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August 17, 2015

The Honorable Mark Mazur
Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave., N.W.
Washington, D.C. 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Ave., N.W.
Washington, D.C. 20224

The Honorable William J. Wilkins
Chief Counsel
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Re: **Report No. 1326 on the Material Participation of Trusts and Estates under Sections 469 and 1411 of the Code**

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the enclosed New York State Bar Association Tax Section Report No. 1326 (the "Report") offering commentary and recommendations on the standards for the material participation of trusts and estates under Sections 469 and 1411 of the Internal Revenue Code of 1986, as amended (the "Code"), which will be issued under U.S. Treasury Regulations (the "Regulations") section 1.469-5T(g).

By way of background, Section 1411 imposes a 3.8% tax on a taxpayer's net investment income in excess of certain income thresholds for taxable years after 2012. This tax applies to individuals, trusts and estates, among others. Net investment income includes income from trades or businesses that are passive activities within the meaning of Section 469. In general, under Section 469, a passive activity is (i) an activity involving the conduct of a trade or business in which the taxpayer does not materially participate or (ii) rental real estate activity (other than

real estate activity of a taxpayer engaged in a "real property trade or business"). The Regulations under Section 1411 reference the Regulations under Section 469 for the definition of a passive activity.

However, such Regulations provide no guidance as to the application of the material participation rules for trusts, estates and beneficiaries. In addition, the legislative history of the Tax Reform Act of 1986 provides limited guidance on how a trust or estate can materially participate under Section 469, noting that an estate or trust materially participates in an activity "if an executor or fiduciary, *in his capacity as such*, is so participating. . . ." S. Rep. No. 313, 99th Cong., 2d Sess. 735 & n. 287 reprinted at 1986-3 C.B. 735 (emphasis added). Only two cases, *Mattie K. Carter Trust v. U.S.*, 256 F. Supp.2d 536 (N.D. Tex. 2003) ("Carter Trust") and *Frank Aragona Trust et al. v. Commissioner,* 142 T.C. No. 9 (2014) ("Aragona Trust"), which are discussed in detail in the Report, examine whether a trust has materially participated in an activity under Section 469. Each case takes a different approach and focuses on different issues relating to material participation by trusts. The Internal Revenue Service has issued three private rulings that are consistent with its litigating position in *Carter Trust* and *Aragona Trust* – namely that the activities of trustees, acting in their capacity as such, should be considered in determining whether a trust materially participates in an activity – but all such private rulings predate *Aragona Trust* and explicitly depart from *Carter Trust.*

In light of the lack of guidance as to the application of the material participation rules to trusts and estates and the recent addition of the 3.8% tax under Section 1411 which applies to trusts and estate, there is a pressing need for guidance on the material participation rules in this context. The Report makes the following specific recommendations regarding the material participation rules for trusts and estates:

1. Where an interest in a trade or business activity is held by a grantor trust, only the grantor's participation (or that of the deemed owner under the grantor trust rules) should be relevant in determining whether the activity is passive or non-passive.

2. Where an interest in a trade or business is owned by a non-grantor trust, whether a trust materially participates in a trade or business in which the trust has an interest should be determined solely by reference to the activities of the trustee or trustees.

3. The trustees whose activities are being relied upon to show material participation should have fiduciary responsibility with respect to the trade or business in which the trust has an interest. This prerequisite generally will be satisfied if the trustee is required to act as a fiduciary in making decisions with respect to the trade or business. However, if there are limitations on the ability of a specific trustee to act, such as in circumstances in which a trustee's authority is limited to making distributions from the trust, then the activities of that particular trustee

(who has limited authority) should not be considered in determining whether the trust materially participates.

4. Trustees should be able to rely upon the safe harbors set forth in Regulation section 1.469-5T(a), with appropriate modifications, to meet the material participation standard.

5. In determining whether a material participation test has been satisfied, the activities of multiple trustees with requisite authority should be aggregated, but with appropriate adjustments to the existing rules relating to safe harbor tests available to individuals.

6. Activities performed by a person serving as trustee (with fiduciary responsibility with respect to the trade or business), whether performed as trustee, employee or otherwise, should be taken into account in applying the material participation test.

7. The activities of a trustee which count toward material participation generally should be determined in the same manner as an individual who is an owner of the trade or business. Thus, mere management authority or oversight similar to that of a shareholder, without involvement in operations, should not be included in determining whether a trust materially participates. However, if the person serving as trustee has the appropriate authority with respect to the operation of the business, and actually undertakes such activity (whether alone or with other trustees), all time spent by that person in the business should be counted toward material participation.

8. In accordance with the Temporary Regulations relating to material participation of individuals, work performed by a trustee that is not of a type that is customarily done by an owner should not count if one of the principal purposes of performing such work is avoiding the application of Section 469.

9. Work performed by the agents or employees of a trustee should not count toward material participation by the trust.

10. Material participation may not be achieved through the activities of corporate trustees, such as banks and trust companies, with a limited exception for private trust companies.

11. For purposes of the real estate professional exception, a trust may be treated as engaging in "personal services" and therefore qualify under the

exception, provided there is at least one trustee who qualifies as a real estate professional.

12. The character of the income (as passive or non-passive), determined at the trust level by reference to the trustee's participation, continues to control the character when such income is distributed, even if the beneficiary's level of participation is different.

13. If gain or loss is recognized upon a trust's conversion from a grantor trust to a non-grantor trust (or vice versa), the gain or loss is passive or non-passive depending on the participation of the taxpayer – the grantor or other deemed owner (or the trust itself) – immediately before the conversion.

14. If a qualified subchapter S trust, or QSST, sells or exchanges S corporation stock for a gain or loss, characterization of such gain or loss as passive or non-passive should be determined by reference to the beneficiary's participation.

15. Death should not automatically change the character of the decedent's trade or business income or losses. There should be a period of time (such as two years) after an individual's death during which the estate is treated as materially participating in any activity in which the individual materially participated in the 12 months prior to her death.

We very much appreciate your consideration of the Report and its recommendations, and would be happy to discuss them with you or provide additional assistance.

Respectfully submitted,

David R. Sicular
Chair

Enclosure

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