Published on *The National Law Review* https://natlawreview.com

Taxpayer Victory Helps Trusts Holding Business and Real Estate Avoid Tax

Article By:

Richard L. Dees

One of the most vexing tax issues remaining unresolved since the 1986 enactment of the passive loss (PAL) rules is whether business or rental income earned by a trust can be active income and whether business or rental losses sustained by a trust can be active losses.1 The enactment of the 3.8 percent net investment income tax (NII Tax) increases the significance of the uncertainty surrounding this issue. The taxpayer's total victory in the March 27, 2014, tax court decision, *Frank Aragona Trust v. Commissioner*,2 provides a partial answer to this question just in time for the 2013 tax filing season. Because the Internal Revenue Service (IRS) may yet appeal this case, it does not definitely resolve these issues.

Income or losses for PAL purposes are generally active when the taxpayer "materially participates" in the business or real estate activity. Congress enacted the PAL rules to prevent a taxpayer from taking business or rental activity tax losses against portfolio, salary and other income, unless the taxpayer materially participated in the business or rental activity generating the loss. These rules are significant for purposes of the NII Tax because income from a business or real estate activity if active is exempt from the NII Tax and if passive is subject to the NII Tax.

Although the PAL regulations are clear that an individual taxpayer's material participation depends on meeting one of the seven tests based on the hours worked in the business, the regulations provide no guidance on how to determine whether a trust has materially participated in a business or real estate activity held in the trust. The PAL regulations specifically reserve on this question. In the more than 25 years since the PAL regulations for individual taxpayers were finalized, until the *Aragona* decision, the only guidance available for determining whether a trust3 materially participates consisted of one sentence of legislative history, a single court case (*Mattie K. Carter Trust v. United States*4), a regulation under a different code section and less than a handful of private rulings. The Aragona is an important addition to the limited guidance on this subject.

Facts

During the tax years at issue in the case, the trustees of the Frank Aragona Trust were Frank Aragona's five children and a lawyer. One son, Paul, was named executive trustee; the lawyer was named independent trustee. The day-to-day management activities of the real estate businesses held in the trust were delegated to Paul. The trust owned rental real estate properties and held and developed real estate.

The trust held 100 percent of Holiday Enterprises, LLC (the LLC),7 which managed most of the trust's real estate rental activities. Three of the trustees were full-time employees of the LLC. The LLC also employed other individuals. The rental properties generated losses in 2003, 2004 and 2006. The trust deducted these losses against its income from other trust assets.

Issues

For the trust to deduct its losses, it had to establish that:

1. The trust was a "real estate professional" under the PAL rules. The IRS argued that it was not possible for a trust to be a real estate professional.

2. The trust materially participated in the rental activities. The IRS argued that the trust did not do so because the trustees participated in the rental activities as employees of the LLC, and not as trustees.

The court found for the Taxpayer on both issues.

Court's Analysis

The most important aspect of the decision is the court's ruling on the second issue. Although the court's ruling on the first issue is a win for this taxpayer, certain procedural issues may limit its value for other taxpayers.

The heart of the court's ruling on the second issue is its analysis of state fiduciary law, rather than federal tax law. The court accepted the IRS argument that in this case only the trustee's activities were relevant in determining whether the trust materially participated.8 The IRS 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 that position, saying:

Even if the activities of the trust's non-trustee employees should be disregarded, the activities of the trustees— 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. ... ("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. [Citations and footnotes omitted.]

Had the underlying business been a true operating company, rather than a company engaged in rental real estate activities, a finding that material participation occurred would have required the conclusion that the losses were deductible. However, the PAL rules provide that rental real estate activities are always passive, unless the taxpayer is a “real estate professional.” On this issue, the IRS argued that a trust can never be a real estate professional. The court rejected this argument. The IRS relied solely on this argument and failed to argue that even if a trust can be a real estate professional; this trust did not meet the requirements of being a real estate professional. These include a requirement that the taxpayer spend at least 750 hours in real estate businesses in which it materially participates andarequirement that time spent in those businesses must amount to more than half of its time spent in all business activities. It is likely that the IRS will raise these issues in future litigations. Thus, other trust taxpayers should expect to have to prove that they meet the tests of being a real estate professional to deduct losses due to rental real estate.

The court concluded in *Aragona* that if trustees are individuals and work in 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.” This holding will provide other taxpayers with a helpful basis for analyzing this issue.

Trust Income Distributed to a Beneficiary

The NII Tax is imposed on net investment income. The NII Tax regulations provide that net investment income in a trust that is distributed to a beneficiary remains net investment income. This statement is consistent with the general rule that income distributed from a trust retains its character to the recipient. For example, tax-exempt interest received by the trust remains tax exempt whether or not distributed to a beneficiary.

The NII Tax regulations, however, do not address the consequence of the distribution of trust income to a beneficiary when the income is not net investment income. It seems reasonable to assume that the distribution of income from an active business in which the trustee materially participated should retain its character as active when distributed to a beneficiary. If that is the case, income distributed from an active business in which the trustee materially participated would remain active income in the hands of the beneficiary, even if the beneficiary does not materially participate in the business.9

Because special tax rules usually apply to trusts owning S corporation stock, this special character rule will be unlikely to affect the NII Tax payable on trust income from an S corporation. A trust owning S corporation stock is usually a grantor trust, aqualified subchapter S trust (QSST) or an electing small business trust (ESBT). Income from an ESBT is taxed to the trust at the highest tax rate and is not taxed to its beneficiaries, even if distributed. The *Aragona* case makes it easier for Scorporation business income in an ESBT to be active and escape the NII Tax. A grantor trust is disregarded for tax purposes, and a QSST is treated as grantor trust as to its S corporation stock. The *Aragona* decision has no impact on grantor trusts because the individual material participation rules apply to determine whether the income is active or passive.

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1 Trust, as used in this *On the Subject*, refers to a non-grantor trust. A grantor trust is ignored for federal income tax and NII Tax purposes. Accordingly, the deemed owner of the trust—either the grantor (trust creator) or beneficiary—is treated as if he or she owned the business interests outright.

2 Opinion available at http://www.ustaxcourt.gov/InOpHistoric/FrankAragonaTrustDiv.Morrison.T C.WPD.pdf.

3 A trust is not an entity, so technically a “trust” cannot take any action any more than a bank account can take an action. Instead, only the trustee can take an action. Because the U.S. Tax Court analyzed the tax issues by referring to the trust as if it were an entity, this bulletin does so as well.

4 256 F. Supp.2d 536 (2003). This case held that the activities of the trust’s agents and employees, not just those of the trustee, could be considered in determining material participation. 5 This previously existing guidance is discussed in detail in Dees, *20 Questions (and 20 Answers!) on the New 3.8*

Percent Tax. (“*20 Questions*”) TAX NOTES p. 683 (8/12/2013) and p. 785 (8/19/2013), available at http://www.mwe.com/files/Publication/ce599bf3-0574-4cc5-b071- 564d4c952143/Presentation/PublicationAttachment/e42df112-bf94-42c2- 91ea-dddf68b2952a/Combined%20Installments%20of%20Tax%20Notes%20Artic le%20on%20Section%201411.PDF?PublicationTypes=2ff5794b-a74c-4934- b4e9-f372ab684e28

6 Despite the lack of guidance, including the U.S. Department of the Treasury’s failure to issue regulations on material participation with respect to trusts, the IRS assessed an accuracy-related penalty in its deficiency notice. But it then conceded during the litigation that penalties were inappropriate.

7 Because the LLC was wholly owned, the LLC was disregarded for the tax purposes. The taxpayer’s lawyers argued at trial that this meant that the trustees employed by the LLC should not be treated as employees. The opinion disregarded this argument.

8 The decision does not address whether the actions of agents or employees who are not trustees can be considered because the trustees’ actions were sufficient without considering the actions of others to meet the material participation requirement. As the court notes, the only other court decision on trust material participation is *Mattie K. Carter Trust v. United States, supra n.4*, which allowed the actions of persons other than the trustee to be considered.

National Law Review, Volume IV, Number 113