A Trust's "Material Participation" Is No Longer Immaterial

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Although it has been more than 25 years since Congress enacted the passive activity loss (PAL) rules, guidance on how the rules apply to trusts is limited. Until now, the PAL rules have been largely irrelevant to trusts that hold income-generating activities. Beginning this year, however, those rules will apply in determining whether trusts are subject to the new 3.8% net investment income tax (NIIT). If a trust materially participates in its activities, the income from those activities generally will not be subject to the NIIT. This article explores the existing guidance on how a trust materially participates.

Congress enacted the PAL rules to limit the ability of taxpayers to use losses from so-called tax shelters against their earned income. *See* S. Rep. No. 99-313, 99th Cong., 2d Sess. 713 (1986). Accordingly, section 469 disallows losses from passive activities except to the extent the taxpayer has passive income. I.R.C. § 469(a)(1) & (d)(1). A passive activity is any trade or business in which the taxpayer does not materially participate and any rental activity. I.R.C. § 469(c)(1) & (2). A taxpayer materially participates in an activity if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. I.R.C. § 469(h)(1).

Section 469 applies to all trusts. Although the Preamble to the temporary regulations provides that rules covering trusts would be included in future regulations, rules on how a trust materially participates have been reserved in the regulations since 1988. Temp. Treas. Reg. § 1.469-5T(g). The temporary regulations provide seven quantitative tests for determining if an individual (including an individual treated as the owner of a grantor trust) materially participates in an activity. Temp. Treas. Reg. § 1.469-5T(a). For example, one test provides that an individual who participates in an activity for more than 500 hours during the year will be treated as materially participating in the activity. Temp. Treas. Reg. § 1.469-5T(a)(1). Although these seven tests do not technically apply to trusts, the Service's *Passive Activity Loss Audit Technique Guide* states that the Service looks to the individual tests as a proxy and will not challenge a trustee that meets one of the tests.

Even if trusts can look to the tests for individuals as a proxy, they must still determine whose hours count toward meeting one of the tests. In the case of a grantor trust, material participation is determined based on the participation of the grantor or beneficiary who is treated as the owner of the trust under section 671. Temp. Treas. Reg. § 1.469-1T(b)(2). Similarly, for qualified subchapter S trusts, material participation is determined based on the participation of the beneficiary who is treated as the owner of the trust. *See* Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 242 n.33 (1987). For non-grantor trusts, the legislative history simply provides that the trust will materially participate "if [a] ... fiduciary, in his capacity as such, is so participating." S. Rep. No. 99-313, *supra*, at 735.

Trusts that have historically held income-generating activities have probably ignored the PAL rules altogether. Now, however, the PAL rules also apply when the trust has income subject to the NIIT. The NIIT imposes a 3.8% tax on the lesser of: (1) the trust's undistributed net investment income, or (2) the excess (if any) of the trust's adjusted gross income over the dollar amount at which the highest tax bracket for trusts begins (in 2013, $11,950). I.R.C. § 1411(a)(2). Net investment income includes not only portfolio income such as interest, dividends, annuities, royalties, rents, investment gains, and certain trading activities, but also income from a trade or business that is a passive activity. I.R.C. § 1411(c)(1) & (2).

Consequently, beginning this year, many non-grantor trusts will be required to demonstrate that they materially participate in their activities, even if they have never applied the PAL rules in the past. To date, *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003), is the only case to consider how a non-grantor trust materially participates. The Service argued that a trust materially participates in an activity only if its trustee meets the standard in section 469(h)(1). The trust argued that its material participation should not be based solely on the participation of its trustee, but rather on the participation of its trustee, employees, and agents. The district court agreed with the trust and concluded that its material participation should be determined by reference to the persons who conduct the business on its behalf.

In TAM 200733023 (2007 TAM), the Service considered whether a trust materially participated in the activities of a partnership. The trustees contracted with special trustees to perform services with respect to the partnership, but the special trustees did not have the power to legally bind or commit the trust to any course of action. The Service, ignoring the court's conclusion in *Mattie K. Carter*, concluded that a trust materially participates only if its fiduciaries so participate. Because the special trustees were not fiduciaries, their hours did not count toward the trust's material participation. *See also* PLR 201029014 (concluding that a trust could materially

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participate if the trustee met the standard in section 469(h)(1)).

Taxpayers have attempted to push the limits of the holding in *Mattie K. Carter* as well. In *Estate of Roger E. Stangeland v. Commissioner*, 100 T.C.M. (CCH) 156 (2010), the trust wanted to count the hours of a consultant designated as a successor trustee. The consultant's relationship to the trust was unclear because he was not acting as trustee and was not an employee or agent of the trust. Because the trust could not prove that the consultant had any formal relationship with the trust, the Tax Court would not count his hours toward the trust's material participation. The court specifically noted that the case was materially distinguishable from *Mattie K. Carter* in that respect, and therefore did not opine on how a trust materially participates.

More recently, the Service narrowed its position further in TAM 201317010 (2013 TAM). The 2013 TAM considered whether two trusts materially participated in the activities of an S corporation and its subsidiary. The trusts owned an interest in Company X, an S corporation. Company X was the corporate parent of Company Y. Individual A owned the remaining stock in Company X, was a beneficiary of the trusts, was the president of Company Y, and was a special trustee of the trusts. As special trustee, A had the power to control decisions regarding the sale or retention of the stock in Company X and to vote the stock. The trusts argued that, unlike the special trustees in the 2007 TAM, A was a fiduciary and because A could not differentiate his participation hours as special trustee, shareholder of Company X, and president of Company Y, all of his participation hours should count toward the trusts' material participation in the activities of Company X. Examination argued that A's participation should count only to the extent that A participated in the activities of Company X in his fiduciary capacity as special trustee. The National Office agreed and concluded that the work performed by A as president of Company Y was not in his capacity as a fiduciary and therefore did not count toward the trusts' material participation. The National Office counted the hours A spent voting the stock and considering sales of stock, but those activities were insufficient to meet the standard in section 469(h)(1).

Although the guidance discussed above is conflicting and generally non-authoritative, several principles can be distilled. First, to avoid the result reached in *Stangeland*, a trust must clearly establish the nature of the relationships of the various individuals that act on the trust's behalf (*i.e.*, as agent, employee, fiduciary, etc.). Second, the trust must determine whose hours to count. Trusts will likely seek to rely on the decision in *Mattie K. Carter* and count hours spent by a trust's employees and agents, while the Service will look only to the hours of the trust's fiduciaries. Third, the trust must determine what hours qualify as participation. The Service will count only hours that are worked in a fiduciary capacity. Thus, individuals acting in multiple capacities such as Individual A in the 2013 TAM should keep a separate activity log to record any hours spent in a fiduciary capacity. Realistically though, non-grantor trusts will rarely materially participate under the Service's position in the 2013 TAM.

The Tax Court may reach the issue of how a trust materially participates in the pending case of *Frank Aragona Trust v. Commissioner*, TL-15392-11, which involves whether a trust is eligible to be a "real estate professional" under section 469(c)(7). To qualify as a real estate professional, the taxpayer must perform more than one-half of the taxpayer's personal services and more than 750 hours of services in real property trades or businesses in which the taxpayer materially participates. If the Tax Court finds that a trust can qualify as a real estate professional, it should also reach the issue of how a trust materially participates. The opinion in *Frank Aragona Trust* could finally bring long overdue clarity to this unsettled area of the tax law. ■