona Trust. However, it subsequently conceded during the litigation that penalties were inappropriate. See Aragona Trust, supra note 7, at 1 n.2.

90 Reg. § 1.469-5(f)(1).

91 See letter from Michael J. Grace to Lindy L. Paull, Chief Tax Counsel, Senate Finance Committee (February 6, 1992), available at
shrewd taxpayer may be able to manipulate the rule to convert active income into
passive income, while an unwary taxpayer could inadvertently hold multiple
positions in a business in which the taxpayer would otherwise materially
participate, thus preventing the taxpayer from being treated as active. As
discussed above, Regulations under section 2032A also provide that the capacity
in which the trustee participates is irrelevant. Applying a rule distinguishing work
done in one capacity or the other in the fiduciary context is no easier than in the
individual context. It is unlikely that taxpayers will maintain records as to the
purpose of involvement in a fiduciary capacity or in an individual capacity, and
further, if such records are produced, their veracity and credibility would be
suspect in many cases. Numerous cases in the Tax Court dealing with taxpayers
who attempt to characterize themselves as real estate professionals or as
materially participating in a trade or business or rental activity in order to deduct
losses illustrate this point.

Because the purpose of the material participation requirement is to require
a taxpayer to participate in an activity beyond that of an investor in order to avoid
either the limitation on passive activity losses or the NII Tax, ignoring the
multiple capacities in which a fiduciary may be involved in the business and
simply looking at the trustee’s actions comes close to providing that a trust is
always passive. Congress could have simply provided that a trust is always, or
nearly always, passive, but has not done so. Rather, the legislative history and
Service rulings and advice have been consistent in asserting that the process by
which a trust can materially participate is through the fiduciary’s “regular,

http://services.taxanalysts.com/taxbase/archive/tnt1992.nsf/SearchIndex/930FACCF245A5AEE85256BB90076CE1A?OpenDocument&highlight=0,Michael,J,Grace ("The regulation drafters took this approach because they believed that taxpayers and the Service would experience too much difficulty trying to determine the capacity in which an individual acted at any time.").

92 We note that exclusions of certain tax-motivated work from the material participation analysis may limit a taxpayer’s ability to manipulate the rules. See Temp. Reg. § 1.469-5T(f)(2)(i).

93 Recent Tax Court cases dealing with taxpayers who attempt to deduct losses by characterizing themselves as real estate professionals or materially participating in trade or business or rental activities include Graham v. Commissioner, T.C. Summ. Op. 2014-79 (taxpayer denied real estate professional when rental management spreadsheets generally included entries for showing the properties, cleaning the premises, and performing general maintenance work. Among the entries were: reporting seven hours to install new locks at one property; reporting 30 hours to “place [] mulch” on a property; meeting with a tenant five times throughout the year even though no rents were collected on the property for the entire year; and recording the same recurring time (usually two hours) for appointments to show a property); Wade v. Commissioner, 108 T.C.M. (CCH) 195, 2014 T.C.M. (RIA) ¶ 2014-169 (Respondent had determined that $3,403,536 of losses petitioners had reported were passive. The record reflected that Mr. Wade spent over 100 hours participating in the businesses during 2008, and his participation consisted primarily of nonmanagement and noninvestment activities, focusing on product development and customer retention. The Tax Court held that the taxpayer Wade “researched and developed new technology that allowed [the S corporations] to improve their products. He also secured financing for the companies that allowed them to continue operations, and he visited the industrial facilities throughout the year to meet with employees about their futures. These efforts were continuous, regular, and substantial during 2008, and we accordingly hold that Mr. Wade materially participated in [the S corporations]”).

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continuous, and substantial” involvement in a business. The courts have reached the same conclusion.

Commentators who have considered the question have uniformly come to agree that time spent by the fiduciary in other capacities should be taken into account for purposes of section 469, and have urged the Treasury to adopt that position in proposing Regulations for determining the material participation of a trust or estate.\textsuperscript{94} For example, the Section commented that: “When considering the efforts of the fiduciary, any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in another role, for instance as an officer or individual investor.”\textsuperscript{95}

Another commentator recommended:

[I]n determining whether a fiduciary . . . materially participates, the “capacity” in which the person participates should not matter . . . This approach would comport with the longstanding general rule that “participation” includes any work done by the individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done.\textsuperscript{96}

\begin{footnotesize}
\textsuperscript{94} Douglas W. Schwartz, Los Angeles County Bar Association Taxation Section, Determining “Material Participation” by a Trust under the New Medicare Contribution Tax, (May 7, 2012), available at http://www.lacba.org/Files/Main%20Folder/Sections/Taxation/Files/14%20Determining%20Material%20Participation%20by%20a%20Trust%20(Schwartz).PDF (asserting that “one should interpret [the Senate Report language ‘in his capacity as such’] as meaning that, once a person is identified as acting in a fiduciary capacity with respect to the trust, then that fiduciary is the relevant person for determining whether material participation has been met, and any such participation by that person in whatever capacity (e.g., as a manager, officer or employee of the business) should be considered so long as the hours spent would count toward material participation if conducted by an individual.”). Leo L. Schmolka, Passive Activity Losses of Trusts and Estates: The Regulations (If I Were King), 58 Tax L. Rev. 191 (2005) (hereinafter “Schmolka”) states that “material participation standards apply to an activity owned by a trust or estate on the basis of a fiduciary’s total participation, regardless of whether the fiduciary acts in multiple capacities. I see no principled basis on which to distinguish work done by the fiduciary while wearing one hat from that done while wearing another.” See also Byrle M. Abbin, Income Taxation of Fiduciaries and Beneficiaries (Wolters Kluwer 2013) (hereinafter “Abbin”).


\textsuperscript{96} Michael J. Grace, Comments to Section 1411 Proposed Regulations (March 5, 2013), available at http://services.taxanalysts.com/taxbase/nt3.nsf/SearchIndex/5C4795E467514E5185257B2600116667?OpenDocument&highlight=0,Michael,J,Grace.
\end{footnotesize}
Accordingly, the capacity in which the trustee acts in a trust-owned business should be irrelevant, provided that the trustee is subject to fiduciary duties when so acting.

C. What Measure of the Relevant Participation by the Requisite Person Is Required for the Trust or Estate to Materially Participate?

Once the fiduciary and its relevant actions are identified, the next question is what measure of relevant fiduciary actions is required for a trust or estate to materially participate. Before discussing our recommendation as to the proper quantum of fiduciary activity to establish material participation by a trust or estate, we will examine the positions taken by the Service (which have been rejected by the courts).

1. Service Unsuccessful in Applying an Hours Test to Fiduciaries in Litigated Cases

Although rejected by the courts, the Service has made three different arguments seemingly tied to counting hours for the purpose of denying most trusts the ability to materially participate. First, in Carter Trust the Service argued that the trust could not count the hours of the agents and employees of the trust towards its material participation. The Service insisted that the participation of agents and employees of the trust(ee) could not be considered, because the trustee then could always buy the requisite hours to establish material participation for the trust. As the Service stated in PLR 201029014:

The focus on a trustee’s activities for purposes of section 469 accords with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner’s employees to satisfy the material participation requirement. See S. Rep. No. 99-313, at 735 (1986) (“the activities of [employees] . . . are not attributed to the taxpayer.”). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of other business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee. Thus, the sole means for a trust to establish material participation is if its fiduciary is involved in the operations of the activity on a regular, continuous, and substantial basis.

If an individual could count the hours of persons employed in the business, the Service argues that any individual would be able to materially participate.
Second, in TAM 201317010 the Service sought to limit the trustee’s hours in the trust-owned business by counting only those related to the actual exercise of the trustee’s legal powers with respect to the trust-owned business. Unlike the first argument, this Service argument imposes a rule more restrictive than is applicable to individuals. If a similar rule looking only to owner-level activities rather than activities as an employee or other service provider applied to individuals, a shareholder in an S corporation, a member of an LLC, or a non-manager partner of a partnership, could never materially participate.

Finally, in Aragona Trust the Service argued that the trustees had elected to count their hours as employees, rather than as fiduciaries. This argument appears to be aimed at preventing the hours of the individual trustees from being double-counted as both employee or individual hours and fiduciary hours. However, state fiduciary law recognizes that the trustees continue to be subject to fiduciary duties to the beneficiaries while acting as employees in the trust-owned business.

Hours may be an appropriate consideration in measuring material participation where an individual is concerned, as prescribed by the seven Individual Hours Tests set forth in the Regulations. An individual has a limited number of hours to spend in different activities. In the trust context, however, an hours test serves no similar purpose. If hours are one of the considerations for determining whether a trust materially participates (again, as prescribed by the seven Individual Hours Tests set forth in the Regulations), the Regulations should further recognize that a trust or estate can materially participate through hours quantified by the trustee’s activities and through the employees and agents of the trustee.

Although the Aragona Trust and Carter Trust cases were decided on different grounds, both had similar facts. Real estate businesses, which were the predominate assets of the respective trusts, were to be maintained in the family through multiple generations while being actively managed by the trustees, agents and employees. In neither case would anyone ever suggest the real estate business was acquired to shelter other sources of trust income. Moreover, neither court tried to scrupulously count hours expended by the corporate trustee (Carter Trust) or the individual trustees (Aragona Trust) under the Individual Hours Tests to determine whether the trust materially participated.

The three theories that the Service had advanced to limit the hours that a trust could count were rejected by these courts. First, the Carter Trust decision usually is viewed as contrary to the Senate Report that only the actions of the fiduciary could be counted towards the trust’s material participation. The court’s language at times did fail to recognize that the trust has no separate legal existence from the trustee and is not an entity under applicable state law. When the court referred to the trust’s agents and employees as a matter of state law, therefore, the court’s statements properly may be read to refer to the trustee’s agents and employees. Thus, the Carter Trust decision can be viewed as
permitting the hours of the trustee’s agents and employees to be attributed to the trustee, conforming to the Senate Report with respect to the fiduciary’s participation. The trustee usually is accountable to the beneficiaries for the actions of its agents and employees under state law, and those actions are attributed to the trustee under tax law.

The Service asserted in PLR 201029014 that allowing an individual to count the hours expended by employees of the business towards satisfying the material participation test will render the Individual Hours Tests meaningless. On the other hand, a trust may act only through the actions of individuals and on this basis the trustee should be able to count the time expended by its employees and agents on behalf of the trust beneficiaries.\textsuperscript{97} Because a tension exists in applying the Individual Hours Tests to trusts, the Regulations on fiduciary material participation should recognize that the actions of the agents and employees of the trustee on behalf of the trust should be attributed to the trustee.

Second, the Service argued in Aragona Trust as it ruled in TAM 201317010 that only the hours of the trustee exercising the legal rights of the trust over the LLC could be counted. Because the individual trustees served as employees of the LLC, rather than as members, the Service argued that the individuals were not acting on behalf of the trust. The court rejected the Service's argument, focusing on the fact that applicable state law imposed fiduciary duties on the individuals while working in a different capacity for an instrumentality of the trust.

Third, the Service’s argument that a trust may not count the actions of its individual trustee when undertaken in another capacity was rejected by the Aragona Trust court. Under state fiduciary law, the hours spent by an individual trustee working as an employee or in another capacity in a trust-owned business nearly always will remain subject to at least some fiduciary duties. Thus, by definition, those hours should count for purposes of determining whether any trust of which the individual is trustee materially participates in a business as the Aragona Trust case held.\textsuperscript{98} This necessarily involves counting hours worked in any capacity if that trustee also owns a portion of the business individually.\textsuperscript{99} The

\textsuperscript{97} The concept of material participation for individuals arose out of the self-employment tax context where only the hours expended by that individual in the activity is relevant, but this concept has no relevance to trusts. An individual owner may devote the necessary time to the business to satisfy an Individual Hours Test, but a trustee should acquire appropriate expert help when the trustee cannot provide the requisite services itself. The trust must acquire all of its hours from individuals.

\textsuperscript{98} Counting hours in multiple capacities is most likely to be an issue when a closely-held or family business is an asset of the trust. The ownership of a closely-held or family business is likely to be divided among individuals, fiduciary arrangements and family entities.

\textsuperscript{99} Cf. Reg. § 1.469-5(f).
existing Regulations view double counting not as abusive, but rather as serving to ensure that each taxpayer-owner gets credit for being active.\textsuperscript{100}

It is inconsistent to apply an hours test prescribed by the Regulations for individuals to trusts and estates, and also deny the trust or estate the ability to count the hours it expends as the Service attempted in \textit{Aragonza Trust}. If the individual trustee also owns an interest in the trust-owned business, the Service has argued in \textit{Aragonza Trust} that the individual hours also could not count towards the trust hours. This creates a perverse rule that the more entwined the trust, the trustee and the business are – as often occurs when the business is family owned – the less likely the trust is to be active.

We believe that, whenever hours are meaningful in the fiduciary context, the Regulations should recognize the ability of a trustee to count hours of participation in whatever capacity, provided all those hours are expended in a fiduciary capacity on behalf of the trust beneficiaries. Further, for purposes of the Facts and Circumstances Test and certain other purposes, a trustee should be permitted to count the hours of employees and agents as well.

2. \textbf{Subjective vs. Objective Test}

The fiduciary material participation test could be an “objective” test or a “subjective” test.

The Individual Hours Tests implement objective standards for purposes of applying the subjective “regular, continuous, and substantial” test in the statute. Because these objective standards are promulgated in legislative Regulations, many argue that these objective standards cannot be applied to fiduciaries in the absence of specific Regulations. The Service has accepted this position in private rulings,\textsuperscript{101} but has adopted positions in litigation that appear to be prompted by a desire to count hours. The Service would apparently prefer an objective test based on hours that would preclude the trustee from counting the hours of employees and agents and double-counting the trustee’s hours for individual and fiduciary purposes. The courts have rejected these limits on an objective test for fiduciary material participation.

Moreover, some commentators argue that the subjective “regular, continuous, and substantial” test in the statute is the right test for determining whether a trust or estate materially participates. That test is consistent with pre-\textsuperscript{102}

\textsuperscript{100} Reg. § 1.469-5T(k), Ex. (1), expressly providing credit toward material participation to a shareholder and the corporation for a shareholder-employee’s work in a partnership owned by both the corporation and the shareholder.

\textsuperscript{101} TAM 200733023 (Aug. 17, 2007) (“Until regulations are promulgated, § 469(h)(1) remains the sole standard for determining whether a trust or estate satisfies the material participation requirement of § 469.”).
existing material participation tests under sections 1402 and 2032A on which Congress based the definition of material participation in section 469.

While some would prefer an objective test designed specifically for trusts and estates, the many different ways to draft trusts and to own business and real estate interests defy any exclusive, objective definition of fiduciary material participation. The proportion the business represents of the entire value of the trust or the share of income of the trust comprised of business income, for example, can change if the business is given to one trust and the other assets are given to another trust. It makes no sense to adopt an objective test that straitjackets drafting trusts into one form to be active and another form to be passive. Rather, a subjective test that considers all relevant factors, including the form of the trust, is preferable.

It is not necessarily easier to satisfy the objective or subjective test: the tests are simply different. The subjective test might not require a fiduciary to work as many hours in the business as the objective test. On the other hand, if the trust and the business have few ties, the subjective test may be harder to satisfy than the objective test, which might be met merely by increasing the hours worked in the business. *Aragona Trust* focused only on the actions of the trustees as employees in the trade or business or rental activity. *Carter Trust*, on the other hand, considered all of the relationships between the ranch operations and the trust, rather than consider only the trustee’s participation in the ranch operations. Although the court believed that its decision was contrary to the Senate Report, the court failed to appreciate that its decision actually attributed the activities of the trust’s agents and employees to the trustee, because the trust has no separate legal existence apart from the trustee. Thus, the case actually is consistent with the Senate Report. Both these cases relied on subjective factors, rather than merely counting hours.

Under a subjective fiduciary material participation test, the Individual Hours Tests could still be meaningful. A subjective test would permit consideration of whether the hours provided by the trustee were appropriate in the trust-owned business. Satisfying the Individual Hours Tests should be a factor in whether a trust or estate materially participated under a subjective test. A rebuttable presumption is different than a safe harbor, which would largely prohibit the Service from challenging the substance or character of the hours.

Because the trustee is the owner of the trust assets under state law, however, fairness requires that an individual trustee who satisfies the Individual Hours Tests should cause the trust to satisfy the fiduciary material participation test. The individual trustee should be the requisite fiduciary with decision-making power over the business or real estate assets. Further, the only hours performed by the individual trustee that can be counted towards material participation by the trust should be hours where the individual trustee owes fiduciary duties to the trust beneficiaries as in the *Aragona Trust* decision. If these requirements are satisfied, to provide parity between individual ownership and fiduciary
ownership, an individual trustee satisfying the Individual Hours Tests also should qualify the trust as materially participating (the “Parity Test”).

The Parity Test we recommend does not go so far as some commentators have suggested by eliminating the distinction between individual hours and hours undertaken in a “fiduciary” capacity.\textsuperscript{102} Although eliminating the distinction would simplify tax administration, we believe that such a divergence from the existing authorities would be unwise. Rather, the Regulations should strive to provide understandable, practical guidance on applying the material participation test to fiduciaries. Similarly, we recommend against any attempt to use new Regulations to rewrite the meaning of “fiduciary capacity” in derogation of its state law meaning, or to overrule the Aragona Trust or Carter Trust decisions.

The Aragona Trust court did not rule that an individual trustee satisfying the Individual Hours Tests would automatically mean the trust would be deemed to materially participate. The court, however, did equate actions undertaken by an individual trustee as actions undertaken by an individual for purposes of the real estate professional test:

The Service argues that a trust is incapable of performing “personal services” because the regulation defines “personal services” to mean “any work performed by an individual in connection with a trade or business”. Sec. 1.469-9(b)(4), Income Tax Regs. We reject the Service’s argument. A trust is an arrangement whereby trustees manage assets for the trust’s beneficiaries. 1 Restatement, Trusts 3d, sec. 2 (2003) (a trust “is a fiduciary relationship with respect to property . . . subjecting the person who holds title to the property to duties to deal with it for the benefit of” others); see also sec. 301.7701-4(a), Proced. & Admin. Regs. (“In general, the term ‘trust’ as used in the Internal Revenue Code refers to an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts.”). If 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.” Sec. 1.469-9(b)(4), Income Tax Regs. We conclude that a trust is capable of performing personal services and therefore can satisfy the section 469(c)(7) exception.

\textsuperscript{102} See, e.g., Schmolka, supra note 94, at 267 (suggested Reg. § 1.469-5(g)(2)(ii)):

[A]ny work . . . done by a fiduciary of a trust or estate in connection with an activity in which the trust or estate owns an interest at the time the work is done shall be treated . . . as participation of the trust or estate in the activity.
The *Aragona Trust* court decided only that the trust materially participated under the “regular, continuous, and substantial” standard of section 469(h). The court’s decision, however, does provide that actions taken by an individual as a fiduciary should count towards meeting the material participation test for a trust. It would be easy to extend this reasoning to provide explicitly in the new fiduciary material participation Regulations that such fiduciary hours would count towards satisfying the Individual Hours Tests, and we recommend that they do so. Applying such an objective test offers a definitive rule consistent with the tax policy of the section 469 Regulations that would treat ownership of a trade or business or rental activity in trust or outright comparably.

The need for parity is strong to the extent that the trustees and the beneficiaries of a trust are the same persons. ¹⁰³

3. Prior ABA Comments on Fiduciary Material Participation

In its most recent Comments on the Proposed Regulations under section 1411, the Tax Section recommended the following tripartite fiduciary material participation tests: ¹⁰⁴

In this regard, we recommend that the new proposed regulation package would provide that material participation by a trust or estate can be accomplished through meeting at least one of three tests:

(a) The fiduciary materially participates under the standards that apply to individuals under previously promulgated Regulations.

(b) The fiduciary, based on all facts and circumstances, participates in the activity on a regular, continuous, and substantial basis during the year.

(c) The fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the

¹⁰³ However, tying parity solely to whether the trustee also is a beneficiary might lead to forming a single trust for multiple beneficiaries where a trust will have a group of beneficiaries. In *Aragona Trust*, for example, all of the decedent’s children were beneficiaries of a single trust, rather than beneficiaries of separate trusts. If the trustees are the same, the test for material participation should be the same whether there is one trust or five trusts for family beneficiaries. A different set of rules for both individuals and fiduciaries will provide greater parity and more consistency.

¹⁰⁴ 2013 ABA Comments, *supra* note 95, at 19.
Upon further examination of the issue, these Comments recommend two alternative tests for determining fiduciary material participation.

First, we recommend an objective test treating the trust or estate as materially participating when an individual or corporate fiduciary satisfies the Individual Hours Tests. The 2013 ABA Comments seem to anticipate a corporate trustee being able to materially participate. The first prong of the 2013 ABA Comments anticipated the \textit{Aragona Trust} decision. The first test in these Comments is based on that decision and the policy of providing comparable treatment to business interests owned in trust and outright. Thus, these Comments refer to the first test as the Parity Test.

Second, we recommend a subjective test combining the last two prongs from the 2013 ABA Comments into one test based on the \textit{Carter Trust} decision. The \textit{Carter Trust} decision reached the right policy result when the close interactions of the trust, the trustee and the ranch operations are considered. The Facts and Circumstances Test – consistent with the \textit{Carter Trust} decision – attributes the actions of the agents and employees of the trustee to the trustee.

4. \textbf{The Two Alternative Fiduciary Material Participation Tests for Trusts and Estates}

The Parity Test and the Facts and Circumstances Test are independent of each other. We recommend that the participation of either an individual fiduciary or a corporate fiduciary can cause the trust or estate to materially participate under either the Parity Test or the Facts and Circumstances Test. Thus, for example, an individual or corporate fiduciary who fails the Parity Test still may satisfy the Facts and Circumstances Test.

a. \textbf{The Individual Parity Test Derived from Aragona Trust}

If a trust or estate has an individual fiduciary and the individual satisfies the Individual Hours Tests (considering only that individual’s hours while owing fiduciary duties to the beneficiaries of the trust or estate), we believe that the proposed Regulations should provide that the trust or estate would be deemed to materially participate in the trade or business or rental activity it owns. The Comments refer to this as the Parity Test, because it establishes a common rule for fiduciary and individual ownership based on the Individual Hours Tests.

\footnote{See 2013 ABA Comments, \textit{supra} note 95, at 19 n.82 (citing to the rules for material participation by a C corporation in Temporary Regulation section 1.469-5T(a)(7), but this third alternative also could be based on the holding in the \textit{Carter Trust} case).}
The actions of an individual trustee should also be the actions of the trust, unless those actions of the individual trustee are not subject to fiduciary duties. Because nearly every state’s law provides that a trustee who acts in any capacity in a trust-owned business has at least some fiduciary duties to the trust beneficiaries, it may be simpler for the Regulations to include a presumption that any hours worked in a trust-owned business are subject to the fiduciary duties owing the trust beneficiaries. Given that this fiduciary principle appears to be the majority rule in the states, the presumption would conform to state law, except in extraordinary circumstances.

One of the Service’s first efforts to enunciate a fiduciary material participation test for its own auditors took a similar form to the test proposed above:

If a business activity is owned by a trust, the examiner will need to determine if the material participation standard is met in order for losses to be fully deductible . . . IRC § 469(h) requires regular, continuous, and substantial participation in the operations of the business to meet material participation and for losses to be fully deductible. There is no guidance in the regulations at this time for material participation of trusts and estates. As an administrative proxy, we look to the seven tests in Reg. § 1.469-5T(a) for material participation, and generally will not raise an issue if the trustee meets one of the tests. However, as a technical matter the tests apply to individuals, not to a trust or trustee. Thus, as a legal matter, the trustee must prove he works on a regular basis in operations, on a continuous basis, and on a substantial basis in operations, i.e., rise to the requirements of IRC § 469(h).

We believe that one of the policies behind the fiduciary material participation rules should be to neither encourage nor discourage the use of a trust to own business assets or real estate. Without providing an equivalent material participation test for both individuals and individual trustees, a taxpayer may be discouraged from using trusts.

The Parity Test adopts the requirement from Aragona Trust that for hours of an individual trustee to count towards material participation, the hours have to be performed in a fiduciary capacity.

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As reflected by the Restatements of Trust discussed above, the overwhelming weight of the law is that the trustee acting in another capacity in a trust-owned business remains subject to fiduciary duties. Therefore, the proposed Regulations should consider providing a consistent presumption to simplify the application of the Parity Test.

b. **The Facts and Circumstances Test from *Carter Trust***

We believe that if considering all the facts and circumstances, the fiduciary, including its agents and employees acting for the benefit of the trust beneficiaries, is involved in a trade or business or rental activity owned by a trust or estate on a regular, continuous, and substantial basis, the trust or estate should be deemed to participate in the trade or business or rental activity.\(^{108}\) If the aggregate hours of the fiduciary, including its agents and employees acting for the benefit of the beneficiaries, satisfy an hours test for material participation by an individual, the trust or estate will be presumed to be materially participating, unless the Service proves that the hours were artificially inflated.

Our recommendation that the Facts and Circumstances Test be applied to trusts and estates is based on the *Carter Trust* decision. *Carter Trust* is often cited for the proposition that the actions of the trust’s agents and employees are being considered in determining whether a trust materially participates.

The employees and others who performed services on behalf of the Carter Trust were actually employed by the trustee. The rules of agency – tax and non-tax – attribute the actions of those agents and employees to the fiduciary. Thus, the issue in *Carter Trust* was not the validity of the Senate Report requiring consideration of only the actions of the fiduciary, but whether the actions of employees and agents of the fiduciary should be attributed to the fiduciary for purposes of determining whether the trust or estate materially participates.

The legislative history of section 469 suggests that the actions of an employee or agent should not be attributed to an individual in determining whether the individual materially participates in a trade or business or rental activity. The relationship between sections 2032A and 469 is discussed in Section II.A.3.c. of these Comments. The Service also has argued under section 2032A that the actions of employees and agents cannot be considered for purposes of determining material participation. However, in *Mangels v. United States*\(^{109}\) the court allowed such attribution. In *Mangels*, farmland owned by a decedent whose court-appointed conservator was a corporation, Northwest Bank & Trust Company, leased the farmland to third-party tenants. The decedent was disabled and could not materially participate. However, the court held that the activities of

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\(^{108}\) For purposes of satisfying the Facts and Circumstances Test, the current Regulations provide that time spent by an individual managing an activity does not count (i) if any person (other than such individual) was compensated for management, and (ii) any person spent more hours than the taxpayer managing the activity. Reg. § 1.469-5T(b)(2)(ii). In the context of closely-held businesses owned and operated by trusts and estates, when full time managers may be employed in such businesses, this limitation would preclude most trusts from materially participating, unless the activities of such employees are attributed to the fiduciary consistent with *Carter Trust* and as proposed in these Comments.

\(^{109}\) 828 F.2d 1324 (8th Cir. 1987).
the corporate conservator managing the farmland could be attributed to the
decedent so that the decedent was treated as having materially participated for
purposes of section 2032A. The court thought that the principle of agency was so
strongly recognized for tax purposes that it overrode the section 2032A principle
of considering only family member participation.

An individual can work in his or her own business to satisfy the Individual
Hours Tests without regard to the value of that work. By contrast, the duties the
fiduciary owes the beneficiaries require that the fiduciary obtain the relevant
expertise. Retaining agents or employees to manage a trust asset demonstrates the
substantial importance that the fiduciary places on managing and operating the
trust assets successfully as required of all fiduciaries.

Unlike an individual or individual trustee or executor, a trust or an estate
has no hours of its own to use in a business it owns; it must acquire all of those
hours through its agents and employees. The Senate Report referred to a
“fiduciary” but it would be reasonable to consider it to have intended to refer to
trusts generally. Thus, counting the actions of the fiduciary and their agents and
employees necessarily follows even though it may have the effect of putting the
trust or estate in a different position than an individual. As reflected the Aragona
Trust and Carter Trust decisions, the courts appropriately view such direct
operations by the trusts, usually involving real estate, as necessarily constituting
material participation by those trusts. For all other trades or businesses or rental
activities operated through entities, which are not disregarded, the actions of the
employees of the entities will not count towards material participation by the trust
or estate, just as the actions would not count for an individual.

In our view, the Parity Test alone is insufficient to determine whether a
trust or estate materially participates in a business it owns. The trust may have a
corporate fiduciary or the fiduciary may retain agents and employees for the
purpose of managing and operating the trust-owned business. Although the Parity
Test based on an individual trustee’s material participation is necessary, the
complex nature of a trust makes the Parity Test alone insufficient. Rather, as
acknowledged by the Carter Trust court, all of the connections between the trust
and the business it owns should be considered in determining whether the trust
materially participates.

We, therefore, have proposed a second fiduciary material participation test
that will consider all facts and circumstances including the actions undertaken by
the employees and agents of the fiduciary. This consideration would extend to the
employees and agents of a corporate trustee through whom the corporation must
act. Both an individual or corporate fiduciary could include the participation of
its agents and employees, including its agents and employees used in the business
pursuant to a contractual arrangement, in determining whether the trust or estate
materially participated. The participation of employees, officers, managers and
directors of an entity that is wholly owned by the trust or estate and, therefore,
disregarded for federal income tax purposes should be included as if directly
employed by the fiduciary. As in *Aragon Trust*, this exception allows a fiduciary to limit the liability risk to the trust or estate related to a trust-owned trade or business or rental activity without forgoing material participation in the activity.

We believe that a rule qualifying entities owned by a trust is appropriate provided that the trustee clearly has normal fiduciary duties over the entity’s personnel. For example, if separate trusts were created for each of the five siblings benefitting from the Frank Aragona Trust, the participation of the employees and agents of an entity owned by all five trusts should be included in determining whether each trust is materially participating. However, permitting the employees of an entity owned by all five trusts could eventually result in the participation of the employees of nearly every business being attributed to a trust-owner, while none of that participation would be attributed to an individual owner. The key distinction is that the trustee or executor must have fiduciary duties to the beneficiaries regarding the actions of these employees. In other words, acting through an entity that shields the trust or estate from liabilities should not preclude a finding of material participation by the trust or estate, so long as the entity does not shield the trustees from liability to the beneficiaries for actions taken by the fiduciaries or those working under the fiduciaries’ direction.

These Comments use the term “agent” to describe a person whose actions are attributable to the fiduciary. If state law exempts the fiduciary from liability for the actions of a person, that person should not be considered an agent of the fiduciary for purposes of satisfying the fiduciary material participation tests. However, that person may be the “fiduciary” under section 469, if the person has decision-making powers over the trust-owned business and owes fiduciary duties directly to the trust beneficiaries.

c. **Rules When a Trust or Estate Has Multiple Fiduciaries**

If the Facts and Circumstances Test we propose in these Comments is adopted in Regulations, the actions of a fiduciary and the fiduciary’s agents and employees in the service of the trust beneficiaries should be aggregated to determine whether the trust or estate materially participates for purposes of that test. Because all factors can be considered under this subjective test, the hours can be ignored under the test if those hours are merely duplicative.

On the other hand, the Parity Test assumes that a trust should be treated as materially participating if its individual fiduciary satisfies the individual material participation tests. If multiple fiduciaries are acting, we believe that it is sufficient if at least one fiduciary materially participates, provided the fiduciary owes fiduciary duties to the beneficiaries of the trust or estate and has decision making authority and the power to act on behalf of the trust or estate, whether that fiduciary can act unilaterally or not. That active fiduciary will have the business expertise and, thus, is likely to influence fiduciary decisions related to the
business, even without that fiduciary possessing unilateral power and control. This is consistent with the *Aragona Trust* case where half the trustees worked full-time in the trust real estate and rental businesses.

d. **Special Individual Hours Tests**

In addition to the definition of individual material participation, at least two special rules under section 469 mandate objective hours tests: the real estate professional exception, and the significant participation passive activity recharacterization rule. This section discusses how these Special Individual Hours Tests should apply in the fiduciary context. As discussed below, under existing law, we believe that both tests require that the hours of the fiduciary counted towards material participation of a trust or estate be performed while owning fiduciary duties to the beneficiaries and, if the fiduciary is responsible to the beneficiaries for the actions of the trustee’s agents and employees, would include the hours of those agents and employees.

(i) **The Real Estate Professional Exception**

Although we recognize that an objective hours test may not be the optimum means for judging whether a trust or estate materially participates, we believe that fairness and good tax policy require that all Special Individual Hours Tests should apply to trusts and estates as well as individual taxpayers. Moreover, when applying the Special Individual Hours Tests to a trust or estate, the fiduciary should count all fiduciary hours.

The two part statutory test for determining whether a taxpayer is a real estate professional under section 469(c)(7) is an example of a test requiring that fiduciary hours be counted. Section 469(c)(7) provides:

(B) Taxpayers to whom paragraph applies. This paragraph shall apply to a taxpayer for a taxable year if-

(i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and

(ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

This test requires that a trust or estate satisfy both prongs to be allowed to demonstrate it materially participated in its rental activities. Despite the *Aragona Trust* court’s statement that it did not have to resolve how to apply these tests because the Service failed to raise this argument, the opinion did address this question:
If 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.” Sec. 1.469-9(b)(4), Income Tax Regs. We conclude that a trust is capable of performing personal services and therefore can satisfy the section 469(c)(7) exception.

The only reasonable interpretation of these two sentences is that the hours worked by the trustees on behalf of the beneficiaries of the trust count as hours worked by the trust. Therefore, the court could have applied these two tests if it had been necessary to address the issues presented by the parties. First, the hours of the six trustees expended on behalf of the trust in the trust’s real estate trades or businesses would be added together to determine whether the trust worked the requisite 750 hours in real estate trades or businesses. With three trustees working full-time in the business, their aggregate hours on behalf of the trust easily exceeded this minimum. Second, all of the hours of all of the trustees expended on behalf of the trust in all of the trust’s trades or businesses would be aggregated, and half those hours would need to be expended in its real estate businesses. The decision suggests that the Frank Aragona Trust had no other trade or business or rental activities. If so, the “more than one-half” test was easily satisfied. The hours spent by the attorney in his legal practice for other clients would not be counted in determining the trust’s hours, because the law firm was not owned by the trust and his work for his other clients was not subject to fiduciary duties owed to the beneficiaries. The time spent in trustee meetings or working on purely trust administration or portfolio investments are not hours counted as time expended in a trade or business or rental activity of the trust for purpose of either prong of the test.

(ii) Significant Participation Passive Activities

We believe that the Regulations should clarify how the section 469 recharacterization rules apply to trusts and estates and their beneficiaries. One of the recharacterization rules applies to the income from a significant participation passive activity (“SPPA”). The objective of new fiduciary material participation Regulations should be to provide parallel treatment for both individuals and trusts and estates under the recharacterization rules.

In particular, the SPPA rules are one of the Special Individual Hours Tests. If the taxpayer works more than 100 hours in an activity, the activity is an SPPA, meaning the income from the SPPA may be recharacterized as non-passive. The SPPA rule is one of the anti-PIG (passive income generator) rules to prevent taxpayers from inappropriately creating passive income to offset

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110 Reg. § 1.469-5T(c)(2).
111 Reg. § 1.469-2T(f)(2)(i).
passive losses. These rules treat a loss from the PIG as passive and non-deductible against positive income for purposes of section 469. On the other hand, the rules characterize the income from the PIG as non-passive and, thus, unable to be sheltered from tax by a passive loss. We do not believe that the drafters of the SPPA recharacterization rule could have intended to exclude trusts and estates from the rule, and allow trusts and estates to generate this type of passive income to use against passive losses.

The section 1411 Regulations provide that income recharacterized as non-passive under the section 469 Regulations will not be net investment income, if the income is not further recharacterized as portfolio income.\(^{112}\) The income from a trade or business or rental activity which constitutes an SPPA is not so recharacterized. Thus, as a practical matter the income from an activity in which the taxpayer participates more than 100 hours will escape the NII Tax without the combined hours from all such activities exceeding 500 hours.\(^{113}\)

If the taxpayer is active in an SPPA, the taxpayer’s income is active and losses are passive, unless the taxpayer meets the SPPA material participation rule under Regulation section 1.469-5T(a)(4). The SPPA recharacterization rule recognizes the difficulty of drawing a line based solely on a specified number of hours to separate active and passive owners.

We recommend that a parallel recharacterization rule should apply to a trust or estate when the fiduciary participates in an activity for more than 100 hours while owing fiduciary duties to the beneficiaries. An individual might own four activities in which the individual works at least 100 hours in each activity. If the individual works more than an aggregate 500 hours in all such activities, the individual will materially participate in each. On the other hand, if a trust only owns two of those activities, the individual trustee’s actions will be undertaken in a fiduciary capacity only with respect to these two activities. The two trust activities will be SPPAs as to the trust due to the individual trustee’s participation.

Although the Individual Hours Tests do not apply to trusts under the litigation positions advanced by the Service, the SPPA recharacterization rule already may apply to trusts and estates under the current Regulations. Regulations section 1.469-2T(f)(2)(i), which states:

An amount of the taxpayer’s gross income from each significant participation passive activity for the taxable year equal to a ratable portion of the taxpayer’s net

\(^{112}\) Reg. § 1.1411-5(b)(2).

\(^{113}\) If the combined hours from SPPAs are more than 500 hours, the taxpayer materially participates in all of those activities under the individual hours material participation test #4 set forth in Temporary Regulation section 1.469-5T(a). Each such activity then stops being a “significant participation passive activity” or SPPA and instead becomes simply a “significant participation activity” or SPA.
passive income from such activity for the taxable year shall be treated as not from a passive activity . . .

This Regulation does not refer to “individual” or “natural person” but instead refers to the taxpayer, suggesting that the Regulation did not intend to exclude trusts and estates from the SPPA recharacterization rule. Finally, Regulations section 1.469-5T(c)(2) provides: “An individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year” (emphasis added).

Because only an individual may satisfy the requirements of Regulation section 1.469-5T(c)(2), the SPPA income recharacterization rules of Regulations section 1.469-2T(f) may only apply to individuals. On the other hand, it appears that these rules more generally apply to all “taxpayers” subject to section 469. Clearly, if the SPPA recharacterization rule does not apply to trusts and estates, trusts and estates could generate passive income to use against passive losses, inconsistent with the purpose behind the recharacterization rules. On the other hand, the SPPA recharacterization rules would provide a pro-taxpayer result under section 1411.

Whatever the treatment under the current Regulations, we recommend that the fiduciary material participation Regulations clarify that the SPPA rules apply to trusts and estates. Those hours would be counted in the same manner as under the Facts and Circumstances Test. If the more than 100 hours test is satisfied as to any of its trade or business or rental activities, the activity would be an SPPA of the trust or estate. Its income would be recharacterized as non-passive for both section 469 and section 1411 purposes, while its losses would remain passive.

5. Participating in Business Activities Does Not Convert a Trust into a Business Entity

Concern may be expressed as to the classification of a trust engaged in a trade or business or rental activity as a business entity, rather than a trust, for federal tax purposes. If classified as an association taxable as a corporation or a partnership, the rules applicable to such entities would control for purposes of section 1411. In Aragona Trust, the Tax Court provided in footnote 11 that “(t)he IRS does not take the position that the trust should be treated as a corporation.”

In Carter Trust, the trust operated its ranch business directly using employees and agents of the trust, rather than through an entity owned by the trust. The Service does not appear to have argued that the trust might be an association for tax purposes, because it directly operated the ranch. “Association”

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114 Aragona Trust, supra note 7, at 20 n.11 (citing Regulation section 301.7701-4(b), which provided that business trusts, defined as devices created by beneficiaries to carry on profit making businesses, are to be treated for federal tax law purposes as corporations or partnerships).
treatment would mean that the trust would be taxed as an association taxable as a corporation, rather than as a trust, resulting in the potential double taxation of its income.”

Nevertheless, without citing authority, the Blue Book concluded almost contemporaneously with *Bedell Trust* that “it is unlikely that a trust as such for Federal income tax purposes will be materially participating in a trade or business activity, within the meaning of the passive loss rule.” Thus, the Blue Book stated “no special rule is provided for determining material participation by a trust.”

Congress subsequently reinforced its intention that a trust can materially participate when it enacted section 42(h)(5)(B) providing “a qualified low-income housing project is described in this subparagraph if a qualified nonprofit organization is to own an interest in the project (directly or through a partnership) and materially participates (within the meaning of section 469(h)) in the development and operation of the project throughout the compliance period” (emphasis added). A nonprofit organization would necessarily be either a corporation or a trust; it could never be an individual. Congress would not enact a meaningless test that no nonprofit organization could satisfy by materially participating. Thus, this low income housing statutory provision reinforces Congress’s intent that a trust or a corporation would be able to materially participate under section 469.

The applicable guidance consistently provides that a trust can materially participate under section 469 and, accordingly, under section 1411. Thus, the trade or business income generated by an entity owned by a trust, or directly operated by the trust, should not be subject to the NII Tax when the trust materially participates in the trade or business.

These Comments are directed toward the promulgation of rules for the material participation of fiduciaries that would apply generally to trusts.

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115 The staff of the Joint Committee on Taxation stated that a trust would be a trust for income tax purposes, and not an association taxable as a corporation, only “if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint venture for the conduct of business for profit. Staff of the Jt. Comm. on Taxation, *General Explanation of the Tax Reform Act of 1986*, at 242, n. 33 (JCS-10-87) (May 4, 1987). General Explanations of tax legislation prepared by the Joint Committee on Taxation, however, do constitute authority upon which taxpayers may rely for purposes of determining whether there is substantial authority for the U.S. federal income tax treatment of an item. See Reg. § 1.6662-4(d)(3)(iii).


117 Id.

118 See, e.g., *Housing Pioneers, Inc. v. Commissioner*, 58 F.3d 401 (9th Cir. 1995) (holding that the nonprofit failed to participate on a regular, continuous, and substantial basis).
established for legitimate trust purposes and to decedents’ estates, and not to situations involving a joint enterprise for the conduct of business for profit or the pooling of assets for active management.

D. How Do These Material Participation Rules Apply to a Trust or Estate with a Corporate Trustee or a Trust Company as Fiduciary?

1. Corporate Trustees

Consistent with principles reflected in the *Carter Trust* decision, the determination of whether a corporate trustee materially participates in a trade or business or rental activity of the trust for purposes of section 469 should focus on that trustee's participation in the activity owned by the trust. A corporation can act only through its employees, directors, officers, managers and agents so the participation of those individuals in the business activity necessarily would be participation by the trust. Because each individual associated with a corporate trustee may play a different role in the operation of the trust-owned business, the aggregate of all their time for the business will be attributed to the corporate trustee for purposes of determining whether the trust materially participates.

The court and the Service disagreed in *Carter Trust* on whether the activities of a trustee’s employees and agents should be attributed to the trust(ee). However, neither the courts nor the Service have addressed the question of material participation by a corporate trustee that, by definition, turns on the actions of the corporation’s employees, officers, directors and agents. Nothing suggests that a trust with a corporate trustee cannot materially participate and would always be passive. Indeed, as discussed below, section 469 applies to closely-held and personal service corporations and its Regulations contemplate that corporations can materially participate.

Moreover, section 42 contemplates that a nonprofit entity can materially participate (within the meaning of section 469) in a housing activity in order qualify for a low income housing credit. Congress obviously intended for a corporation or a trust to be able to materially participate under section 469. We know of no policy reason that should disqualify a trust with a corporate trustee from qualifying as active in a trade or business or rental activity.

The subjective nature of the Facts and Circumstances Test also permits the Service to rebut the nature of any Individual Hours Tests counted for the trust or estate to prevent abuse. For example, a corporate trustee providing 500 hours of janitorial staff or tax return preparers for a business as part of its package of trustee services might have those hours disregarded as mere “busy work.” The subjective test actually provides more tools for the Service to fight abuse than the Individual Hours Tests do. Under the Facts and Circumstances Test, the quality, and not just the quantity, of the hours should be relevant.
The court in *Carter Trust* permitted an individual trustee to count the hours of his employees and agents. That holding makes sense. As explained above, a corporate trustee necessarily is able to count the hours of its employees and agents to satisfy the fiduciary material participation test. An individual trustee, therefore, also should be able to count the participation of the employees and agents of the individual trustee so that individual and corporate trustees are comparably treated. It would be reasonable to expect that an individual trustee cannot count the hours of employees and agents for purposes of satisfying the Parity Test, because an individual cannot do so for purposes of the Individual Hours Tests.

Also, as discussed above, state law imposes fiduciary duties directly on employees and officers of a trust company acting as trustee, as well as imposing duties on the trust company itself. That means each employee or officer could be considered a fiduciary under the *Aragona Trust* case. The state law fiduciary issues were not raised in *Carter Trust*. However, that court would have likely considered those state law fiduciary duties as important as the *Aragona Trust* court did.

The court in *Carter Trust* did note by analogy the rules regarding material participation for closely-held C corporations, based on the premise that the trust was akin to a separate entity. The Regulations under section 469 provide objective tests to determine whether a corporation to which the passive loss rules apply materially participates in a particular activity.

A corporation is a closely-held C corporation if “at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals.”\(^{119}\) A C corporation will be treated as a personal service corporation if its principal activity is the performance of personal services and such personal services are substantially performed by employee-owners.\(^ {120}\) For purposes of section 469, an employee-owner is any employee who owns, on any day during the taxable year, any of the outstanding stock of the personal service corporation, with attribution rules.\(^ {121}\)

\(^{119}\) I.R.C. §§ 465(a)(1)(B), 469(j)(1). This rule is applied with reference to the attribution rules of section 544(a), as modified by section 465(a)(3). Thus, for example, attribution applies between family members including siblings, spouses, ancestors, and lineal descendants, and requires looking through legal entities to their owners. These attribution rules are considerably broader in certain respects than those applying under other Code provisions such as section 318 (e.g., applying to brothers and sisters, rather than only lineally). Thus, for example, corporations with stock owned by more than five individuals, but controlled by an extended family group, often will qualify as closely-held for purposes of the passive loss rules.

\(^ {120}\) I.R.C. §§ 469(j)(2), 269A(b)(1).

\(^ {121}\) I.R.C. § 269A(b)(2).
Both closely-held C corporations and personal service corporations, subject to the passive loss limitations, will be treated as materially participating in an activity if one or more shareholders holding stock representing more than 50% (by value) of the outstanding stock of such corporation materially participate in such activity. In addition, closely-held C corporations will be treated as materially participating in an activity if: (i) during the entire 12-month period ending on the last day of the taxable year, such corporation had at least one full-time employee substantially all the services of whom were in the active management of such business, (ii) during the entire 12-month period ending on the last day of the taxable year, such corporation had at least three full-time, non-owner employees substantially all of the services of whom were services directly related to such business, and (iii) the amount of the deductions attributable to such business which are allowable to the taxpayer solely by reason of sections 162 and 404 for the taxable year exceeds 15% of the gross income from such business for such year.

While the Carter Trust court noted these rules in its opinion, it ultimately concluded that it did not need to resort to those rules to hold in favor of the taxpayer. The corporation rules apply only when the taxpayer is a corporation, not when the taxpayer is a trust or estate with a corporate trustee. However, the statutory recognition that a corporation can materially participate through the actions of its employees shows that a trust with a corporate trustee is not necessarily passive. The closely-held corporation rules relate to the application of section 469 when the corporation is the taxpayer, which is different than the case when the trust is the taxpayer.

2. Unique Tax Issues When the Fiduciary Is a Private Trust Company

Generally speaking, there is very limited authority regarding the manner in which a trustee that is a private trust company (a "PTC") will be treated for federal income tax purposes. On July 11, 2008, the Service issued Notice 2008-63 (the “Notice”), a notice of a proposed revenue ruling regarding the income, estate, gift and GST tax consequences where family members in two situations create a PTC to serve as the trustee of trusts having family members as settlors and beneficiaries.

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122 When applicable, the passive loss limitations allow a closely-held C corporation or personal service corporation to offset income from passive activities with the losses from passive activities. Therefore, if a closely-held C corporation’s business activities include property rentals and operation of an active trade or business, losses from the rental activities cannot be used to offset taxable profits from the active trade or business activities. Because these losses are passive, they can only offset future earnings from the rental activity.

123 I.R.C. § 469(h)(4)(A).


Importantly, the Notice states the general intention that the choice to use a PTC as trustee should be tax neutral: a taxpayer who uses a PTC should not be subject to more restrictions than if the taxpayer had used individual trustees. On the other hand, a taxpayer using a PTC should not escape tax consequences that would have applied had the taxpayer appointed the PTC decision-makers as individual trustees.

We believe that the Regulations, when issued, should provide neither an incentive nor disincentive under sections 469 and 1411 for using an individual or corporate trustee. Thus, these “look-through” rules should be available to a PTC acting as trustee for purposes of these sections of the Code. However, we recommend that the PTC “look-through” rules apply only when the actions of the PTC’s employees and agents are inadequate to cause the trust to materially participate under the Facts and Circumstances Test. To treat public and private trust companies alike, the Regulations would need additional complicated rules attributing the employees and agents of the corporation to the PTC decision-maker who might be treated as individual fiduciaries. By applying the public trust company rules to a PTC as an entity before applying the look-through PTC rules, the PTC is fairly treated without the need for further complicated entity rules.

E. When Is a Trust or Estate Beneficiary’s Material Participation Relevant?

1. The Regulations Should Provide That the Material Participation of the Fiduciary, Not the Beneficiary, Is Relevant to Determining Whether Income or Loss Retained in a Trust or Estate Is Active or Passive

While the trustee is the legal owner of the trust assets, the beneficiary also has an equitable interest in those assets. Moreover, the trustee’s fiduciary duties require the trustee to act in the best interests of the trust beneficiaries in administering trust assets, rather than be free to pursue the fiduciary’s personal interests. Thus, when the trust is the taxpayer, the beneficiary’s material participation in the trust-owned trade or business or rental activity may not be relevant to the determination of whether the income from activities in which the trust invests is active or passive with respect to the trust as a taxpayer.

a. Rationale for the Proposed Rule

We recommend that the material participation of the trust fiduciaries and their agents, rather than the material participation of a beneficiary, be considered in determining whether income or loss retained by, and taxed to, the trust is active or passive. The following reasons support this conclusion.
First, these Comments support maintaining the current law’s focus on the fiduciary’s participation as provided in the Senate Report. Rather than adopt an entirely new approach, we recommend that the Regulations adopt existing law and clarify the rules with respect to fiduciary material participation.

Second, with respect to taxpayers other than a trust, the authorities under section 469 recognize the relevance of a person’s material participation under just two circumstances: when the person is the taxpayer or, when the taxpayer is an entity, the entity necessarily acts through the person or persons under principles of agency. When the trust is taxed on income or loss, the beneficiary is neither the taxpayer nor the person acting for the trust. The beneficiary, as such, owes no fiduciary duties to the other beneficiaries and, therefore, acts only for his or her own self-interest. Of course, as in Carter Trust, the beneficiary may also be a fiduciary.

b. The Treatment of Beneficiaries under the Existing Section 469 Regulations

As noted above, a beneficiary has an equitable ownership in trust assets under state law. However, the existing section 469 Regulations ignore this ownership interest. The Regulation on grouping activities provides as follows:

(a) Scope and purpose. This section sets forth the rules for grouping a taxpayer’s trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of section 469. A taxpayer’s activities include those conducted through C corporations that are subject to section 469, S corporations, and partnerships.

The Regulation does not mention a trust or estate. Because the current section 469 Regulations reserve guidance on trusts and estates, the silence could be attributable to the intention of Treasury and the Service to defer all mention of trusts and estates until Regulations are eventually issued.

The silence, however, implies that a line is being drawn between the treatment of a trust or estate, on the one hand, and an S corporation or partnership, on the other. One argument for drawing a line between a trust and an S corporation or partnership is that a trust may pay tax at the trust level on undistributed income, and is a “taxpayer” under section 469, while generally an

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126 Senate Report, supra note 6, at 735.
127 One of the reasons for considering only the material participation of a taxpayer is to permit the taxpayer to file an income tax return without the cooperation of another person who is not an agent or employee. If the beneficiary’s material participation impacts whether trust income or loss is active or passive, the trustee would be unable to do its own tax planning for the trust.
128 Reg. § 1.469-4(a).
129 Reg. § 1.469-8.
S corporation or partnership does not pay tax at the entity level. Therefore, section 469 recognizes the individual shareholders or partners, while ignoring S corporations and partnerships and treating the individual beneficiaries as distinct from the trusts and estates.

The Regulations provide that the shareholder of a C corporation *that is a taxpayer “subject to section 469”* is treated as conducting any activity owned by the corporation. The quoted Regulation implies that the beneficiary of a trust is not treated as conducting any activity owned by the trust for the beneficiary’s benefit. Treasury and the Service may or may not have intended that distinction, but it exists nonetheless.

Regulation section 1.469-5(f), addressing material participation, increases the impact of the grouping Regulation. It provides:

> [A]ny work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity.

If the beneficiary is unable to treat an activity owned by the trust as an activity in which the beneficiary has an interest, the beneficiary would not be considered to materially participate in a business in which the beneficiary was a full-time employee. If the beneficiary had an ownership interest in a trust-owned activity, the inability of the beneficiary to group separate activities with the related trust-owned activity could prevent the beneficiary from materially participating. The inability to group the activities could cause the beneficiary not to materially participate in the beneficiary’s individually owned activities related to the trust-owned activities, despite the activities being related sufficiently to be grouped under the existing grouping Regulations. This policy is not well founded, especially because the mere ownership of a direct interest of one percent in the trust’s activity would allow grouping.

This grouping Regulation has other effects. A real estate professional with an extensive real estate business could not group rental real estate held in trust for the real estate professional’s benefit, unless the real estate professional owned some direct interest in the rental activity. This result ignores the beneficiary’s equitable ownership in the trust rental activity through the trust. The income distributed to the real estate professional is just as economically significant as the income from any directly owned real estate. Any losses incurred by the trust also might have an adverse economic impact on the real estate professional, and such losses could adversely impact the real estate professional’s children or grandchildren. Thus, unless the trust or estate is a real estate professional, the losses will remain passive.
The grouping rules also impact the recharacterization of the rents received by a taxpayer as non-passive if the taxpayer rents property to a business in which the taxpayer materially participates (the “self-charged rules”). Because the taxpayer cannot materially participate in a business wholly owned by the trust, the rental income would be passive, rather than non-passive. However, apparently the rental income would be non-passive to the taxpayer if the taxpayer owned only one percent of the business activity of which the trust owns the remaining 99%.

Although not a trust case, in *Connor v. Commissioner* a dentist and his wife were negatively affected by the adoption of the final Regulations dealing with grouping under section 469. In that case the wife owned a rental property that she rented to her husband’s personal service corporation. The earlier Regulations had not included the language that treated the owner of a C corporation subject to section 469 as owning the activities of the C corporation. Under those rules, the wife’s rental income would be passive, rather than non-passive, allowing it to be offset against passive losses from other rental activities. The Seventh Circuit analyzed the history of these rules, ultimately concluding that the insertion of the language into the final Regulations at the last minute without inclusion in proposed Regulations was within Treasury’s authority.

Whether the Service’s silence in the Regulations was intended to have the effect or not, we believe it should result in the interpretations described above. In issuing the final Regulations on self-charged items of income and expense, the Service acknowledged that commentators had criticized the omission of trusts and estates from the Regulations:

Certain commentators requested that the regulations be extended to apply to transactions between taxpayers and trusts, estates, REMICs and housing cooperatives. The regulations address the transactions identified by Congress involving S corporations and partnerships (including entities classified as partnerships for federal tax purposes). Application of the self-charged rules to other types of entities would require a significant expansion of the scope of these regulations to address broader issues concerning the manner in which section 469 applies to those entities.

We offer the following comments with respect to this statement in the preamble to the self-charged Regulations. First, at least as to the taxpayer friendly self-charged rules, the silence regarding trusts and estates is apparently

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130 Reg. § 1.469-2(f)(6).
131 218 F.3d 733 (7th Cir. 2000).
132 See also *Krukowski v. Commissioner*, 279 F.3d 547 (7th Cir. 2002).
133 Reg. § 1.469-2(f)(6), incorporated for purposes of I.R.C. § 1411 by Reg. § 1.1411-4(g)(6).
intended to have a substantive effect, denying trusts and estates their benefits. Second, the Treasury recognizes that the application of the self-charged rules to trusts and estates would require significant expansion of the scope of the Regulations (which may now be appropriate). Finally, the statement indicates that the Treasury appears to have felt it only had an obligation to issue self-charged Regulations that applied to S corporations and partnerships, which were the only “entities” Congress mentioned specifically, while acknowledging that other types of entities may be subject to the same policy considerations under section 469.

The last sentence in the statement echoes the Service’s position in Aragona Trust. The Service similarly defended its Regulations, arguing that the legislative history fails to specify that a trust can be a real estate professional. That court rejected the argument that legislative silence should be determinative. A future court could decide that omitting any mention of trusts and estates in the Regulations means they should have no effect on applying section 469 to trusts or estates.

Neither a shareholder in a corporation nor a partner in a partnership has an ownership interest in the assets of either entity equivalent to that of a beneficiary. Nor are the fiduciary duties that a manager, director, officer or other employee of the entity owes to an owner generally as strict as the fiduciary duties a trustee or executor owes to a beneficiary (absent exculpation in the governing documents). These factors should be taken into account if the Service revisits the grouping rules in the context of developing new Regulations under section 1.469-8.

The Service developed the section 469 Regulations without addressing the policy questions implicated in applying section 469 (and now section 1411) to trusts and estates. We recommend that the section 469 grouping Regulations should be revised to conform to the final guidance on material participation by trusts and estates.

c. Conclusion

We believe that the Senate Report and the reasons discussed above require focus on the fiduciary’s material participation in determining whether trust or estate income retained and taxed to the trust or estate is active or passive. The treatment of trusts and estates under the existing section 469 Regulations also supports this conclusion.

Both the Fiduciary Participation Test and the Taxpayer Participation Test provide the same result when income is retained by the trust or estate. Further consideration is required when income is distributed to a beneficiary, a separate taxpayer, as discussed further below.

\[135\] Note that the Treasury appears to refer to trusts and estates as “entities” along with REMICs and housing cooperatives.
2. Whose Material Participation Is Relevant for Determining Whether Income Distributed to a Beneficiary Is Active or Passive?

With respect to income allocated and distributed to the beneficiary, when the beneficiary pays the tax on that income, none of the first three reasons for ignoring the beneficiary’s material participation apply. First, the Senate Report refers to the fiduciary’s material participation on behalf of the trust. The treatment of the beneficiary is not addressed. Second, the beneficiary is the taxpayer with respect to the distributed income. Finally, when income actually is distributed, no uncertainty exists as to the beneficiary’s interest in the income of the trust-owned trade or business or rental activity – the beneficiary’s interest in the income from the trade or business or rental activity for that year is no longer speculative.

The next section will explore whether the fourth reason – the existing Regulations under section 469 – or other considerations should similarly make the material participation of the trustee or the beneficiary relevant in determining whether distributed income is active or passive.

a. When the Trust-Owned Business is Operated as an S Corporation

Whether the material participation of the fiduciary or of the beneficiary should determine whether income distributed to a beneficiary from a trade or business or rental activity operated by an S corporation owned by a trust is active or passive will depend on the type of trust (in each case a permitted S corporation shareholder subject to special rules).

Four types of common law trusts can hold S corporation stock: a grantor trust, a QSST, an electing small business trust (“ESBT”), and certain transitional trusts created at, or becoming irrevocable due to, an individual’s death, whose eligibility to own S corporation stock is transitional.

As discussed above, a grantor trust is ignored for federal tax purposes, including for purposes of sections 469 and 1411. Thus, only the activities of the grantor or other deemed owner is relevant to determine material participation with respect to a grantor trust-owned S corporation.

A QSST is a single beneficiary trust that is required to distribute, or if not required to distribute, in fact distributes all of its fiduciary accounting income to the beneficiary, and with respect to which a timely QSST election is made. The

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137 I.R.C. § 1361(d).
139 I.R.C. § 1361(c)(2)(A)(ii) and (iii).
Code treats the beneficiary as the deemed owner under the grantor trust rules of all of the K-1 income of an S corporation owned by a QSST.\textsuperscript{140} The Senate Report to section 469 makes no specific reference to a QSST. The Blue Book expands on the Senate Report by providing that in the case of a QSST, the material participation of the beneficiary as its deemed owner is relevant to determine whether the QSST’s participation in the S corporation’s activity is passive. A QSST is treated like any other grantor trust for purposes of section 469.\textsuperscript{141} Thus, only the beneficiary’s material participation is relevant to determine whether the S corporation income allocable to the beneficiary of the QSST is active or passive without regard to the material participation of the trustee. Even if the QSST is otherwise a non-grantor trust, upon the election by the beneficiary to treat the trust as a QSST, the non-grantor status is converted to grantor trust status with respect to the S corporation stock held by the QSST.

Unlike the QSST, an ESBT was not recognized by statute as an eligible S corporation shareholder until 1996.\textsuperscript{142} The taxation of an ESBT for regular income tax purposes is unlike that of any other trust. The ESBT may be comprised of three portions: a grantor trust portion (if the trust has a grantor trust portion), an S portion and a non-S portion.\textsuperscript{143} The grantor portion of the ESBT is to be taxed like any other grantor trust.\textsuperscript{144} The non-S portion is taxed like any other simple\textsuperscript{145} or complex trust under the normal rules of subchapter J.

All of the K-1 income and other items from an S corporation are taxed to the S portion under a unique set of trust tax rules intended to tax the income (including trade or business or rental activity income) at the highest tax rate.\textsuperscript{146} This is accomplished by denying the S portion of an ESBT a distribution deduction under section 651 or section 661.\textsuperscript{147} Conversely, the beneficiary is not subject to tax on distributions from the S portion. Because an ESBT cannot

\textsuperscript{140} I.R.C. § 1361(d)(1)(B).
\textsuperscript{141} We recommend that the proposed Regulations should confirm this treatment.
\textsuperscript{143} Reg. § 1.641(c)-1(b).
\textsuperscript{144} Prop. Reg. § 1.1411-3(c)(1)(i). If a grantor or another person is treated as the owner of a portion of the ESBT, the items of income and deduction attributable to the grantor portion (as defined in Regulation section 1.641(c)-1(b)(1)) are included in the grantor’s calculation of net investment income and are not included in the ESBT’s computation of tax. \textit{Id.}
\textsuperscript{145} ESBTs can have multiple current beneficiaries and do not require that all income be distributed annually. A trust that has only one beneficiary and could qualify as a QSST, nevertheless, may elect to be an ESBT instead to cause the trust to pay tax in the trust’s state of residence, rather than the beneficiary’s state; to limit the beneficiary’s knowledge of the S corporation K-1 items; or, when the trust is exempt from the GST tax and the trust instrument does not mandate income distributions, to avoid making current distributions of accounting income to the beneficiary as required by the QSST rules. On the other hand, an ESBT pays tax at the highest individual income tax rate. A QSST election, therefore, may be more likely to be made if the trust permits the distribution of accounting income currently and the beneficiary pays tax at a significantly lower rate.
\textsuperscript{146} I.R.C. § 641(c).
\textsuperscript{147} \textit{See} Reg. § 1.641(c)-1(d)(2)(ii).
reduce its S corporation income by making distributions to its beneficiaries, only
the trustee’s material participation should be relevant to determine whether the
trust-owned S corporation income is active or passive.

Under the QSST rules, because the beneficiary is treated as the deemed
owner of the S corporation stock and all items of income or loss attributable to
such stock, the focus should be on the beneficiary’s material participation. Under
the ESBT rules, because the trust always pays the tax on the S corporation
income, the focus is only on the trustee’s material participation. Thus, the
S corporation rules consistently focus on the identity of the taxpayer to determine
whether the income is active or passive.

Accordingly, under present law S corporation stock held in trust is
generally subject to special rules that (a) treat the beneficiary of a QSST as the
grantor of a grantor trust with respect to the S corporation income or loss, further
making the beneficiary’s material participation relevant for purposes of sections
469 and 1411, and (b) treat an ESBT as the taxpayer with respect to the S portion
of the trust, in which case the material participation of the trustee would be
relevant for purposes of sections 469 and 1411.

b. Determining the Character of Trade or Business
or Rental Activity Income Distributed by a Non-
Grantor Trust to the Beneficiary for Purposes of
Sections 469 and 1411

Section 469 is directed at limiting the use of losses by a taxpayer unless
the taxpayer is materially participating in the trade or business or rental activity
which generates the losses. When the taxpayer is a trust, the material
participation test, applied at the taxpayer (trust) level, should determine whether
losses are active or passive, and if active, can be used to offset other items of
taxable income. If passive, such losses can only be used against other items of
passive income. Upon termination of an estate or trust, any suspended passive
activity losses relating to an interest in a passive activity cannot be allocated to the
beneficiary. Instead, the basis in such activity is increased by the amount of any
passive activity losses allocable to the interest, and no losses are allowed as a
deduction on the estate’s or trust’s final Form 1041 or as a deduction to the
beneficiary.148

Section 469 is directed at limiting the use of passive losses. Except in the
year of its termination, an estate or trust recognizes its passive losses – the losses
cannot be allocated to a beneficiary.149 From the inception of the Regulations
under section 469, the trustee needed to determine whether the income retained by

148 Section 469(j)(12) provides that carryforward passive losses of the trust or estate would be
added to basis and not available for use by the beneficiary.
the trust or distributed to its beneficiaries is active or passive. The Service has consistently argued that whether the losses or income of a trust is active or passive depends on the material participation of its fiduciaries.\textsuperscript{150}

The proponents of the Fiduciary Participation Test recommend that the fiduciary material participation Regulations should follow existing authority in determining when a trust materially participates, focusing on the trustee’s material participation to determine whether income is active or passive at the trust level. This classification will determine whether the income is “net investment income” \textit{(i.e., passive)}, when distributed to a beneficiary. The Fiduciary Participation Test recognizes that the original section 469 Regulations are focused on determining whether income and loss generated at the trust level is active or passive. If passive, the beneficiary’s passive losses can be used to offset that income; if active, the beneficiary’s passive losses cannot be so used.

Proponents of the Taxpayer Participation Test believe that section 1411 brings an entirely new dynamic to the analysis. As discussed below, the question of whether the material participation of the fiduciary or the beneficiary should determine if distributed income is active or passive is a close one. Policy arguments can be made in favor of either approach. The proponents of the Fiduciary Participation Test conclude that existing Regulations – not just those under section 469 discussed above, but also under section 1411 – require that the fiduciary’s material participation determine whether distributed income is active or passive at the trust level. Accordingly, the proponents of the Fiduciary Participation Test recommend a recharacterization rule (consistent with the other recharacterization rules in the section 469 Regulations) that applies when the beneficiary materially participates in the trade or business or rental activity generating the income distributed to the beneficiary (the “Beneficiary Recharacterization Rule”).

We are unaware of any authority providing whether the material participation of the beneficiary or of the fiduciary controls the classification of the distributed income as active or passive. Proponents of the Taxpayer Participation Test believe that the material participation of the beneficiary should determine whether gain or income of a trade or business or rental activity distributed by a trust to the beneficiary is active or passive. Both the Fiduciary Participation Test, through the Beneficiary Recharacterization Rule, and the

\textsuperscript{150} As noted above, the Senate Report accompanying the 1986 Tax Reform Act, which included section 469, treats an estate or trust as materially participating in an activity “if an executor or fiduciary, \textit{in his capacity as such}, is so participating . . .” \textit{Senate Report, supra} note 6, at 735. The Senate Report further provides that “[i]n the case of a grantor trust . . . material participation is determined at the grantor rather than the entity level.” \textit{Id.} The argument that only the material participation of the fiduciaries is relevant assumes the Senate Report intends that the only way a trust or estate can materially participate is through its fiduciaries. Another interpretation might be that the Senate Report merely provided an example of how a trust or estate can materially participate.
Taxpayer Participation Test, get to the same result with respect to income retained by a trust or estate, or distributed to a beneficiary materially participating in the trade or business or rental activity, on a basis consistent with the purposes of section 469 and section 1411. We believe that both tests are consistent with the policy objectives of sections 469 and 1411.

(i) Non-Tax Considerations

Traditionally, the beneficiary of a trust has only an equitable interest in, and no legal ownership or control over, an asset held in trust for the beneficiary. Rather, the trustee as its legal owner has control over a trust-owned business. If a trustee chose to be active in the business, arguably he or she could be active, while the beneficiary lacking any control could not be active. This argument has been made to justify using fiduciary material participation, rather than beneficiary material participation.

However, under section 469, a taxpayer’s control over an entity is not relevant to whether the taxpayer’s income from that entity is active or passive. Thus, an owner with non-voting stock is treated no differently than an owner with voting control over an entity. The focus is on an individual’s actual involvement with the business – through the objective concept of material participation and which cannot be easily manipulated – rather than on the individual’s legal powers over the business. Thus, the beneficiary’s lack of control over a trust-owned business should not affect whose material participation determines whether its distributed income is active or passive.

(ii) Tax Considerations

(a) Is a Trust a “Pass-Through” Entity as to Distributed Income under Section 469?

The general rule under section 469 is that the material participation of the upper tier owner is relevant to determine whether that taxpayer’s income or loss from a trade or business is active or passive. That rule applies to S corporations and partnerships, including through multiple tiers of ownership. Section 469 refers to S corporations and partnerships as “pass-through” entities.\footnote{Regulation section 1.469-7(b)(1) defines a “pass-through” entity as including only an S corporation or partnership for purposes of the self-charged rules. As discussed in the prior section, this means that the interest on a loan between a beneficiary and trust for the beneficiary cannot be offset under the self-charged interest rules of section 469. \textit{Cf.} Reg. § 1.469-7(c).}

A trust is a tax hybrid governed by the federal tax rules in subchapter J. The trust is taxed on its retained income as a separate taxpayer, but the beneficiary is taxed on the income distributed to the beneficiary during the taxable year. Because a trust may be a taxpayer, it is distinguishable from an S
corporation or partnership. When the income is passed through and taxed to the beneficiary should the trust be considered a “pass-through” as to the distributed income?

The income allocated to the beneficiary is determined by the trust’s distributable net income (“DNI”), which is a unique concept in the federal tax law. The rules applicable to determining the trust’s DNI are extensive, for example, the Regulations under subchapter J contain a three part rule for determining whether a trust’s capital gains may be included in DNI. Also trust administration expenses reduce the DNI available for distribution. Both S corporations, and particularly partnerships, however, have rules allocating taxable income and gain among their owners – the same purpose served by the DNI concept. So DNI alone cannot differentiate a trust from an S corporation or partnership as to its distributed income.

A trustee as a taxpayer could group or ungroup its activities for the purposes of determining whether the retained income or loss from those activities is active or passive to the trust. If the trustee groups activities together and reports their income together, the beneficiary will not be able to ungroup the activities for the beneficiary’s own tax purposes. However, an S corporation or partnership may group its activities, which then cannot be ungrouped by its owners. So a trust’s power to group alone cannot differentiate a trust from an S corporation or partnership as to its distributed income.

A pass-through entity such as an S corporation or partnership pays no tax at the entity level. All of the business income is passed through and taxed to the owners, regardless of whether the income is distributed. The trust or estate, on the other hand, is taxed under subchapter J of the Code at the trust or estate level, unless the income is distributed to a beneficiary, in which case the trust or estate deducts the DNI distributed to its beneficiaries. Through the distribution deduction under the DNI regime, the amount and types of income comprising the distribution deduction retain their character and are allocated among the beneficiaries and taxed as if received by them directly. Accordingly, a trust’s distribution deduction alone cannot be interpreted to differentiate a trust from an S corporation or partnership as to its distributed income.

No general tax principle, therefore, justifies treating the trust business income distributed to a beneficiary differently than the income allocated to the owner of an interest in an S corporation or partnership.

(b) The Subchapter J Character Rule Does Not Demand That a Trust’s Active or Passive Income Remain So When Distributed

152 Reg. § 1.643(a)-3(b)(1) – (3).
Subchapter J requires that DNI include all of the income that could be distributed to beneficiaries, including trade or business income. Sections 651 and 661 provide deductions for distributions of that DNI. Sections 652 and 662 correspondingly include the amounts of DNI deducted by the trust in the beneficiaries’ respective gross income. The Regulations require each class of income entering into DNI to be allocated proportionately to the beneficiary unless “the trust instrument provides for the distribution or accumulation of different classes of income or unless local law requires such an allocation.”

The income distributed to the beneficiaries retains its “character” as determined at the trust level under subchapter J. For example, tax-exempt interest received by the trust is included in DNI. When distributed to the beneficiaries, it remains tax-exempt interest. Business income earned by the trust included in DNI and allocated to a beneficiary should remain business income. Some argue that this character rule requires active or passive income of the trust to remain so when distributed to beneficiaries, but that argument is not certain.

This character rule is set forth in Regulations section 1.652(b)-1, which provides:

The tax treatment of amounts determined under §1.652(a)-1 depends upon the beneficiary’s status with respect to them not upon the status of the trust. Thus, if a beneficiary is deemed to have received foreign income of a foreign trust, the includability of such income in his gross income depends upon his taxable status with respect to that income.

In other words, the “character” of the income remains business income when distributed to a beneficiary, but is it the “status” of the beneficiary, as a material participant or not, that determines whether that business income is active or passive? The following discusses the limited guidance on this question.

The Regulation provides that the beneficiary will be taxed on the foreign income distributed from a trust if the beneficiary is a United States citizen, but not if the beneficiary is a foreigner. United States bank interest that would be taxable if received by a United States trust or estate will escape tax under section 652(b) if distributed to a foreign taxpayer, although it remains United States bank interest. Temporary and Proposed Regulations under section 128 held that the interest on an All-Savers certificate, that would otherwise be taxable if received by the trust would instead be tax-free if the interest was distributed to the

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153 Reg. §§ 1.652(b)-2 and 1.662(b)-2.
154 Regulation section 1.662(b)-1 provides a similar rule for complex trusts, and states that the principles contained in Regulation section 1.652(b)-1 shall apply. See Rev. Rul. 1957-277, 1957-1 C.B. 12
individual beneficiary.\textsuperscript{156} This limited authority points to “status” as meaning whether the beneficiary is taxed on the distributed income or not.

The Service has held that income received by a trust as income from the trade or business of farming and distributed to the beneficiary retained its character as such despite the beneficiary not actually engaging in farming.\textsuperscript{157} “Status” under this ruling did not mean whether the beneficiary was engaged in farming or not. It was sufficient that the trust was engaged in farming and that comprised a part of the character of the distribution.\textsuperscript{158} However, the ruling also discussed that exempting farmers from paying tax estimates on farm income due to its uncertainty implicated the same policy reason whether the farm income was received directly or indirectly through a trust.

\begin{enumerate}
\item\hspace{1em}Application of the Subchapter J Character Rule under Section 469
\end{enumerate}

Under section 469, the distributed income never changes from taxable to non-taxable according to the identity of the beneficiary. Rather, the beneficiary’s status only affects whether the income may be offset by the beneficiary’s other passive losses. Although not conclusive, the guidance under section 469 as to the application of the Subchapter J Character Rule supports determining whether the income is passive or active to the trust and maintaining that classification when distributed.\textsuperscript{159} Whether business income retains its classification as active or passive when distributed to a trust beneficiary has never been authoritatively resolved under section 469. Two private letter rulings involving a pooled income fund distributing rental income state:

\begin{quote}
[A]mounts distributed from the Fund that are includable in the gross income of an income beneficiary for that year will be income to that beneficiary from a passive activity, within the meaning of \S\ 469, in the same proportion as the Fund’s net income from that rental enters into the computation of the Fund’s DNI for that year bears to the Fund’s entire DNI for that year. \textsuperscript{160}
\end{quote}

\begin{enumerate}
\item\hspace{1em}T.D. 7789, 46 Fed. Reg. 51,584 (1981).
\item\hspace{1em}GCM 38431 (July 1, 1980); Rev. Rul. 1980-366, 1980-2 C.B. 342, obsoleted by Rev. Rul. 2004-90, 2004-2 C.B. 317, presumably because section 6073 was repealed, although the principles might still be relevant.
\item\hspace{1em}This holding is consistent with the beneficiary having an equitable ownership interest in the trust assets.
\item\hspace{1em}The neutral word “class” or “classification” will be used to refer to active or passive income, rather than the \textit{loaded} word “character.”
\item\hspace{1em}PLR 200608002 (February 24, 2006); PLR 200608003 (February 24, 2006).
\end{enumerate}
PLR 9114025\textsuperscript{161}, which addresses the same issue in the charitable remainder context, states more specifically:

Provided the income that Trusts derive from their ownership of the limited partnership interests in Partnership constitutes income from a rental activity within the meaning of section 469(c)(2) of the Code, we conclude that such income, to the extent it is treated as distributed to the unitrust beneficiaries under characterization rules of section 664(b) and the regulations thereunder, will similarly be treated as income from a \textit{rental activity} in the hands of the unitrust beneficiaries.

Although sections 664(b) and 652(b) are different, we believe that the treatment of the income in the hands of the beneficiaries as rental income, rather than specifically as passive income, is a better reading of these private letter rulings. For purposes of section 469, rental income is passive except in the case of a real estate professional.

Under prior law, a charitable remainder trust lost its tax-exempt status if it received unrelated business taxable income. Under the 2006 Tax Act,\textsuperscript{162} a CRT receiving unrelated business taxable income maintains its tax-exempt status, but an excise tax is imposed in the amount of 100\% of the unrelated business taxable income incurred by the CRT. Except with respect to the rules recommended in these Comments with respect to pre-contribution gain from the sale of trade or business or rental activity assets contributed to a CRT, the income from a CRT or a pooled income fund should always be passive.

(d) \textbf{Section 1411 and the Determination of Material Participation at the Trust Level}

Although these Comments deal with proposed guidance and Regulations under section 469, we recognize the impact of the proposed fiduciary material participation Regulations under section 1411.

The section 1411 Regulations adopt the position that the character of income received by the estate or trust as NII or not is to be determined once at the trust level. The character rule under section 1411 (the “Section 1411 Character Rule”) – to contrast with the character rule under section 652 – is set forth below:

\begin{quote}
If one or more items of net investment income comprise all or part of a distribution for which a deduction is allowed under paragraph (e)(3)(i) of this section, such
\end{quote}

\textsuperscript{161} PLR 9114025 (January 7, 1991).
items retain their character as net investment income under section 652(b) or section 662(b), as applicable, for purposes of computing net investment income of the recipient of the distribution who is subject to tax under section 1411.\footnote{Reg. § 1.1411-3(e)(3)(ii).}

Because NII is a defined term, its use in this context would imply that any taxable income characterized as NII at the trust level remains NII and subject to the NII Tax when allocated to the beneficiary. Ordinarily, this rule is meaningless when net investment income is defined the same whether the taxpayer is an individual or a trust. The exceptions are trade or business income and rental income, which will be passive or active depending on whether the taxpayer materially participates in the activity generating the income, and, if the income is rental income, whether the recipient is a real estate professional. Only if the taxpayer is passive would that income be subject to the NII Tax.

The Regulations do not say that their converse also is true: that active income not subject to NII Tax in the trust will be active income not subject to NII Tax to the beneficiary. However, an example\footnote{Reg. § 1.1411-3(e)(5) Ex.3.} provides that none of the income of an estate was NII, because the estate’s taxable year began before the January 1, 2013, effective date of the NII Tax. The example goes on to state:

[N]one of the income received by Estate during its fiscal year ending October 31, 2013, is net investment income. Pursuant to paragraph (e)(3)(ii) of this section, because none of the distributed interest or dividend income constituted net investment income to Estate, the $10,000 of interest and $1,000 of dividends that Estate distributed to S does not constitute net investment income to S.

The example cites the Section 1411 Character Rule to conclude that the income is not net investment income when distributed to the beneficiary, because it was not net investment income to the estate. Unfortunately, the example deals with portfolio income, not income from a trade or business or rental activity. The other examples are further limited to situations not involving trade or business or rental activities.

Arguably, these two provisions in the section 1411 Regulations mandate that income should be characterized as active or passive in the trust, and that character should be maintained when distributed to a beneficiary. The Fiduciary Participation Test accepts this conclusion. However, the Taxpayer Participation Test comes to a different conclusion, summarized below.
Section 469 generally looks to the material participation of the person who recognizes the item of income or loss as taxable income or loss (i.e., the “taxpayer”) to determine whether that loss or income is active or passive with respect to the taxpayer. Section 1411(c)(2), entitled “Trades and Businesses to which (the NII) Tax Applies,” provides that “(a) trade or business is described in this paragraph if such trade or business is – (A) a passive activity (within the meaning of section 469) with respect to the taxpayer . . .”. Consistent with the statutory provision, Regulation section 1.1411-5(b) defines a passive activity as follows:

(b) Passive activity—(1) In general. A passive activity is described in this section if—

(i) Such activity is a trade or business; and

(ii) Such trade or business is a passive activity with respect to the taxpayer within the meaning of section 469 and the regulations thereunder (emphasis added).

Proponents of the Taxpayer Participation Test believe that the statute should be interpreted to provide that the trust or estate should be considered the taxpayer for purposes of determining whether a trade or business or rental activity is passive only with respect to undistributed income. Only then is a trade or business or rental activity a passive activity (or a nonpassive activity) with respect to the trust or estate as the taxpayer. Proponents of the Taxpayer Participation Test believe that this interpretation is consistent with the statutory language which directs the focus on the taxpayer, not another party (such as a fiduciary) whose material participation or lack of material participation should neither insulate income from nor trigger the application of the NII Tax.

When income of an estate or trust is distributed to a beneficiary, the income is allocated and carried out to the beneficiary under subchapter J. Proponents of the Taxpayer Participation Test believe that the beneficiary should be considered the taxpayer for purposes of determining whether income from a trade or business or rental activity distributed to the beneficiary is active or passive. This analysis should be correct in the context of both sections 469 and 1411.

The proponents of the Taxpayer Participation Test suggest that the Fiduciary Participation Test, determining the character of the income as active or passive based on the material participation of the fiduciary, would deviate from existing ordinary income tax principles under chapter 1 of the Code more than necessary to carry out the policy objectives of section 1411 in the context of trusts and estates.

The stated policy of the Regulations under section 1411 is to adhere to ordinary income tax rules and concepts to the extent possible and to let the subchapter J rules operate normally. After subchapter J allocates items of income (including net investment income) between the trust and its beneficiaries, the NII Tax could be separately applied to each taxpayer’s net investment income.
If the Section 1411 Character Rule is intended to preclude NII Tax avoidance, a deviation from subchapter J would be defensible. However, no such tax avoidance concern is apparent, and to the contrary, proponents of the Taxpayer Participation Test believe that tax avoidance may be encouraged if income is characterized as active at the trust or estate level, based on the material participation of the fiduciary, and then distributed to passive beneficiaries.

The concern of Treasury and the Service in promulgating the Section 1411 Character Rule might have been a taxpayer’s ability under subchapter J to deduct expenses against specific classes of taxable income; however, the final Regulations preserve this flexibility. The concern of Treasury and the Service might have been that the investment income subject to the NII Tax and not subject to the NII Tax would be allocated disproportionately among the trust and its beneficiaries to produce the lowest possible NII Tax. However, existing rules under subchapter J prevent disproportionate allocations of classes of gross income, unless required by the trust instrument and the allocations have economic (non-tax) significance.\textsuperscript{165}

Therefore, the proponents of the Taxpayer Participation Test believe that applying the recharacterization rule at the beneficiary level would prevent the conversion of non-passive income into passive income, as well as absolve beneficiaries who materially participate in the trade or business or rental activity of the trust from being subject to the NII Tax simply because the interest in the trade or business or rental activity was held in trust. Proponents of the Taxpayer Participation Test believe it to be consistent with the larger policy objectives of section 1411.

(e) Consistency of Treatment of Income From S Corporation and Partnership Interests Held by a Trust

As discussed above, under the QSST rules, the beneficiary is treated as the deemed owner of the S corporation stock and all items of income or loss for income tax purposes. When income from a partnership interest held by a trust is distributed to a beneficiary, the beneficiary pays the tax on that income.

We believe that it is not good tax policy to provide a rule under section 1411 that results in the taxation of income from a partnership interest held by a trust or estate which is distinctly different from the rule that applies to the taxation of income from an interest in an S corporation held by a trust. If a beneficiary of a trust or estate is materially participating in the trade or business or rental activity carried on by the partnership, there is no policy reason why the result should be

\textsuperscript{165} Reg. §§ 1.652(b)-2(b) and 1.662(b)-1 (noting that pursuant to Reg. § 1.652(b)-3(b), certain deductions may be directly allocated so long as a portion is allocated to nontaxable income).
different when the partnership interest is held in trust with a passive trustee, when
the S regime would clearly look to the beneficiary’s material participation if the
trade or business or rental activity was conducted by an S corporation and the
QSST election is in effect.

Our Comments propose fiduciary material participation rules that treat
similarly situated trade or business or rental activities held in trust the same,
whether the activities are operated directly by the trust (as a sole proprietorship or
a disregarded entity such as a single member LLC), or operated by an S
corporation or partnership, interests in which are held by the trust.

(f) Tax Forms and Section 1411

Another justification for a Fiduciary Participation Test is that it simplifies
tax return preparation and lends itself to ease of administration. The Schedule K-
1 from the trust will show two numbers – one for passive income and one for
active income – rather than a separate Schedule K-1 for each activity passed
through from trust-owned businesses, which can include many separate activities.
The current tax forms provide for the separate reporting of all activities.

Although the Section 1411 Character Rule became final in 2013, the
instructions for the Schedule K-1, unlike some prior years, actually do not appear
to contemplate that the character of income distributed to a beneficiary from a
trade or business or rental activity necessarily will retain its active or passive
characterization at the trust level for all tax purposes:

To assist the beneficiary in figuring any applicable
passive activity loss limitations, also attach a separate
schedule showing the beneficiary’s share of income
derived from each trade or business, rental activity, and
other rental activity.166

In earlier years, such as 2005, the Schedule K-1 required the trustee to sort
trade or business or rental activity income into passive or non-passive before
entering it on the Schedule K-1, suggesting at that time that the character of active
or passive at the trust carried over to the beneficiary for purposes of section
469.167

Although the characterization of income for purposes of section 469
should determine its character for purposes of section 1411, the instructions to the

166 Internal Revenue Service, 2013 Instructions to Schedule K-1(Form 1041) for a Beneficiary
Filing Form 1040, Boxes 6 through 8 – Ordinary Business Income, Rental Real Estate, and Other
167 See Ann Sutton & Laura Howell-Smith, Federal Income Taxation of Passive Activities ¶15.03
2013 Schedule K-1 for Form 1041 require one number for purposes of the net investment income distributed to the beneficiary:

Net investment income tax (Code H). Use Code H to identify the amount of the beneficiary’s adjustment for section 1411 net investment income or deductions.

However, the instructions then continue, undercutting the concept of a single number:

An attachment may be provided with the K-1 informing the beneficiary of the detailed items to be reported on Form 1040.

We believe that the application of the Section 1411 Character Rule should not prohibit the beneficiary’s material participation from being determinative of whether income distributed to a beneficiary is active or passive. If the Regulations were to adopt the Taxpayer Participation Rule and make the beneficiary’s material participation determinative of whether income distributed to the beneficiary is active or passive, income would be classified at the trust level as income from a trade or business or rental activity, but whether the NII Tax applies to the income distributed to the beneficiary would depend on whether the beneficiary materially participates in the trade or business or rental activity.

(iii) Summary of Current Law on the Classification of Income Distributed to a Beneficiary as Active or Passive

In summary, because the active or passive classification is unique under the income tax, no precise analogies exist. However, the limited guidance suggests that active or passive is part of the “character” of the trade or business or rental activity income. Under subchapter J, trade or business or rental activity income never escapes tax when distributed to a beneficiary. Section 1411, however, taxes trade or business or rental activity income only when it is passive with respect to the taxpayer. Notwithstanding this distinction, the section 1411 Regulations arguably treat active or passive as “character” based on the fiduciary’s material participation.

The section 1411 Final Regulations do not address the question as to whose material participation is relevant as to distributed income - the Regulations are neutral on this question. One of the most important policy decisions in the Regulations under section 1411 is that whenever possible the Regulations should follow the ordinary income tax rules, rather than try to fix the flaws – or fill in the

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gaps – of those rules. The preamble to the final Regulations under section 1411 cited this principle in refusing to provide any rules for determining whether a trust materially participates. Rather, the preamble concludes that a new Regulations project under section 469 is required.

Despite this conclusion, the section 1411 Final Regulations arguably resolve the uncertainty of whose material participation is relevant in determining whether distributed business income is active or passive in favor of the fiduciary. There is no acknowledgement of the pre-existing uncertainty under section 469. Rather, the preamble to the Final Regulations goes to great lengths to explain why the Regulations do not change existing law. The new character rule under section 1411 depends on whether the trust materially participated, rather than the individual beneficiary: Ironically, this is guidance that, according to the preamble, the Service was declining to provide under section 1411, because those rules were to be promulgated under section 469.

(iv) **Ramifications of a Fiduciary Focused Rule**

(a) **A Fiduciary Participation Test is More Favorable to Some Taxpayers**

The Section 1411 Character Rule will likely be more advantageous to some taxpayers than a Taxpayer Participation Test. Making the trustee’s material participation determinative of whether distributed income is active or passive permits an active trustee to distribute active trade or business or rental activity income to a passive beneficiary to convert passive income to active income.169

Tax planning to take advantage of this rule is easy to anticipate when a donor or potential testator desires to transfer an interest in a family business. If the donee materially participates and is active, the donor may want to make the gift outright or to a trust with respect to which the donee is the deemed owner under section 678. If the donee is passive, the donor may want to make the gift in trust with an active fiduciary for the trust-owned business. On the other hand, if the beneficiary’s material participation is determinative, the upfront planning opportunities and the opportunities for tax avoidance are limited.

Because certain individuals, such as minors and the disabled, cannot materially participate, the strict application of the Fiduciary Participation Test would allow a family business owner to use a trust for the individual with an

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169 See Schmolka, supra note 94, at 211. “Were I the trustee, even if I did not see myself as that of a group facilitator, in today’s parlous times I would be cautious about the repercussions of making distributions that carried passive losses to those who already had passive losses of their own they could not use, while leaving those with passive phantom income gasping for oxygen like so many blowfish washed up on a beach.” Id.
active fiduciary to avoid the NII Tax on the income from a gifted equity interest, whether income is distributed or not. We know of no other application of the NII Tax that can be so easily manipulated by tax planning with a result that is clearly not intended by the framework of section 1411. We believe that to permit such arrangements would not be good tax policy.

(b) A Fiduciary Participation Test Requires a Revised Treatment of Depreciation, Depletion and Amortization Deductions

Although a trust distributes only income, not loss, the treatment of the depreciation, depletion, or amortization deduction under the federal income tax is similar to distributing a loss. Section 167(d) requires that the depreciation, depletion, or amortization deduction of a trust be allocated among the trust and its beneficiaries. The Regulations provide that the allocation is to be made on the basis of fiduciary accounting income, rather than taxable income, meaning that the depreciation, depletion, or amortization deduction can be allocated to a beneficiary, without any income or DNI being allocated to that beneficiary. The beneficiary may not have legal ownership in the trust-owned business and may not be allocated any taxable income from the business, yet the beneficiary may be allocated part or all of the depreciation, depletion, or amortization deduction. Under section 167(d), the beneficiary is treated as receiving the depreciation, depletion, or amortization deduction directly, rather than treated as passing through the trust.

Under section 167(d), if not trumped by the later enactment of section 469, if the beneficiary materially participates and is therefore active in the trust-owned business, the depreciation, depletion, or amortization will be a deduction against the beneficiary’s other income. If the beneficiary is passive in the trust-owned business, the depreciation, depletion, or amortization will be a deduction against the beneficiary’s other passive income unrelated to the business. If the passive beneficiary has no passive income, presumably the depreciation, depletion, or amortization deduction would carry forward as a passive loss. We recommend that the Regulations clarify that the suspended passive loss would become an active loss if the trust disposed of its business in a fully taxable transaction to an unrelated party, reflecting the beneficiary’s equitable ownership of the trust assets.

On the other hand, if the trustee’s material participation determines whether the distributed income of the trust-owned business when distributed to a beneficiary is active or passive and the beneficiary’s material participation determines whether the depreciation, depletion, or amortization deduction is active or passive, a mismatch may result. If the trustee is active and the beneficiary passive, for example, the beneficiary would be unable to deduct the beneficiary’s depreciation, depletion, or amortization deduction against the income distributed from the business. The new Regulations, therefore, would
need to prevent this mismatch if the fiduciary’s material participation is determinative.\textsuperscript{170}

An article explaining the American Law Institute revisions to the fiduciary income tax that formed the basis for subchapter J in the 1954 Code provides that the purpose of the fiduciary income tax is to divide the income tax exemption for gifts and bequests in section 102(a) between the trust or estate and its beneficiaries to reflect that income from the property is not exempt from income tax under section 102(b).\textsuperscript{171} The article explains the depreciation, depletion, or amortization deduction as follows:

\begin{quote}
[S]uppose that either the state law provides or the grantor has stated that the amount distributed to the beneficiary [as income] shall not be reduced by depreciation or depletion. Since a depreciation reserve out of the income of the trust property would serve in effect to replace the property and thus maintain the trust corpus, a distribution of that reserve to the beneficiary is for our purposes the equivalent of distribution of corpus. It likewise should be protected by the gift exemption [from income tax].\textsuperscript{172}
\end{quote}

This explanation for the direct allocation of depreciation, depletion, or amortization would suggest that the depreciation, depletion, or amortization

\begin{flushright}
\textsuperscript{170} Professor Schmolka tackles the issues of depreciation being separately allocated to a beneficiary. He contends that section 167(d) should not apply until the depreciation deduction has been subject to section 469 within the trust or estate. The Professor’s approach addresses the problems that could result from a passive depreciation deduction summarized at Schmolka, supra note 94, 199-200:

The following three rules summarize the § 469 status of any income derived from a passive activity that is included by a beneficiary under § 652 or § 662 and of any depreciation allocated to a beneficiary by § 167(d).

(a) If a trust or estate has a passive activity loss for the taxable year, no income included by a beneficiary under § 652 or § 662 is passive activity gross income.

(b) A trust’s or estate’s passive depreciation deduction is never a passive activity deduction in the beneficiary’s hands.

(c) Gross income included by a beneficiary under § 652 or § 662 retains its passive character if, but only if, the entity has net positive passive income (excess of passive income over passive deductions, including previously suspended losses), and even then, only to the extent of the net income (the excess). Mechanically, this is accomplished by segregating the net passive income as a separate class of income within DNI, subject to allocation to beneficiaries under §§ 652(b) and 662(b) just as any other class of income.

An anti-abuse rule applies, however, whereby the net passive income may be recharacterized as not passive in the beneficiary’s hands, depending on whether the beneficiary participates in the entity’s activity, and if so, to what extent.


\textsuperscript{172} Id. at Section I.A.2.b.
\end{flushright}
deduction always should be fully deductible by the beneficiary against all types of income.

(c) A Fiduciary Participation Test Will Lead to Inconsistent Treatment When a Taxpayer Owns Interests in a Trade or Business or Rental Activity Both Directly and as a Beneficiary of a Trust.

It is not unusual for a beneficiary of an estate or trust which holds an interest in a trade or business or rental activity through a pass-through entity to also own a direct interest in the entity that operates the activity. For example, a partnership or LLC may be owned by four family members in equal proportions, including the mother, father and two children, with each owning a 25% interest. All of the partners materially participate in the business while they are all alive. The mother and father pass away and their interests are held by a corporate fiduciary executor and trustee. The corporate executor and trustee do not materially participate in the trade or business or rental activity.

If the Fiduciary Participation Test applies to determine the character of the income distributed to the two children through the estate or trust, half of the income would be subject to the NII Tax (the income distributed to the children through the estate or trust) and half of the income would not be subject to the NII Tax (the income distributed directly to the children as partners). Conversely, if one of the children does not materially participate, the income distributed to the passive child could be converted to active income, avoiding the tax, if the final rule provides that the material participation of the trust is relevant, and the trustee of the trust (i.e., the active child) materially participates in the trade or business or rental activity.

This example points out how a Fiduciary Participation Test will lead to inconsistent treatment when there is no indication that such inconsistent treatment or tax avoidance is consistent with the purpose and scope of the NII Tax.

c. If the Fiduciary Participation Test is Applicable, Passive Income Distributed to a Beneficiary From a Trust Should Be Recharacterized as Active if the Beneficiary Materially Participates in the Trust-Owned Business

The proponents of the Fiduciary Participation Test recognize that fiduciary material participation is not as relevant when a beneficiary, rather than the trust or estate, is the taxpayer. The current Regulations under section 469 used the material participation of the taxpayer to determine whether the taxpayer’s income or loss is active or passive. This approach would suggest that only the
beneficiary’s material participation would have been relevant for purposes of
determining whether the trust or estate income distributed and taxed to the
beneficiary was active or passive.

However, the grouping Regulations under section 469, finalized at about
the same time, suggest a different approach. Those Regulations divorced the
beneficiary from any ownership interest in trust or estate assets. Thus, whether
specifically considered at the time or not, it appears that the Service considered
the participation of the beneficiary irrelevant in determining whether trust income
was passive or non-passive.

The Service also would have been concerned at the time of the current
Regulations under section 469 that an active beneficiary could use a passive
fiduciary to convert active income into passive income. If the beneficiary had
passive losses, a passive fiduciary could convert otherwise active income of the
beneficiary into passive income to offset against those passive losses. Of course,
the economic and other substantive differences between outright ownership and
trust ownership are sufficiently different that tax motivation is unlikely to prompt
the use of a trust. Moreover, the beneficiary would have needed a third party to
create the trust to avoid the application of the grantor trust rules. In other
instances, however, the current Regulations under section 469 discount practical
difficulties when promulgating rules to prevent the creation of passive income.

Thus, rather than label income distributed from a trust or estate with a
passive fiduciary as passive to the beneficiary, the current Regulations as they did
in similar cases likely would have provided a recharacterization rule. If a trust or
estate distributed passive income from a trade or business or rental activity to a
beneficiary active in that trade or business or rental activity, the distributed
income would be recharacterized as non-passive income. If the Service had
attempted to write a recharacterization rule at the time, it may have seen that the
limitations on the grouping rule made it impossible for a beneficiary to materially
participate in a trade or business or rental activity wholly owned by a trust or
estate. Nevertheless, the recharacterization Regulation could determine whether
the beneficiary materially participated by assuming the beneficiary owned an
interest in the trade or business or rental activity through its beneficial interest in
the trust or estate. Otherwise, the trust would block the application of the
recharacterization rule.173

The current section 469 Regulations are replete with instances under its
PIG rules where under the same facts income is active and loss is passive.
Because the losses (other than depreciation, depletion, or amortization
deductions) are trapped in a trust or estate, a rule recharacterizing passive income
distributed from a trust or estate as non-passive if the beneficiary is active (a

173 Schmolka, supra note 94, at 269 (referencing Suggested Regulation § 1.469-8(f)(2)(ii)); accord
Abbin, supra note 94, at § 816.3.
“Beneficiary Recharacterization Rule”) would operate similar to the other PIG rules.

As with the SPPA rule discussed above, the anti-abuse PIG rules under section 469 are likely to operate as pro-taxpayer rules under section 1411. Because otherwise passive income may be converted into non-passive income, unless the income is further recharacterized as net investment income, no NII Tax would be payable on the non-passive income if either the fiduciary or the beneficiary is active.

If adopted by the Regulations, the Fiduciary Participation Test and the Beneficiary Recharacterization Rule would result in the recharacterization of trade or business or rental activity income distributed from a trust or estate with a passive fiduciary to a beneficiary who materially participates in the trust or estate owned trade or business or rental activity (but not in recharacterization in the reverse case of an active fiduciary and passive beneficiary). Proponents of the Fiduciary Participation Test believe that a Beneficiary Recharacterization Rule is consistent with good tax policy.

Proponents of the Fiduciary Participation Test believe it is appropriate that when the fiduciary does not materially participate, the income distributed from the trust or estate would remain passive at the trust or estate level and be included in the net investment income distributed to the beneficiary as reported on Schedule K-1. The beneficiary would enter this amount as net investment income on the beneficiary’s Form 8960. That would enable the amount of net investment income to be matched by the Service and promote ease of administration. If the beneficiary is materially participating in the activity, the beneficiary would adjust the number on the Form 8960 under the Beneficiary Recharacterization Rule as with any other recharacterization rule. Because the section 469 rules determine whether income is active or passive for purposes of section 1411, no change in the basic philosophy of the section 469 Regulations would be required for the Beneficiary Recharacterization Rule to apply to income allocable to an active beneficiary. As discussed above, the trustee need not provide any additional information to a beneficiary beyond that already provided with the Schedule K-1 for the beneficiary to recharacterize the income (assuming that the amount of trade or business or rental activity income is separately stated somewhere).

174 Any depreciation, depletion or amortization deduction directly apportioned to the beneficiary would first be netted against the distributed income. The deduction would not be recharacterized.

175 The Regulation would have to treat the beneficiary as having an interest in the trust-owned business for this purpose. Professor Schmolka assumes that such a recharacterization rule would be necessary and says that the professional groups agree. Schmolka, supra note 94, at 250 n.150. See also Abbin, supra note 94, at § 816.3 (“Thus, if a trust makes a passive income distribution (determined at the trust level) to beneficiaries, such distribution generally will be treated as passive income to those beneficiaries unless the recipient beneficiary materially participated in which case it is likely to be recharacterized in the distributee’s hands as active income.”).
F. What Special Rules Should Apply When an Event Results in a Potential Change in the Tax Status or the Identity of the Taxpayer?

The section 469 Regulations for individual material participation do not provide guidance for when the individual owner acquires the business or rental activity during the taxable year. There is no proration rule if the activity is owned for less than all of the year. Because fiduciary material participation usually will be measured by the subjective standards of the Facts and Circumstances Test, this hours “yardstick” may be adjusted appropriately depending on the period of time the business or rental activity is owned by the trust or estate (subject, presumably, to the 100 hour minimum requirement).

Rather than just rely on subjective standards, however, we believe that the Regulations should include specific rules for certain transitions uniquely involving trusts and estates. These rules recognize that the material participation of a person other than the taxpayer may be most relevant to determining whether the income or loss is active or passive. An analogy is the treatment of the gain from a deferred installment obligation under section 1411.176 The amount of excludable active gain and the nature of the gain as active or passive is determined at the time the sale occurs. This determination then applies to the receipt of all future payments, whether the recipient is active or not at the time of the receipt of a future payment, including receipt by another taxpayer as income in respect of a decedent. By determining the amount and the nature of the income or gain at the most appropriate time, the question of whether the gain is active or passive need not be revisited each time a payment is received. All of these transitory rules reflect fact situations where good tax policy requires that the material participation of the prior owner determine the character of income or gain as active or passive, rather than the material participation of the taxpayer at the time the payment is made.

1. Sale of S Corporation Stock by a QSST

One case in which the proposed transitory rule will come into play is when a QSST sells its stock in an S corporation. Regulation section 1.1361-1(j)(8) recognizes the tension between the application of the passive loss rules at the QSST beneficiary level for multiple years, switching to taxation at the trust level for purposes of the sale of the S corporation stock.

Regulations section 1.1361-1(j)(8) provides:

Coordination with grantor trust rules. If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation.

176 Reg. § 1.1411-7(d).
for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary’s terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code. However, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST shall be treated as a disposition by the income beneficiary.

The rule of the final Regulations under section 1361, taxing the gain to the trust, is a reversal of the original treatment in the proposed Regulations, which taxed the gain to the beneficiary as deemed owner. The reversal is explained in the preamble to the final Regulations:

The final regulations also change the result in Rev. Rul. 1992-84, 1992-2 C.B. 216. Rev. Rul. 1992-84 holds that if a QSST sells its S corporation stock, the current income beneficiary and not the trust must recognize any gain or loss. After the publication of Rev. Rul. 1992-84, practitioners expressed concern with respect to the sale of the stock by a QSST in an installment sale. Practitioners questioned whether the trust could effectively use the installment method under section 453 to report gain realized on the sale of the stock and expressed concern about how the IRS would treat an installment sale of S stock by a QSST. Practitioners suggested that since the income beneficiary was treated as the owner of the stock sold, the income beneficiary would be treated as the owner of the installment obligation received in exchange for the sale of the stock.

However, concern was expressed that because the QSST ceases to be a QSST as to the S corporation stock that was sold, the income beneficiary would no longer be treated as the owner of the installment obligation held by the trust and there may have occurred a disposition of the installment obligation under section 453B(a).

On further consideration, the IRS and Treasury have determined that the income beneficiary of a QSST who is a section 678 deemed owner of the S corporation stock solely by reason of section 1361(d)(1) should not be treated as the owner of the consideration received by a QSST upon its disposition of S corporation stock. Under the final regulations, the consideration is treated as received by the trust in its status as a separate taxpayer under section 641. Thus, for example, any gain recognized on a sale of the S corporation stock is the gross income of the trust.

The preamble goes on to provide that this special rule is limited to QSSTs and is not to be applied to grantor trusts more generally. Interestingly, the change in the taxpayer recognizing the gain from the beneficiary to the trust necessitated another change in the Regulations to make it clear that the sale would be treated as a disposition by the beneficiary for purposes of triggering the allowance of any carryforward passive losses.

Proposed Regulations section 1.1411-7(a)(4)(iii)(C) provides:

_Treatment of Qualified Subchapter S Trusts (QSSTs)._ In the case of a disposition of S corporation stock by a QSST, the rules of this section are applied by treating the QSST as the owner of the S corporation stock.

After summarizing the history and the reasons for this special QSST rule, the preamble concluded:

[With respect to the section 1411 treatment of the disposition by the beneficiary by reason of section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8), the Treasury Department and the IRS believe that the general administrative principles enumerated in § 1.1411-1(a), when combined with the general treatment of section 469(g) losses within § 1.1411-4, provide an adequate framework for the treatment of QSSTs beneficiaries without the need for a special

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178 The last sentence of Regulation section 1.1361-1(j)(8) provides that “solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST shall be treated as a disposition by the income beneficiary.”
Consistent with the income tax treatment of a QSST under chapter 1 of the Code, the Proposed Regulations provide that, when a QSST disposes of S corporation stock, the trust is treated as the taxpayer for purposes of the NII Tax. By declining to apply a special rule, however, the preamble to the Proposed Regulations implies that the gain should be characterized as passive or active for purposes of the NII Tax based on whether the taxpayer trust, rather than the beneficiary, materially participates.

For the reasons explained below, we believe that material participation with respect to the gain on the sale of S corporation stock by a QSST should be determined based on the material participation of the QSST beneficiary, prior to the sale.

There are good reasons why a QSST, rather than its beneficiary, is taxable on the gain of the sale of the QSST’s S corporation stock. An analysis of how the NII Tax rules approach the one concern that drove this result (the sale of S corporation stock on the installment basis) shows that it supports our recommendation and is consistent with the treatment of QSSTs under the passive loss rules under section 469. In fact, the approach in the Proposed Regulations in respect of a QSST’s disposition of S corporation stock is inconsistent with the treatment of installment sales under the Proposed section 1411 Regulations. The taxation of an installment sale under the Proposed Regulations depends on the character of the property in the year of the sale, in effect, immediately before the sale. Section 1411 is then applied in the year of the disposition as if the entire amount of gain recognized for chapter 1 is taken into account by the transferor in the year of the disposition.

Reg. § 1.1361-1(j)(8) provides that if a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, the Regulation further provides that an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the federal income tax consequences of a disposition of the stock by the QSST.

The preamble to the final Regulations explains the history leading up to why and when a QSST sells its S corporation stock, Reg. § 1.1361-1(j)(8) taxes the sale proceeds to the trust rather than the beneficiary:

The final regulations also change the result in Rev. Rul. 1992-84, 1992-2 C.B. 216. Rev. Rul. 1992-84 holds that if a QSST sells its S corporation stock, the current income beneficiary and not the trust must

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179 Prop. Reg. § 1411-7(d).
recognize any gain or loss. After the publication of Rev. Rul. 1992-84, practitioners expressed concern with respect to the sale of the stock by a QSST in an installment sale. Practitioners questioned whether the trust could effectively use the installment method under section 453 to report gain realized on the sale of the stock and expressed concern about how the IRS would treat an installment sale of S stock by a QSST. Practitioners suggested that since the income beneficiary was treated as the owner of the stock sold, the income beneficiary would be treated as the owner of the installment obligation received in exchange for the sale of the stock. However, concern was expressed that because the QSST ceases to be a QSST as to the S corporation stock that was sold, the income beneficiary would no longer be treated as the owner of the installment obligation held by the trust and there may have occurred a disposition of the installment obligation under section 453B(a).

On further consideration, the IRS and Treasury have determined that the income beneficiary of a QSST who is a section 678 deemed owner of the S corporation stock solely by reason of section 1361(d)(1) should not be treated as the owner of the consideration received by a QSST upon its disposition of S corporation stock. Under the final regulations, the consideration is treated as received by the trust in its status as a separate taxpayer under section 641. Thus, for example, any gain recognized on a sale of the S corporation stock is the gross income of the trust. Similarly, the trust may report any gain realized upon the sale under section 453 if the sale otherwise qualifies as an installment sale. This provision of the final regulations reflects an interpretation of section 1361(d)(1) and has no bearing upon the operation or effect of the principles of sections 671 through 679 beyond the context of a QSST.180

Thus, Regulation section 1.1361-1(j)(8) taxes the sale proceeds to the trust rather than the beneficiary because the rules applicable to installment sales would produce an anomalous result.

Generally, Proposed Regulation section 1.1411-7(d) determines the character of an installment sale for NII Tax purposes by looking to the facts in the year of sale and then mechanically applying them to receipts in future years.181

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181 The proposed Regulation provides:

Deferred recognition transactions. In the case of a disposition of a Pass-through Entity in an installment sale under section 453 (or in exchange for an annuity contract), the calculations described in paragraphs (b) and (c) of this section shall be applied in the year of the disposition as if the entire amount of gain recognized for chapter 1 is taken into account by the transferor in the year of the disposition. For this purpose, it is assumed that any contingencies potentially affecting consideration to the transferor that are reasonably expected to occur will occur, and in the case of annuities based on the life expectancy of one or more individuals, the present value of the annuity (using existing Federal tax valuation methods) is used to determine the estimated gain. If the calculations in this section
This implies that one looks to material participation at the instant of the sale without being concerned with material participation in future years. In the partnership realm, this implication is made explicit when looking to redemptions of partnership interests under section 736. Section 736(b) payments are treated as sales of partnership interests, and section 736(b) payments are treated as an installment sale in the year of disposition for section 1411 purposes, even though for income tax purposes each year’s payment stands alone. The preamble to the 2013 Proposed Regulation explains:

Section 736(b) payments to retiring partners in exchange for partnership property (other than payments to retiring general partners of service partnerships in exchange for Section 736(a) Property) are governed by the rules generally applicable to partnership distributions. Thus, gain or loss recognized on these distributions is treated as gain or loss from the sale or exchange of the distributee partner’s partnership interest under section 731(a).

The proposed regulations provide that section 736(b) payments will be taken into account as net investment income for section 1411 purposes under section 1411(c)(1)(A)(iii) as net gain or loss from the disposition of property. If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply §1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4). Gain or loss relating to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) regardless of whether the payments are classified as capital gain or ordinary income (for example, by reason of section 751).

In the case of section 736(b) payments that are paid over multiple years, the proposed regulations provide that the characterization of gain or loss as passive or nonpassive is determined for all payments as though all payments were made at the time that the liquidation of the exiting

result in a transferor excluding only a portion of the chapter 1 gain from net investment income, the amount of excluded gain will constitute an addition to basis for purposes of applying section 453 to determine the amount of gain is includable in net investment income under §1.1411-4(a)(1)(iii) as payments are received.

Supplementary Notes:

182 Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:
   Gain or loss attributable to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) and paragraphs (a)(1)(iii) and (d) of this section as gain or loss from the disposition of a partnership interest.

183 Prop. Reg. § 1.1411-4(g)(ii)(iv) provides:
   A taxpayer who elects under §1.736-1(b)(6) must apply the principles that are applied to installment sales in §1.1411-7(d).

184 Reg. § 1.736-1(a)(6). Although a partner retires when he ceases to be a partner under local law, a retired partner or a deceased partner's successor will be treated as a partner for partnership income tax purposes (subchapter K, chapter 1 of the Code) until the partner's interest in the partnership has been completely liquidated. Reg. § 1.736-1(a)(1)(ii).
partner’s interest commenced and is not retested annually. The proposed regulations thus adopt for section 1411 purposes the section 469 treatment of section 736(b) payments paid over multiple years as set forth in § 1.469-2(e)(2)(iii)(A).\textsuperscript{185}

Probably because section 469(g)(1) prevents the passive loss rules from restricting losses when an activity is sold and frees all suspended passive losses,\textsuperscript{186} no guidance explains how the passive loss rules treat the installment sale


\textsuperscript{186} I.R.C. § 469(g) provides as follows:

\textit{Dispositions of entire interest in passive activity.} If during the taxable year a taxpayer disposes of his entire interest in any passive activity (or former passive activity), the following rules shall apply:

(1) \textit{Fully taxable transaction.}

(A) \textit{In general.} If all gain or loss realized on such disposition is recognized, the excess of—

(i) any loss from such activity for such taxable year (determined after the application of subsection (b)), over

(ii) any net income or gain for such taxable year from all other passive activities (determined after the application of subsection (b)),

shall be treated as a loss which is not from a passive activity.

(B) Subparagraph (A) not to apply to disposition involving related party. If the taxpayer and the person acquiring the interest bear a relationship to each other described in section 267(b) or section 707(b)(1), then subparagraph (A) shall not apply to any loss of the taxpayer until the taxable year in which such interest is acquired (in a transaction described in subparagraph (A)) by another person who does not bear such a relationship to the taxpayer.

(C) \textit{Income from prior years.} To the extent provided in regulations, income or gain from the activity for preceding taxable years shall be taken into account under subparagraph (A)(ii) for the taxable year to the extent necessary to prevent the avoidance of this section.

(2) \textit{Disposition by death.} If an interest in the activity is transferred by reason of the death of the taxpayer—

(A) paragraph (1)(A) shall apply to losses described in paragraph (1)(A) to the extent such losses are greater than the excess (if any) of—

(i) the basis of such property in the hands of the transferee, over

(ii) the adjusted basis of such property immediately before the death of the taxpayer, and

(B) any losses to the extent of the excess described in subparagraph (A) shall not be allowed as a deduction for any taxable year.

(3) \textit{Installment sale of entire interest.} In the case of an installment sale of an entire interest in an activity to which section 453 applies,
of stock in an S corporation. Because the Proposed and Final Regulations under section 1411 treat owners of S corporations and partnerships the same, we believe that section 1411 should treat shareholders generally who sell S corporation stock on an installment basis the same as partners whose interests are redeemed in installments under section 736(b). Because partners whose interests are redeemed in installments under section 736(b) determine net investment income based on material participation at the beginning of the payments and do not re-test participation in subsequent years, the sale of S corporation stock by a QSST should result in the determination of net investment income based on material participation of the beneficiary at the date of the initial sale, and not re-test participation in subsequent years.

As noted above, Regulation section 1.1361-1(j)(8) recognizes the tension between the application of the passive loss rules at the QSST beneficiary level for multiple years, switching to taxation at the trust level for purposes of the sale of the S corporation stock. The regulation’s last sentence recognizes this tension:

However, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST shall be treated as a disposition by the income beneficiary.\(^\text{187}\)

If the determination of whether QSST income is active or passive depends on whether the QSST beneficiary is materially participating in the activity during the period the S corporation stock is owned by the QSST, we do not believe that upon the sale of the S corporation stock, the determination should be shifted to whether the trustee of the QSST is materially participating in the activity. There does not appear to be any other case where this result is obtained when applying section 1411 to a disposition of an asset under section 1411(c)(1)(A)(iii) (Category 3 of net investment income) or otherwise.

We recommend that Proposed Regulation section 1.1411-7(d) should recognize this tension and contradiction rather than applying the rules of chapter 1 to section 1411 without considering these issues. Regulation section 1.469-5T(a) generally assumes that material participation will be determined over an entire taxable year or a number of years. The general concept under section 1411 is that a taxpayer who is active in a business for a period of time should not be subject to NII Tax with respect to the sale of business assets. We believe that testing material participation for a person who is treated as owning the business solely for an instant in time, due to the artificial construct of Regulation section 1.1361-1(j)(8), would be contrary to the policy behind sections 469 and 1411. That

\(^{\text{187}}\) Reg. § 1.1361-1(j)(8).
policy would require a QSST to establish participation at both the trust level and the beneficiary level to avoid the NII Tax, just in case the business is suddenly sold due to the appearance of a strategic investor or some other unexpected turn of events.

Therefore, we recommend that Proposed Regulation section 1.1411-7(d) be revised to provide that the beneficiary shall be treated as the owner for purposes of establishing material participation as applied to sections 469 and 1411 when the QSST sells S corporation stock, and that the trust shall be treated as the owner for all other purposes under chapters 1 and 2A. This result is not inconsistent with Regulation section 1.1361-1(j)(8), which deals with the treatment of the income beneficiary as disposing of the S corporation stock for purposes of section 469 and the treatment of the trust as the taxpayer subject to taxation on the sale of the S corporation stock under section 1001.

2. **Transition by a Trust Between Grantor and Non-Grantor Status**

Where a trust ceases to be a grantor trust or a non-grantor trust becomes a grantor trust, we recommend that future Regulations on fiduciary material participation provide that any gain or loss resulting from the event be passive or active depending on the participation of the owner immediately before the event, rather than the participation of a trust deemed to be a transitory owner. The character of any gain or loss arising after the event should be determined under the regular material participation rules.

If the cessation or commencement of grantor trust status results from an event, other than death, any gain, income or loss realized under section 1001, or other income tax provision, as a result of that event shall be active or passive based on the material participation of the owner of the assets for federal income tax purposes (the “tax owner”) immediately before the event. If the tax owner was an individual immediately before the event, the individual material participation rules will apply to classify the gain or loss as active or passive. If the tax owner was a non-grantor trust immediately before the event, the fiduciary material participation rules will apply to classify the gain or loss as active or passive. If the gain or income resulting from the event is included in DNI and allocated to a beneficiary, however, the gain will be active or passive depending on the material participation rule for that income.

Although we believe the recommended rule should be universal, we are aware of only a few instances where the transition between grantor and non-grantor status results in gain or loss. The most straightforward is a grantor trust becoming a non-grantor trust when the liabilities on the trust assets exceed the grantor’s basis in the assets. In that event, the grantor’s “relief” from non-recourse liabilities is considered consideration received. Because the grantor is
the taxpayer with respect to that gain, this special rule is unnecessary in that context. However, the rule would be significant in other contexts.\textsuperscript{188}

3. \textbf{Application of Section 469 to Charitable Remainder Trusts for Purposes of Section 1411}

An individual often uses a charitable remainder trust to provide a benefit to charity while retaining a stream of payments for life or a term of years. Section 469 is not implicated by a CRT. The donor’s carryover losses are added to the basis of the gift property. The CRT is not a taxpayer so it is not subject to the passive loss rules.

However, the determination of whether the CRT’s income is passive or active matters for purposes of the determining the beneficiary’s taxes on any CRT distributions. The tier system assumes that the trustee can determine whether income and gain of the CRT is subject to the NII Tax or not. Therefore, we recommend simple material participation rules for determining whether CRT gain or income is active or passive.

We do not support any rule characterizing income or gain accruing after the transfer to the CRT as active. Although we understand that some commentators argue that the characterization of the activity as passive or active in the hands of the donor should carry over for all purposes, we believe that is difficult to reconcile with the adverse tax treatment of unrelated trade or business or rental activity income earned by the CRT. We recognize that this rule may in rare cases penalize a real estate professional materially participating in a rental activity given to the CRT.

However, unrealized pre-contribution gain should be treated differently. Frequently the CRT is funded with an appreciated asset destined to be sold. In that case, the determination of whether the gain is active or passive often is crucial. We believe that the appropriate analogy for determining whether the gain on the future sale of the property by the CRT is active or passive is the section 1411 Regulation treatment of installment payments resulting from a sale of property. The NII Tax consequences are determined at the time of the sale. We recommend that the material participation of the donor at the time of the gift to the CRT should determine whether the CRT’s gain on the sale of the property is active or passive when subsequently distributed to the donor.

The gain excluded from the NII Tax as active should be determined as if the gift property was sold for fair market value on the date of contribution. The

\textsuperscript{188} Consistent with the recommendation 1 under this Section F of our Comments, this recommendation would cause any gain or loss recognized by a trust resulting from the sale of stock by a QSST to be characterized as active or passive according to the material participation of the beneficiary of the QSST, while such beneficiary is the deemed owner of the S corporation stock under section 1361(d)(1)(B).
contributed property will already have been appraised for purposes of the charitable deduction. Any post-contribution gain or other income earned by the CRT, however, should be deemed passive under the above rule.\textsuperscript{189}

4. \textbf{Death of an Individual}

An individual’s death will result in the creation of a probate estate consisting of the assets owned individually by the decedent. If those assets include a business activity in which the decedent materially participated, or a rental activity of the decedent who was a real estate professional, it is unfair that the asset would immediately convert to a passive activity in the estate. Thus, we recommend that death be provided a more appropriate transition under section 469.

The purpose of section 469 is to limit the tax benefits to a taxpayer who acquires a tax shelter to reduce the taxpayer’s taxable income from other sources. When an asset is acquired by death or gift, that consideration does not apply. While a gift might be treated differently due to the donor’s ability to control its timing, death is not within the decedent’s control. Moreover, the death of an owner of a closely-held business might well trigger losses that will take a while for the family to utilize.

Two individual material participation rules contemplate that material participation by a taxpayer in prior years would result in material participation in subsequent years. Test #5 set forth in Temporary Regulations section 1.469-5T(a) provides that an individual shall be considered to materially participate if the individual materially participated in five out of the preceding ten years. Test #6 provides with respect to a “personal service activity” an individual who materially participated during any three taxable years, whether or not consecutive, would be considered to materially participate in that activity permanently. The taxpayer’s intervening death should not cut off the application of these two “look back” tests. Therefore, we recommend that these two rules apply for determining whether an estate\textsuperscript{190} or other testamentary substitute or successor materially participates in a business or rental activity.

We believe that the five out of ten year Individual Material Participation Test provides the appropriate measure for determining material participation of an estate if the decedent’s material participation is inherited by the estate. If the decedent materially participated until the decedent’s death, the estate would be treated as materially participating for five more years. If the decedent had retired from the business three years before death, the estate would be considered to

\textsuperscript{189} Under the tier rules, the passive income or gain, which will include the NII Tax in the maximum tax rate on passive income, will be treated as distributed before active income or gain, which is not subject to the additional NII Tax. Reg. § 1.1411-3(d)(2).

\textsuperscript{190} If the section 645 election is made, the decedent’s revocable trust will be combined with the probate estate.
materially participate for two more years.\textsuperscript{191} We also propose that the five out of ten year rule apply when the death of the deemed owner causes a trust, or portion thereof, to cease to be a grantor trust. This special rule also should apply to any other testamentary substitute, including when the trade or business or rental activity is owned in joint tenancy. A joint tenancy will usually benefit the surviving spouse who prior to the decedent’s death would have benefitted from spousal attribution.

Unlike the five out of ten year rule, the three year rule for a personal service activity has no built in sunset. Thus, we recommend that the rule apply only for five years after death – the maximum period for applying the five out of ten year rule. Similarly, we recommend that an individual’s status as a real estate professional at death extend to his or her estate or testamentary successor for five years.

The surviving taxpayer may elect this special material participation rule in its taxable year including the death of the individual, or if death causes a new taxable year, in the first taxable year immediately following that death. This survivor’s rule will continue to apply to that taxpayer for the remaining period. However, this survivor’s rule will not prevent an estate or other successor taxpayer from materially participating under another rule.

\textsuperscript{191} Because the estate might elect a fiscal year, the five out of ten test should be treated as referring to the estate’s taxable year.