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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

MATERIAL PARTICIPTION OF TRUSTS AND ESTATES UNDER SECTIONS 469 AND 1411 OF THE CODE

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MATERIAL PARTICIPATION OF TRUSTS AND ESTATES UNDER SECTIONS 469 AND 1411 OF THE CODE

This report (the "Report")[1] responds to a request[2] by the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") in the preamble to the United States Treasury Regulations (the "Regulations") under Section 1411 of the Internal Revenue Code of 1986, as amended (the "Code"), for comments regarding rules on material participation of estates and trusts to be issued under Regulations section 1.469-5T(g).[3]

This Report is divided into three parts. Part I summarizes the Report's principal recommendations. Part II provides background regarding Section[4] 1411 and Section 469, the Regulations issued under Section 469, and case law and Service rulings relating to material participation of trusts under Section 469. Part III offers proposed rules for determining material participation for trusts and estates and related issues.

I. Summary of Principal Recommendations

Our recommendations include the following:

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1 The principal authors of this Report are Alan Halperin and Joseph Septimus. Austin Bramwell, Robert Barnett, Jonathan G. Blattmachr, Henry Bubel, Evelyn M. Capassakis, Jerome Caufield, Richard L. Dees, Albert Dumaual, Mitchel L. Gans, Karen Goldberg, Laurence Keiser, Eric M. Lopata, Richard Miller, Stuart L. Rosow, and Martin Shenkman made substantial contributions. Helpful comments were provided by Amy Heller, Michael Schler and David Sicular. The Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or the House of Delegates.

2 Fed. Reg. Vol. 78, No. 231, p. 72393 (Dec. 2, 2013).

3 This section of the Regulations presently is reserved for rules on the "Material participation of estates and trusts." The 2015-2016 Priority Guidance Plan also includes the item: "Guidance regarding material participation by trusts and estates for purposes of §469."

4 All references to Sections, unless otherwise indicated, shall be to the Code.

1. Where an interest in a trade or business activity is held by a grantor trust,[5] 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.

[5] Unless otherwise provided, the analysis bearing on trustees and trusts applies to executors and estates. For ease of reference, where the analysis is the same, this Report does not refer separately to executors and estates.

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.

II. Background and Applicable Authority

A. Material Participation and the Net Investment Income Tax

Section 1411 imposes a 3.8% tax on a taxpayer's net investment income in excess of certain modified adjusted gross income thresholds for taxable years beginning after December

31, 2012. The threshold amounts are $250,000 for married taxpayers filing jointly, $125,000 for married taxpayers filing separate returns, and $200,000 for all other taxpayers.

The tax on net investment income is imposed on individuals, trusts and estates. Income from trades or businesses that are passive activities within the meaning of Section 469 is included in the definition of net investment income.[6] The Regulations under Section 1411 refer to the Regulations under Section 469 for the definition of a passive activity.[7] Yet, while Section 469 was enacted nearly 30 years ago, the Service has not issued Regulations providing guidance as to the application of the material participation rules to trusts, estates and beneficiaries.[8] With the enactment of Section 1411 (and its reliance on Section 469 for material participation principles), as well as Section 1411's broad application to trusts and estates, there is a pressing need for guidance.

B. Material Participation by Individuals under Section 469

1. Background

In considering how the material participation rules should apply to trusts, estates and beneficiaries, the starting point is an understanding of the rules as they apply to individuals.

Congress enacted the passive activity loss rules as part of the Tax Reform Act of 1986 in order to curb taxpayers' use of tax shelters to reduce taxes on other sources of positive income.[9] Specifically, Section 469 limits the deductibility of losses from sources defined as "passive activities" against sources of income, such as salary and net earnings from self-employment, and portfolio income, such as dividends, interest and capital gains.

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6 Section 1411(c)(2)(A).

7 Treas. Reg. § 1.1411-5(b)(1)(ii).

8 To date, the Service has not issued any other guidance as to how Section 1411 should apply to trusts and estates.

9 *See e.g.* Pub. L. No. 99–514, Title V (1986) (discussing passive loss rules under the heading "Tax Shelters").

Section 469(c) defines "passive activity" as an activity involving the conduct of a trade or business in which the taxpayer does not materially participate. Section 469(h)(1) provides that a taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is "regular, continuous, and substantial." The presence or absence of material participation generally is to be "determined with reference to all of the relevant facts and circumstances."[10] The legislative history states that the individual's involvement must relate to operations, not merely management, and lists several factors that are important to the analysis, but that are not dispositive.[11] Such factors include whether an activity is an individual's principal business, whether the individual is present at the place where the principal operations are conducted and the individual's knowledge or experience with respect to the activity.[12]

Congress granted the Service authority to promulgate Regulations defining material participation for purposes of Section 469.[13] Regulations interpret the material participation standard by providing that a taxpayer materially participates in a particular activity in a taxable year only if the taxpayer meets any one of seven tests, four of which are quantitative, one of which is facts and circumstances based, and two of which are based on a taxpayer's material participation in prior years. The quantitative tests consider the number of hours an individual participates in an activity, the participation of the individual relative to the participation of other individuals, or both.

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[10] S. Rep. No. 313, 99th Cong., 2d Sess., at 733 (1986), reprinted at 1986-3 C.B. 735.

[11] Id.

[12] Id. at 734.

[13] Section 469(l)(1).

2. The Regulatory Material Participation Tests for Individuals

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 tests:[14]

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 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 (a trade or business activity in which the taxpayer works for more than 100 hours during the taxable year) 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; or

7. Based on all of the facts and circumstances the individual participates in the activity on a "regular, continuous, and substantial" basis during such taxable year and the individual participates for more than 100 hours during the year in such activity.[15]

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14 Treas. Reg. § 1.469-5T(a).

15 Treas. Reg. § 1.469-5T(a)(7).

The facts and circumstances test (test seven) is briefly discussed in the Regulations.[16]

The Regulations limit the concept in three respects. First, they provide that, generally, other sections of the Code and Regulations (such as Sections 1402 and 2032A) will not be considered in determining whether an individual has met the facts and circumstances test.[17] Second, a taxpayer cannot qualify as materially participating under the facts and circumstances test if she participates in an activity during the taxable year for 100 hours or less.[18] Third, services performed by an individual in the management of an activity are disregarded under the facts and circumstances test unless (1) no other individual is compensated for performing management services in connection with such activity, and (2) no other individual

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[16] Treas. Reg. §1.469-5T(b)(1) was reserved for further elaboration of the regular, continuous, and substantial involvement in operations standard.

[17] Treas. Reg. §1.469-5T(b)(2)(i). Under Section 1402(a)(1), material participation is relevant in determining when a farmland owner who rented land under a crop share lease should treat the rental income as self-employment income.

Under Section 2032A, an estate of a decedent who materially participated (or who had family members who materially participated) in farming could value farmland at its special use value (rather than its higher fair market value) for federal estate tax purposes. Regulations under Section 2032A specifically address the manner in which a trust establishes material participation and focus on the actual activities performed, rather than the title or capacity of the participant.

Regulation section 20.2032A-3(f)(1) provides:

With indirectly owned property as with property that is directly owned, there must be an arrangement calling for material participation in the business by the decedent owner or a family member…Where property is owned by a trust, the arrangement will generally be found in one or more of four situations. First, the arrangement may result from appointment as a trustee. Second, the arrangement may result from 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 or her material participation in its activities. Third, the participants may enter into a contract with the trustees to manage, or take part in managing, the real property for the trust. Fourth, where the trust agreement expressly grants the management rights to the beneficial owner, that grant is sufficient to constitute the arrangement required under this section.

[18] Treas. Reg. §1.469-5T(b)(2)(iii).

performs management services that exceed, by hours, the amount of such services performed by the taxpayer.[19]

3. Special Rules With Respect to Material Participation by Individuals

Limited Partnerships. If the individual only holds a limited partnership interest in the activity, the individual must establish material participation in the activity for the taxable year by satisfying tests one, five or six.[20]

Spousal Attribution. Participation by a person's spouse in the activity during the taxable year (regardless of whether (i) the spouse owns an interest in the activity or (ii) the spouses file a joint return for the taxable year) is treated as participation by such person in the activity during the taxable year for purposes of applying Section 469 and the Regulations thereunder.[21]

Anti-Abuse Rules. The Regulations generally provide that any work done by an individual 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, without regard to the capacity in which the individual does the work.[22] Nevertheless, two kinds of work are not counted in determining the number of hours the taxpayer has spent participating in an activity. First, work in connection with an activity is not counted if it is of a type not customarily done by an owner of such activity, *and* one of the principal purposes for the performance of such work is to avoid the application of the passive loss rules.[23] Second, work done in an individual's

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[19] Treas. Reg. §1.469-5T(b)(2)(ii).

[20] Treas. Reg. § 1.469-5T(e)(2).

[21] Section 469(h)(5); Treas. Reg. § 1.469-5T(f)(3).

[22] Treas. Reg. § 1.469-5(f)(1).

[23] Treas. Reg. §1.469-5T(f)(2)(i).

capacity as an investor is not counted unless the taxpayer is directly involved in the day-to-day management or operations of the activity.[24] Work done in an individual's capacity as an investor includes studying and reviewing financial statements or operations reports, preparing or compiling summaries of finances or operations for the individual's own use and monitoring finances or operations in a non-managerial capacity.[25]

C. Rental Real Estate Activities

Section 469 has special rules applicable to real estate activities. Rental real estate activity is generally passive under Section 469(c)(2), with an exception for activities of a taxpayer engaged in a "real property trade or business."[26] A "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. The exception applies only if (i) more than half of all of the taxpayer's personal services performed in the conduct of a trade or business during a taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (ii) the taxpayer performs more than 750 hours of service during the year in real property trades or businesses in which the taxpayer materially participates. These requirements are met for both taxpayers filing a joint return only if either spouse independently fulfills both requirements.[27] This rule stands in contrast to the seven

[24] Treas. Reg. §1.469-5T(f)(2)(ii)(A).

[25] Treas. Reg. §1.469-5T(f)(2)(ii)(A).

[26] Section 469(c)(7).

[27] Section 469(c)(7)(B) and Treas. Reg. § 1.469-9(c)(4). See also, *Julie A. Oderio v. Commissioner*, 107 T.C. Memo (CCH) 1214 at *6.

general material participation tests in which case the hours are pooled for the two spouses, regardless of whether they file jointly.[28]

D. Material Participation by Trusts and Estates under Section 469

Section 469 specifically includes trusts and estates on the list of taxpayers to which it applies.[29] In addition, the list identifies individuals, closely held C corporations and personal service corporations.[30] A corporation is closely held if, at any time during the last half of the taxable year, more than 50% (by value) of its outstanding stock is owned, directly or indirectly, by five or fewer individuals.[31] Neither the Code nor the Regulations describe how material participation by a non-grantor trust or estate is to be determined for purposes of Section 469.[32] Regulation section 1.469-5T(g) has been reserved for Regulations applying the material participation requirements to trusts and estates.

1. Income Taxation of Trusts

Income that is earned by a trust may be included in the income of the grantor (if living), the beneficiaries, or the trust itself, depending on the nature of the trust and distributions that are made by the trust. When the grantor of the trust retains or other persons are given certain interests in or powers over the trust such that the trust is classified as a "grantor trust" for income tax purposes, the grantor or the other person with certain powers is required to include all of the trust's income on her own income tax return. The income of a trust that is not classified as a

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28 The provision requiring that a taxpayer independently perform more than 750 hours in real property trades or businesses to qualify for the exception from passive loss limitations under Section 469 without the benefit of spousal attribution was added in conference. See House-Senate Conference Committee Report, H.R. Rep. No. 103-213, 103rd Cong., 1st Sess. (Aug. 4, 1993) at *547.

29 Section 469(a)(2)(A).

30 The list does not identify partnerships and S corporations, as they are viewed as entirely flow-through vehicles.

31 Section 542(a)(2).

32 As noted below, grantor trusts are ignored for purposes of Sections 469 and 1411.

grantor trust is included in the income of the beneficiary, if trust income is distributed (or deemed distributed) to the beneficiary, and is deductible by the trust. If trust income is not distributed (or deemed distributed) to a beneficiary, the income is taxable to the trust.

2. Grantor Trusts

Grantor trusts – that is, trusts that are treated as owned for income tax purposes by the grantor or another person under the rules of Sections 671 through 679 – are ignored both for chapter 1 income tax purposes[33] and for purposes of the net investment income tax under Section 1411.[34] This principle extends to the application of the material participation rules.[35]

3. Section 469 Legislative History With Regard to Trusts

The legislative history of the Tax Reform Act of 1986 provides limited guidance on how a trust or estate can materially participate for purposes of Section 469. The Senate Report accompanying the Tax Reform Act of 1986, which includes 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...."[36]

4. Case Law Applying Section 469 to Trusts

Two courts have considered which persons acting on behalf of a trust should be considered in determining whether a trust materially participates in an activity. The two courts took different approaches. We note that both cases involved individual trustees.

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33 Rev. Rul. 85-13; Rev. Rul. 2007-13; Treas. Reg. § 1.1001-2(c) (ex. 5); *Madorin v. Comm'r*, 84 T.C. 667 (1985); *see also* CCA 201343021 ("[W]e conclude that a trust treated as a grantor trust is ignored as a separate entity apart from the owner for all federal income tax purposes. . . ."); *but see Rothstein vs. U.S.*, 735 F.2d 704 (2d Cir. 1984).

34 Treas. Reg. § 1.1411-3(b)(v).

35 S. Rep. No. 313, 99th Cong., 2d Sess. 735, reprinted at 1986-3 C.B. 735.

36 S. Rep. No. 313, 99th Cong., 2d Sess. 735 & n. 287, reprinted at 1986-3 C.B. 735 (emphasis added).

Carter Trust

In 2003, in *Mattie K. Carter Trust v. United States*[37] ("Carter Trust"), the District Court for the Northern District of Texas held that material participation of trusts should be determined by taking into account the activities of both the trustee and the trust's non-trustee employees and agents. The taxpayer trust, which had an individual trustee, owned a cattle ranch. The trust employed a number of full- and part-time employees who performed activities for the ranch, including a full-time ranch manager "who managed the ranch's day-to-day operations, subject to [the trustee's] approval."[38]

The Service argued that in determining whether a trust materially participates for purposes of Section 469, only the activities of a trustee, acting in its capacity as such, are considered. In support of its argument, the Service cited to the legislative history of Section 469, which states that "[a]n estate or trust is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating."[39]

The court first looked to the statute itself to determine whether a trust's participation should be measured solely by reference to the activities of its trustee and found that the Service's interpretation of Section 469(h)(1) "is arbitrary, subverts common sense, and attempts to create ambiguity where there is none."[40] The court rejected the Service's argument and determined that the statutory language of Section 469 should apply to determine material participation. According to the court, because, under Section 469(a)(2)(A), trusts are defined as "taxpayers," and the material participation test is applied to the "taxpayer," the logical

[37] 256 F. Supp.2d 536 (N.D. Tex. 2003).

[38] Id. at 538.

[39] S. Rep. No. 313, 99th Cong., 2d Sess. 735 & n. 287.

[40] 256 F. Supp.2d at 541 ("[T]he absence of regulations and case law does not manufacture statutory ambiguity.").

conclusion is that the material participation standard applies to the trust, as opposed to the trustee. The court stated:

> 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.[41]

In addition, because legal entities such as trusts can only act through their fiduciaries, employees, and agents, the court concluded that "the material participation of Carter Trust in the ranch operations should be determined by reference to the persons who conducted the business of the ranch on Carter Trust's behalf, including [the trustee]."[42] Since the activities of all of these persons acting on behalf of the Carter Trust were regular, continuous, and substantial, the court ruled that the Carter Trust had met the Section 469 material participation standard.[43]

Aragona Trust

More recently, in 2014, the Tax Court considered the issue of a trust's material participation in *Frank Aragona Trust et al. v. Commissioner*[44] ("Aragona Trust"). The taxpayer in Aragona Trust was a trust involved in certain real estate activities, including owning rental properties and holding and developing other real estate. For the years at issue, there were six

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41 Id.

42 Id. With respect to individuals, Regulation section §1.469-5(f)(1) provides that, subject to certain exceptions, "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 shall be treated for purposes of this section as participation of the individual in the activity." (emphasis added).

43 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. As a result, even if the court had accepted the legal standard urged by the Service, the Carter Trust would have prevailed under Section 469. The Service has indicated informally that this finding made it unnecessary to appeal or non-acquiesce in that decision to express its disagreement with the court's consideration of the actions of persons other than the trustee.

44 142 T.C. No. 9 (2014).

trustees, three of whom were also employees of a wholly owned limited liability company ("LLC") through which the taxpayer conducted a portion of its real estate business. The LLC also employed approximately 20 people in addition to the trustees. Two of the six trustees had minority ownership interests in the entities in which the trust conducted its business.

The Service made two principal arguments as to why the rental real estate activities of the trust should be passive activities for purposes of Section 469. First, the Service argued that a trust engaged in rental real estate activity can never be eligible for non-passive treatment under Section 469(c)(7). As noted above, one of the requirements of Section 469(c)(7) is that the taxpayer must perform more than half of his "personal services" in a real property trade or business during the taxable year.[45] "Personal services" are defined by the Regulations as "work performed by an *individual* in connection with a trade or business."[46] The Service also cited to the legislative history which noted that Section 469(c)(7) applies to individuals and closely held C corporations. Based on the reference to "individuals" in the Regulations and legislative history, the Service argued that a trust cannot be eligible for this exception, as it is not an individual.

The court disagreed. Specifically, the court noted that for tax purposes the term "trust" generally means an arrangement…whereby trustees take title to property for the purpose of protecting it and conserving it for beneficiaries under the ordinary rules applied in chancery or probate court."[47] Accordingly, the court held that if the trustees of the trust are individuals, then their work can be considered work performed by an individual, and therefore eligible for non-passive treatment under Section 469(c)(7).

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[45] Section 469(c)(7)(B)(i).

[46] Treas. Reg. § 1.469-9(b)(4) (emphasis added).

[47] Treas. Reg. § 301.7701-4(a).

The Service's second argument was similar to what it proffered in Carter Trust. Specifically, the Service sought to disregard the activities of (1) the trustee employees of the LLC, (2) the two trustees with minority ownership interests in the operating entities of the trust,[48] and (3) the 20 non-trustee employees of the LLC.

With respect to the first category – activities of the trustees who are employees of the LLC - the Service argued that "(1) the trustees performed their activities as employees of [the LLC], and (2) it is impossible to disaggregate the activities they performed as employees of [the LLC], and the activities they performed as trustees."[49] Accordingly, the Service argued that none of these activities should be counted. The court disagreed, noting that, under applicable state law,[50] the trustees owed a fiduciary duty to the trusts regardless of whether they were acting as employees or as trustees.[51] Even as employees, the trustees were legally bound to exercise their fiduciary duties to the beneficiaries:[52]

> 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 [the 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.
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> …
>
> 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*

48 These two trustees were also LLC employees, and the Service's argument in respect of the trustees with ownership interests was made as an alternative argument if the Tax Court rejected the Service's argument to exclude the activities of the trustee employees of the LLC.

49 Aragona Trust, 142 T.C. at *7.

50 The trust was governed by Michigan law.

51 Aragona Trust, 142 T.C. at *8.

52 In effect, a trustee who wore "two hats," one as a trustee and one as an employee, was always wearing his or her "trustee hat."

> *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 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 [the LLC], should be considered in determining whether the trust materially participated in its real-estate operations.[53]

With respect to the activities of trustees with minority ownership interests, the court found that a trustee's minority interest in an entity in which the trust itself had a majority interest, particularly where the interests of the trustees (as owners) and the trust's interests as owners were generally compatible, did not cause the trustees' actions to be disregarded in determining whether the trust materially participates.

Having found against the Service with respect to the activities of all of the individual trustees, the court determined that the trust materially participated in the real estate business. The court therefore did not need to consider, and did not consider, the question of whether the activities of the trust's non-trustee employees should be disregarded.[54]

5. <u>PLRs and TAMs</u>

The Service has issued three private rulings (two Technical Advice Memoranda (the "TAMs") and one Private Letter Ruling (the "PLR")) consistent with its litigating position in *Carter Trust* and *Aragona Trust*: namely, only the activities of trustees, acting in their capacity as such, should be considered in determining whether a trust materially participates in an activity.[55] The TAMs and the PLR were each issued after the *Carter Trust* decision but before the *Aragona Trust* decision and each TAM states that "notwithstanding the decision in [*Carter*

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53 Aragona Trust, 142 T.C. at *23-34 (citations and footnotes omitted).

54 Aragona Trust, 142 T.C. at *8, FN 15.

55 TAM 200733023; PLR 201029014; TAM 201317010.

Trust], the Service believes that the standard enunciated in the legislative history is the proper standard to apply to trusts for purposes of Section 469."[56]

E. State Law Considerations and Fiduciary Duties

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 a state trust law concept. A trust is a fiduciary relationship where a trustee manages a trust's assets for the benefit of the trust's beneficiaries. The obligations that a trustee owes to trust beneficiaries are called "fiduciary" duties.

In *Aragona Trust*, the Tax Court's consideration of applicable state law relating to fiduciary duties served as the keystone in its analysis; specifically, it found that, under state law, the trustees continue to owe a fiduciary duty to the trust and its beneficiaries regardless of whether they were acting as employees or as trustees. Other state laws impose similar responsibilities on trustees. For example, the Second Circuit Court of Appeals has 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."[57] Accordingly, a trustee generally is bound by fiduciary duties when it performs activities for a trust, regardless of what role (such as, manager, officer or director) such person also occupies.[58]

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[56] TAM 200733023; TAM 201317010.

[57] *Saltzman v. Comm.*, 131 F.3d 87, 90 (2d Cir. 1997) (citations omitted).

[58] See Restatement of Trusts, 3d ed., 2013.

III. Proposed Rules For Determining Material Participation for Trusts and Estates

A. Grantor Trusts

Trusts treated as owned for income tax purposes by the grantor or another person under the rules of Sections 671 through 679 are referred to as grantor trusts. Such trusts generally are ignored for chapter 1 income tax purposes.[59] Moreover, the Regulations under Section 1411 already provide that, in determining a taxpayer's net investment income, grantor trusts are transparent. Specifically, the Regulations provide:

> Each item of income or deduction that is included in computing taxable income of a grantor or another person under section 671 is treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating such person's net investment income.[60]

The legislative history in connection with Section 469 adopted a similar view. "In the case of a grantor trust . . . material participation is determined at the grantor rather than entity level."[61] Accordingly, where an interest in a trade or business activity is held in a grantor trust, only the grantor's participation (or that of the deemed owner) is relevant in determining whether the activity is passive or non-passive. We recommend that the Regulations under Section 469 confirm this widely accepted principle.

B. Determination by Reference to the Activities of the Trustee

Whether a non-grantor trust materially participates in a trade or business in which the trust holds an interest should be determined by reference to the activities of the trustee. This rule is based on the legislative history, which, as discussed above, states that a trust is treated as materially participating if its fiduciary materially participates. Relying on the activities of

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59 See footnote 33.

60 Treas. Reg. § 1.411-3(b)(v).

61 S. Rep. No. 313, 99th Cong., 2d Sess. 735.

persons interested in the business for the determination of material participation also is consistent with the treatment of other legal entities under the statute and Regulations. The material participation of both personal service corporations and closely held C corporations is determined based on the participation of such corporations' majority shareholders.[62] In this case, the trustees in effect function as the majority shareholders through their fiduciary duties to the beneficiaries.

An example would be instructive. Assume that an individual owns 100% of the equity of a trade or business conducted through a limited liability company; the individual does not materially participate in the business. Upon his death, the equity in the LLC and therefore the business is transferred to a trust for the benefit of his minor grandchildren who are not active in the business. The trustee of the trust is the decedent's son. In this instance, the determination as to whether the trust materially participates in the business generally should be made by reference to the amount of work that the son performs with respect to the business. Whether the son actually materially participates will depend upon his activities.

We recognize that the settlor of the trust, through the choice of trustee, may be able to convert an activity which is passive in his hands into one that is not passive in the hands of the trust. While this result seems to follow inexorably from the statute and legislative history, the ability to effect such a result needs to be limited to situations where the trustee role has appropriate substance. In particular, it should apply only in those cases in which the trustee's interests and authority are akin to those of an owner and where the activities of the person serving as trustee are comparable to those of an active owner who materially participates. The recommendations which follow are intended to address the foregoing concerns.

[62] Treas. Reg. §1.469-1T(g)(3)(i).

We also note that, at first blush, focus on the trustee's conduct may suggest that, by organizing a business as a trust and naming as trustee an individual who satisfies the material participation test, one could skirt the material participation rules applicable to corporations, limited partnerships and other business entities. However, the proposed rules described in this Report are to apply to those trust arrangements created for purposes of protecting or conserving property for beneficiaries within the purview of Regulation section 301.7701-4(a).[63] These rules would not apply to business trusts.[64] The Regulations, to remove any doubt, should clarify that these rules do not apply to commercial or business trusts.

C. Authority of the Trustee

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. The fiduciary responsibility of the trustees with respect to the trade or business should be determined by reference to the governing documents (including the trust agreement) and the law of the jurisdiction within which the trust is organized. The proposed regulation for

63 Treasury Regulation section 301.7701-4(a) provides the following guidance as to the definition of a trust:

> 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. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary partners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code 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 enterprise for the conduct of business for profit.

64 Treasury Regulation section 301.7701-4(b) defines business trust as "other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a devise to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code."

determining whether an investor in a trade or business is treated as a limited partner similarly is determined by reference to state law principles.[65] If the person serving as trustee bears such authority subject to the fiduciary standard of care, then this requirement should be satisfied.[66]

If, on the other hand, the trustee whose activities are being considered to establish material participation has limited authority with respect to the trust, then the trustee should not be treated as having sufficient authority. Specifically, consider a situation where such person's role (as to the trust) is limited to distributions or mere administration, with no authority to vote or otherwise control trust assets.[67] In this case, the trustee should not be considered to have the requisite fiduciary responsibility. If, instead, the trustee has an investment authority, including such authority over the trade or business, then the trustee should be viewed as having the requisite fiduciary responsibility, and thus her activity - whether as trustee or in another capacity – should be included in the determination of whether the trust materially participates.

Some states allow the settlor to provide that certain activities on behalf of a trust may be exercised in a non-fiduciary capacity.[68] If the individual charged with overseeing the trust's investment in the trade a business is excused from fiduciary responsibility, then her activity should not be considered in determining whether the trust materially participates.

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65 *See* Prop. Treas. Reg. § 1.469-5(e)(3)(i), which have not yet been finalized. The proposed regulations provide that an individual will not be treated as materially participating in activities in which the individual holds interests in a limited partnership as limited partner. An interest in an entity is treated as a limited partnership if, among other requirements, "the holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement." *See* New York State Bar Association Tax Section, *Report on the Proposed Regulations under Section 469 Governing the Definition of Limited Partner,* Report No. 1259 (February 29, 2012) for our comments on the proposed regulations.

66 We recognize that determining whether a fiduciary standard of care exists is a state law concept determined on a state-by-state basis.

67 Some states statutes specifically allow the settlor, in the trust instrument, to bifurcate the trustees' responsibilities, and allocate the isolated duties to different fiduciaries, while exonerating them from liability for acts of other fiduciaries with different responsibilities. See, e.g., 12 Del. C. § 3313

68 *See, e.g.*, 12 Del. C. § 3313(a).

D. Material Participation Tests that Apply

Trustees should be able to rely upon the safe harbors set forth in Regulation section 1.469-5T(a) to meet the material participation standard. Like trusts and estates, C corporations are only able to participate through their individual majority shareholders.[69] Whether those shareholders meet the material participation standard is based upon the same quantitative and facts and circumstances tests that are applied to all other individuals.[70] The participation of trustees should be measured in a manner that is consistent with the statute and Regulations, and should therefore be based on the complete list of tests for individuals that is set forth in the Regulations.

E. Aggregation of Activities of Multiple Trustees

Regulations should address how a trust with more than one trustee may achieve material participation. One approach would allow for the activities of all of the trustees in the aggregate to qualify as material participation. This approach follows from the statute's treatment of the trust or estate as the taxpayer.[71] Since the work of each trustee is considered participation by the trust, and since the trust is the taxpayer whose participation Section 469 evaluates, it arguably should not matter whether one or multiple trustees contribute to the total. This approach is consistent with the court's analysis in Aragona.

A second approach would not allow for the hours of multiple trustees to be aggregated and it would require that at least one trustee satisfy the objective material participation standards. This approach is consistent with the approach taken by the Regulations in the analogous situation of determining whether a closely held corporation is to be treated as

[69] Treas. Reg. §1.469-1T(g)(3)(i).

[70] Treas. Reg. §1.469-1T(g)(3)(iii).

[71] Section 469(a)(2)(A).

materially participating. In that setting, the activities of each relevant shareholder must be assessed without regard to the activities of other shareholders.[72]

We believe that it may be appropriate to consider an intermediate position, and offer two alternative approaches. In each alternative, the activities of multiple trustees would be aggregated, but with certain meaningful limitations. For example, the Regulations (i) could limit the number of trustees whose activities are to be considered (say, to five trustees), and (ii) provide that any trustee whose conduct is to be considered must satisfy a minimum threshold number of hours (such as 50 hours). Alternatively, the Regulations could increase the number of aggregate hours depending on the number of trustees to be considered. For example, the Regulations might provide that the number of trustees whose activities are to be considered and the requisite aggregate hours are to be as follows: with two trustees, 150% of the hours required of one individual; with three trustees, 175%; with four trustees, 190%; and with five trustees, 200%.

F. Capacity in which Work is Performed and Activities Included

The activities of a trustee that count toward material participation generally should be determined in the same manner as an individual who is an owner of the trade or business. Under the statute, the trust is the taxpayer, not the trustee.[73] The Regulations should look to the participation of the trustee only as an extension of the trust. The spectrum of work that is counted also should be subject to the limitations contained in the Regulations for individuals.[74]

72 Treas. Reg. §1.469-1T(g)(3)(i)(A).

73 Section 469(a)(2)(A).

74 Treas. Reg. § 1.469-5T(f)(2).

The Regulations specifically should reiterate that only those activities which would count towards material participation in the case of an individual should count in the case of a trustee. Thus, in accordance with the statute, Regulations, and legislative history, mere management authority or oversight similar to that of a shareholder, without some involvement in operations, should not be included in determining whether a trust materially participates.[75]

With an individual, all hours spent, regardless of capacity in which the work was performed, count in determining whether she materially participated.[76] As an exception to this general rule, the Regulations provide that work will not count toward material participation if it is not of a type that is customarily done by an owner and is performed with a principal purpose of avoiding the application of Section 469.[77]

We suggest that the Regulations adopt a similar version of that rule such that, if a trustee has the appropriate fiduciary responsibility with respect to the business, all actions taken by the person serving as trustee in connection with the business would be considered in determining whether one of the safe harbor tests has been met. Thus, activities performed by a trustee would be considered whether undertaken in her capacity as a trustee, an employee or otherwise.[78] However, the activities will not count if they are the type that ordinarily would not be performed by an owner and if one of the principal purposes of performing the work is avoiding the application of Section 469. As in the case of the existing Regulations, the facts and

75 Section 469(h)(1); Treas. Reg. § 1.469-5T(b)(2)(ii).

76 Treas. Reg. § 1.469-5(f).

77 Treas. Reg. § 1.469-5T(f)(2).

78 This approach is consistent with the Tax Court's decision in Aragona Trust. In that case, "the trustees acted as a management board for the trust and made all major decisions regarding the trust's property." Aragona Trust, 142 T.C. at 4.

circumstances will determine whether one of the principal purposes of the work is avoidance of the statute.

G. Agents of Trustees

A related issue is whether activities of employees or agents of the trust should count in analyzing material participation. The one case to consider the issue, *Mattie Carter Trust,*[79] concluded that such activities should be taken into account. The court reasoned that, like a corporation, a trust can act only through its trustees, employees and agents. Because the trust is the taxpayer, the court reasoned the activities of those who can act on behalf of the taxpayer should be considered. According to the court, the statute was clear on its face and no resort to the legislative history was necessary.[80] The court specifically rejected the Service's view that only the activities of the trustees should count.

Despite the court's analysis in *Mattie Carter Trust*, we believe that the Regulations specifically should provide that the material participation test will not count work performed by an agent or an employee of a trustee.[81] The Regulations for individual taxpayers generally only count work performed by the individuals themselves.[82] The Regulations for trusts should not unnecessarily expand the universe of individuals whose participation may be attributed to the taxpayer. Doing so might unfairly benefit trust beneficiaries over direct holders

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[79] 256 F. Supp. 2d 536 (ND Tex. 2013).

[80] It should be noted that the court found that the activities of the trustee alone were sufficient to result in material participation.

[81] We note that, in *Mattie Carter Trust,* reliance on agents and employees was not the sole basis of the court's determination that the trust materially participated. The court independently found that material participation existed based on the activities of the trustee.

[82] *See e.g.* Treas. Reg. §1.469-5T(a) (counting only an individual's participation in an activity for purposes of determining whether the individual materially participates). There is only a limited exception for the spouses of individual taxpayers under Treas. Reg. §1.469-5T(f)(3).

of interests in a trade or business and further might expand the opportunities for avoiding Section 469 (and 1411) through the use of trusts.

H. Corporate Trustees

We recommend that, in general, the activities of a corporate trustee, such as a bank or trust company, should not cause a trust to materially participate in a trade or business. We recognize that, as a matter of state law, a corporate trustee's fiduciary duties extend to its directors and officers.[83] Accordingly, the requisite linchpin for trustee material participation – activity by persons with fiduciary duties – could exist. Nevertheless we believe that as a matter of policy the activities of corporate trustees should not be permitted to cause a trust to materially participate in a trade or business. In the case of closely-held corporations and personal service C corporations, only an individual shareholder, not a shareholder that is a legal entity, may establish material participation on behalf of the corporation.[84] By analogy, a trust with only a corporate trustee would not be considered to materially participate.

If the Service adopts our recommendation that a corporate trustee may not materially participate (despite the fiduciary duties owed by those working for the trustee), such a rule should be subject to an exception for private trust companies. [85] By analogy to the rule for closely held corporations, if the persons who control the corporate trustee are themselves

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83 *Childs v. National Bank of Austin*, 499 F. Supp. 1096 (N.D. Ill. 1980).

84 Treas. Reg. §1.469-1T(g)(3)(i).

85 A private trust company generally is a company whose sole purpose is to act as trustee with respect to a specific trust or trusts. A private trust company does not provide trust services to the public and does not solicit trust business. *See* Notice 2008-63, 2008-31 I.R.B. 261 (providing the contents of a proposed revenue ruling concerning the income, estate, gift and generation-skipping transfer tax consequences in situations in which family members create a private trust company to serve as trustee of trusts having family members as grantors and beneficiaries).

materially participating in the trade or business, then the corporate trustee may be considered to materially participate.

I. The Exception for a Real Property Trade or Business

1. General Application of the Exception

We recommend that Regulations adopt *Aragona Trust's* decision that a trust can engage in "personal services" for purposes of the real property trade or business exception set forth in Section 469(c)(7). As stated above, rental real estate activity is generally passive activity under Section 469(c)(2), with an exception for taxpayers who provide "personal services" in a real property trade or business. In *Aragona Trust*, the Service argued that a trust cannot be treated as performing "personal services" under the regulation that defines personal services as "work performed by an individual,"[86] and the legislative history.[87] The court rejected the Service's argument because the legal nature of a trust allows the trustee to constitute the "individual" for purposes of the "personal services" requirement. Specifically, the court held that "[i]f 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.'"[88]

2. One or More Trustees

The Tax Court in *Aragona Trust* did not, however, determine specifically how many hours of personal services were performed by the trust or whether "more than one half of personal services" requirement was satisfied, because the Service did not raise this issue. Accordingly, *Aragona Trust* did not resolve how to apply the "personal services" test to a trust

86 Treas. Reg. §1.469-9(b)(4).

87 See Section II.D.4 of this Report for a more detailed discussion of the Service's arguments in Aragona Trust.

88 *Aragona Trust*, 142 T.C. at *18.

that has more than one individual trustee. Specifically, the issue is whether, in satisfying the "personal services" test of Section 469(c)(7)(B), must at least one of the trustees alone have sufficient personal services or is it sufficient to aggregate the hours of the individual trustees for this purpose?

We believe that, unlike the general material participation rule we propose, it is appropriate to require at least one of the trustees to satisfy the real property trade or business exception. The statutory requirements under Section 469(c)(7)(B) appear to require that one individual, whose capacity and time per year is limited, to spend a significant portion of time, both in absolute and relative terms, on rental real estate activities. Other aspects of Section 469(c) also support this view. For purposes of satisfying the general material participation requirement under Section 469, a husband and wife are permitted to aggregate their hours in determining whether they materially participate in an activity.[89] This spousal aggregation rule, however, does not apply for either of the prongs of the real property trade or business exception,[90] which indicates an intention that the real property trade or business exception must be satisfied by one individual.

This recommended rule is consistent with the Tax Court's analysis of *Aragona Trust*. As more fully described above, in *Aragona Trust*, the Service argued that a trust is not capable of performing the regulatory definition of "personal services" which requires that the work be performed by an "individual". The court disagreed with the Service on the ground that an individual trustee can satisfy the requirement that an individual perform personal services for

[89] Section 469(h)(5).

[90] Section 469(c)(7)(B) (flush language) and Treas. Reg. §1.469-9(c)(4).

purposes of the real property trade or business exception.[91] To the extent that one looks to the trustee as an individual to satisfy the real property trade or business exception, it would seem counterintuitive to allow for the time of multiple individuals to satisfy the exception.[92]

J. Trust Distributions

With non-grantor trusts, the activity of the trustees determines whether the resulting trust income or loss is passive or non-passive. An important issue is whether (a) such characterization controls when trust income is distributed to a beneficiary or (b) the character is subject to change, upon distribution, based on the beneficiary's participation. We recommend that, consistent with general principles under subchapter J of chapter 1 of the Code and other persuasive authority, the fiduciary's participation should control the determination as to whether the distributed income is passive or non-passive.

1. DNI Rules Relating to the Taxation of Trusts and Beneficiaries

Some entities -- such as C corporations -- are taxed as separate taxpayers. Other business arrangements, such as partnerships and S corporations, are treated as pass-through entities. A non-grantor trust is a hybrid for tax purposes. The accumulated income and capital gains generally are taxed at the trust level. However, distributions or amounts required to be distributed generally carry out the trust's taxable income to the beneficiary or beneficiaries by

91 Aragona Trust, 142 T.C. at *17-19.

92 We recognize that, under the general material participation analysis (outside the real property trade or business exception), we have recommended aggregation of trustee activity, subject to certain adjustments. Some have questioned whether a different rule is warranted. Indeed, another thoughtful report has recommended that the hours of the trustees may be aggregated for purposes of determining whether a trust satisfies real estate professional exception. *See, e.g,* American Bar Association Section of Taxation Comments on Material Participating by a Trust or Estate Under Internal Revenue Code Section 469 (January 20, 2015) (hereinafter, the "ABA Comments") at 43. However, for the reasons stated in the Report, we believe that, in order for the real estate professional exception to apply to a trust, at least one trustee must qualify as a real estate professional.

way of a deduction for the trust[93] and corresponding inclusion of taxable income for the recipient.[94] The trust's distributable net income, or DNI, plays a critical role, providing both quantitative limitations and qualitative elements, in allocating the tax attributes between the trust and its beneficiaries.[95]

The DNI rules provide that distributed income retains its character as determined at the trust level. The Regulations provide:

> In determining the gross income of a beneficiary, the amounts includible . . . [in the beneficiary's income] have the same character in the hands of the beneficiary as in the hands of the trust. For example, to the extent that the amounts . . . consist of income exempt from tax under section 103, such amounts are not included in the beneficiary's gross income. Similarly, dividends distributed to a beneficiary retain their original character in the beneficiary's hand . . . Also, to the extent that amounts . . . consist of "earned income" in the hands of the trust under the provisions of section 1348, such amount shall be treated under section 1348 as "earned income" in the hands of the beneficiary.[96]

At first blush, the foregoing character rule seems determinative; the character of the income (as passive or non-passive) is determined at the trust level (based on the trustee's participation), and that determination controls the character in the hands of the beneficiary. However, the analysis is more complex and nuanced.

The Regulations clarify:

> The tax treatment of amounts determined under § 1.652(a)(i)(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

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93 Sections 651 and 661.

94 Sections 652 and 662.

95 The Regulations generally require each class of income comprising DNI be allocated proportionately among the beneficiaries who have received distributions. Treas. Reg. §§ 1.652(b)-2 and 1.662(b)-2.

96 Treas. Reg. § 1.652(b)-1. See also Treas. Reg. § 1.662(b)-1, providing that similar character rules (applicable to so-called simple trusts) are to apply to complex trusts.

> includibility of such income in his gross income depends upon his taxable status with respect to that income.[97]

The question arises as to whether the character of the income as passive or non-passive, determined by reference to the trustee's activity, fixes the tax treatment for the beneficiary. Or, alternatively, does the beneficiary's status as a potential material participant with respect to the distributed income alter the tax treatment?

2. Service Pronouncements Bearing on the Classification of Income Upon Distribution

To date, the Service pronouncements bearing on the issue have concluded that the character in the hands of the trust, and not the status of the beneficiary, controls whether distributed income is passive or non-passive. For example, the Service has determined that farming trade or business income earned by a trust and distributed to a beneficiary retained its character even though the beneficiary did not engage in farming.[98] The outcome, according to the Service, did not turn on the status of the beneficiary as a farmer or non-farmer. Since the trust was engaged in the requisite activity, the resulting character of the income was set and remained the same in the hands of the beneficiary.

Further, the Service, in two private letter rulings, has considered whether distributed income from pooled income funds would retain its character as rental income for purposes of Section 469. Specifically, the Service concluded:

> [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 § 469, in the same proportion as the Fund's net

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97 Treas. Reg. § 1.652(b)-1.

98 GCM 38431 (July 1, 1980); Rev. Rul. 1980-366, 1980-2 C.B. 342, which now is obsolete due to the repeal of Section 6073 (Rev. Rul. 2004-90, 2004-2 C.B. 317).

> income that rental enters into the computation of the Fund's DNI for that year bears to the Fund's entire DNI for that year.[99]

In yet another private letter ruling involving charitable remainder trusts, the Service similarly concluded:

> Provided the income that Trusts derive from their ownership of the limited partnership interests in the 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 the characterization rules of section 664(b) and the regulations thereunder, will similarly be treated as income from a rental activity in the hands of the unitrust beneficiaries.[100]

Consistent with the foregoing principles, the Regulations under Section 1411 bearing on what constitutes net investment income with respect to trust distributions provide:

> If one or more items if net investment income comprise all or part of a distribution . . ., such 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.[101]

3. <u>Recommendation</u>

We recommend that, consistent with the foregoing authority, the character of income as passive or non-passive, once determined at the trust level by reference to the trustee's activity, control such character in the hands of the beneficiary. This approach is consistent with the focus, under Section 469, on the fiduciary's activity. It further follows from the general principle that the determination of the income as passive or non-passive depends upon the activity of the taxpayer who owns the underlying interest at the time the income was generated.

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99 PLR 200608002 (Feb, 24, 2006); PLR 200608003 (Feb. 24, 2006).

100 PLR 9114025 (Jan. 7, 1991). Section 664 addresses the characterization of income distributed from charitable remainder trusts.

101 Treas. Reg. § 1.1411-3(e)(3)(ii).

K. Special Rules Concerning Gains and Losses Unique to Certain Trusts

In two circumstances, each unique to certain trusts, we recommend that Regulations clarify the application of rules governing whether gain or loss constitutes passive or non-passive income or loss. First, Regulations should provide that, if gain is recognized upon a trust's conversion from a grantor trust to a non-grantor trust (or vice versa), the gain (if with respect to property that was used in a trade or business) is passive or non-passive depending on the participation of the grantor or other deemed owner (or the trust itself) at the moment before the conversion. In addition, Regulations should provide that, if a qualified subchapter S trust or "QSST" disposes of S corporation stock, the determination of whether gain or loss constitutes passive activity income or loss is based on the participation of the income beneficiary, as the deemed owner of the stock up until the moment of disposition, rather than the trustee.

1. Change of Tax Status

The conversion of a trust from a grantor trust to a non-grantor trust is treated for income tax purposes as a transfer of property by the grantor or other deemed owner to the non-grantor trust.[102] Consequently, in accordance with the principle that the amount realized from a disposition of property includes liabilities discharged,[103] a change to non-grantor trust status may trigger recognition of gain to the extent that liabilities with respect to trust property exceed basis.[104] (Where a trust ceases to be a grantor trust by reason of the death of the grantor or other deemed owner, by contrast, gain is not recognized, as death is not generally a taxable event for

102 Treas. Reg. § 1.1001-2(c) Example 5; *Madorin v. Comm'r*, 84 T.C. 667 (1985); *see also* Rev. Rul. 77-402.

103 Treas. Reg. § 1.1001-2(a); *Crane v. Comm'r*, 331 U.S. 1, 12-16 (1947). Where property is encumbered by a liability, even a gratuitous transfer may trigger gain recognition. Treas. Reg. § 1.1001-2(c) Example 4.

104 Treas. Reg. § 1.1001-2(c) Example 4; Rev. Rul. 77-402; *Madorin v. Comm'r*, 84 T.C. 667 (1985).

income tax purposes.[105]) Conceivably, the reverse is also true: that is, where a trust changes from a non-grantor trust to a grantor trust, gain may be recognized to the extent that the trust's liabilities exceed basis.[106]

Like another report,[107] we recommend that, for purposes of Section 469, the character of any gain recognized upon a change from grantor trust to non-grantor trust status (or vice versa) be determined by reference to the participation of the income-tax owner at the moment before the change takes place. For example, if a grantor trust holds an interest in property that is used in a trade or business activity, and the trust converts to a non-grantor trust, then any gain recognized should be treated as passive if the grantor or other deemed owner did not materially participate in the activity at the time of the conversion. So characterizing gains upon termination of grantor trust status is consistent with the general principle, discussed earlier, that grantor trusts are ignored for income tax purposes. Just as an individual's gain from the disposition of her own property, if used in a trade or business, is passive or non-passive depending on whether she materially participates, so should gain from a disposition property owned through a grantor trust be passive or non-passive depending on the grantor or other deemed owner's participation. Regulations should clarify that the same treatment applies when the gain is triggered by termination of grantor trust status.

105 CCA 200923024 ("[T]he death of the owner [of a grantor trust] is generally not treated as an income tax event."); *see also*, Blattmachr, Gans, and Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 JTAX 149 (Sep. 2002); *but cf.* Treas. Reg. § 1.684-2(e) (providing that, upon a foreign grantor trust ceasing to be a grantor trust as a result of the grantor's death, a sale is deemed to occur the moment before death).

106 This Report takes no position as to whether income is in fact recognized in this setting.

107 *See* ABA Comments at 84-85.

2. Gain or Loss from the Disposition of S Corporation Stock Owned by a QSST

A qualified subchapter S trust or "QSST" is a special form of grantor trust under Section 678(e). In general, if a trust meets the requirements of a QSST set forth in Section 1361(d)(3) and the income beneficiary makes a QSST election, then the beneficiary is treated as the owner for income tax purposes of the S corporation stock held by the trust.[108] The income beneficiary of the QSST thereafter includes in computing his or her taxable income the QSST's pro rata shares of the S corporation's income, loss, deduction or credit.[109]

As discussed, grantor trusts, including QSSTs, are generally ignored for income tax purposes. Thus, only the participation of the QSST beneficiary, as the deemed owner of the S corporation stock, should be relevant in determining whether a trade or business held through the S corporation is a passive activity for purposes of Section 469. Regulations should confirm that conclusion, just as they should confirm that, in the case of other grantor trusts, material participation is determined solely by reference to the deemed owner.

Unlike in the case of other grantor trusts, however, gain or loss from the disposition of the property owned directly by a QSST is not attributed to the deemed owner at the moment before disposition. Instead, under the special rule of Regulation section 1.1361-1(j)(8), when a QSST disposes of its S corporation stock, the trust is considered the owner of the stock at the time of disposition and any gain or loss is attributed to the trust rather than the income beneficiary.[110] Regulation section 1.1361-1(j)(8) thereby creates an anomaly: the owner

108 Section 1361(d)(2). The QSST also thereby becomes a permitted S corporation shareholder. Sections 1361(c)(2)(A)(i), 1361(d)(1)(A).

109 Sections 671, 1366(a).

110 According to the preamble to the Regulations, the rationale for this rule is that, if the QSST beneficiary were treated as the owner of S corporation stock sold in an installment sale, then, when QSST status simultaneously terminates at the time of the sale, the beneficiary would be treated as having immediately transferred the

of a QSST's S corporation stock for purposes of determining the consequences of sale is a different taxpayer from the owner of the stock up until the moment of the sale. Without further regulatory guidance, it is unclear which owner's (or both owners') participation should count when determining whether gain or loss from the disposition of property constitutes passive activity income or deduction.

The better view, we believe, is that gain or loss from a disposition of QSST-owned S corporation stock should be characterized as passive or non-passive (to the extent that such gain or loss is allocable to property used in a trade or business activity) based on the income beneficiary's participation rather than the trust's participation. This interpretation follows from the principle that a taxpayer's material participation is measured over a period of time.[111]

For gain or loss from the disposition of QSST-owned S corporation stock to be considered derived from a non-passive trade or business activity, the taxpayer must have materially participated in the period prior to the disposition. During that same period, the income beneficiary of the QSST, as the deemed owner prior to disposition of the stock, already determines whether items of income and deduction flowing from the S corporation are from a passive activity. If the trustee's participation instead determined whether gain or loss from the

installment obligation to the trust, thereby effectively preventing installment sale treatment. T.D. 8600, 1995-2 C.B. 135. The Regulations prevent that result by instead treating the trust as the owner the S corporation stock at the time of the disposition. Yet the rule of Regulation section 1.1361-1(j)(8) is not limited to installment sales, but applies to all dispositions of S corporation stock by a QSST. The primary, if unexpressed rationale for the rule, therefore, seems to be broader: namely, that the income beneficiary of a QSST is entitled to the income from the trust but is not necessarily entitled to corpus, even though proceeds from the sale of property are normally allocated to corpus. *See*, *e.g.*, New York's Estates, Powers and Trusts Law section 11-A-4.4(2). Thus, if a QSST sells S corporation stock, the sale proceeds will not necessarily be distributed to the income beneficiary but instead may be held in further trust for the remainder beneficiary. The burden of tax on gains from the sale of S corporation stock (or the benefit of deduction from a loss), therefore, should be borne by the trust rather than the income beneficiary. *Cf.* Section 643(a)(3) (providing that capital gain is generally not included in a distributable net income).

[111] *Cf.* Treas. Reg. § 1.469-5T(a) (measuring material participation of an individual, in some cases, by the numbers of hours of participation, and, in other cases, based on the nature of the individual's participation "during" the taxable year).

disposition of the stock is passive or non-passive, then two different taxpayers' participation in the same activity, during the period of time, and with respect to the same ownership interest would determine whether the activity is passive or non-passive. We do not believe that the artificial rule of Regulation section 1.1361-1(j)(8) compels such a division in the identity of the taxpayers whose participation determines whether items are passive or non-passive. Rather, like other reports,[112] we recommend that the participation of the QSST income beneficiary, as the owner up until the moment of sale, control whether a trade or business conducted by an S corporation in which the QSST is a shareholder is passive or non-passive, both during the time that stock is held by the trust and for purposes of characterizing gain or loss upon a disposition of the stock.

3. Charitable Remainder Trusts

At least one other report has suggested that, where appreciated property that was used in a trade or business is contributed to a charitable remainder trust, or "CRT," the character of any gain from the sale of that property for purposes of Section 469 should be based on the donor's participation rather than the participation of the trust or the beneficiary.[113] Under this approach, if the donor materially participated in the activity in which the property was held, then any gain from the sale of the property should be considered non-passive activity income that cannot be used to offset passive activity deductions of the CRT or the CRT's beneficiaries, and any such gain would potentially avoid classification as net investment income subject to tax

[112] *See* ABA Comments at 84; American College of Trust and Estate Counsel Recommendations for REG-130843-13 (February 26, 2014).

[113] *See* ABA Comments at 85-86. It is worth noting at the outset that CRTs usually will not hold property that is used in an active trade of business, as CRTs are subject to a punitive 100% excise tax on unrelated business taxable income or "UBTI" within the meaning of Section 512. Section 664(c)(2). On the other hand, rents from real property (and an incidental amount of rents from personal property leased with such real property) are generally excluded from the definition of UBTI. Section 512(b)(3). Thus, it seems that the only case where a CRT will have income from a trade or business activity, whether passive or non-passive, is where its income includes rents from real property or gains from the sale of such property.

under Section 1411. As we understand the suggestion, when the gain is carried out from the CRT to the beneficiaries under the rules of Section 664(b), the gain would be excluded from net investment income, even if neither the beneficiaries nor the CRT materially participated in the underlying trade or business activity.

We do not agree with this suggestion. Section 469 classifies items of income and deduction from a trade or business based on the participation of the taxpayer to whom the items belong. Thus, it seems that only the taxpayer's participation during the period when she has an ownership interest in a trade or business activity is relevant to whether items of income or deduction from the activity are passive or non-passive.[114]

In the case of a CRT, as with other non-grantor trusts, we recommend that the trustee's participation rather than the beneficiary's should determine whether items of net income from a trade or business activity deemed to be carried out to a beneficiary under the rules of Section 664(b) are passive or non-passive. In any event, a rule classifying gain as passive or non-passive based on the participation of the donor of a CRT would instead attribute the participation of the prior owner to the taxpayer who later actually recognizes the gain. Such a rule, we believe, would depart from the Code's mandate that income and deduction be classified based solely on the participation of the taxpayer. Consequently, we do not recommend that

[114] *See* Treas. Reg. § 1.469-5(f)(1) (providing that work by an individual "in connection with an activity in which the individual *owns an interest at the time the work is done*" is generally considered participation) (emphasis added); Treas. Reg. § 1.469-5T(k) Example 6; *but cf.* Section 469(h)(3) (providing, by a cross reference to Section 2032A, that surviving spouses of farmers can in some cases be deemed to materially participate if the deceased spouse materially participated, provided that the surviving spouse actively manages the farm).

Regulations provide that the donor's participation determines whether income of a CRT, including gain, is passive or non-passive.[115]

L. Death of the Taxpayer

An individual's death, absent a special rule to the contrary, may cause a trade or business in which he or she was a material participant to become a passive activity. The reason is that the primary duty of an executor or other fiduciary of a decedent's estate is to collect, marshal and distribute the decedent's assets.[116] Rather than actively participate in the decedent's trades or businesses, therefore, an executor often focuses on the orderly windup and disposition of the decedent's property and rely on interim management to continue the operation of any trades or businesses. Eventually, the legatees of the decedent's business interests may become material participants when they succeed to ownership. In the meantime, although it is certainly possible for an executor to be a material participant in a trade or business owned by a decedent's estate,[117] the estate administration will not typically entail material participation by the fiduciary.

We agree with others that death, an involuntary and unanticipated event, should not automatically cause a change in the character of the decedent's trade or business income or losses except where the character of the executor's participation happens to be the same as that of the decedent.[118] Nor should the rules create a distorting incentive for testators to appoint

[115] We recognize that, without such a rule, a taxpayer who materially participates in a trade or business in which appreciated property is used, by transferring the property to a CRT, may attempt to convert the inherent non-passive gain into passive activity gain that, when carried out to the beneficiaries, can be used to offset the beneficiaries' passive activity deductions. We believe, however, that the potential for abuse is small. In any event, any potential for abuse can be addressed by through an anti-abuse rule similar to that of Regulation section 1.469-2(c)(2)(iii).

[116] *See, e.g.*, Estate of Pope, 4/18/95 N.Y.L.J. 26 (col. 3).

[117] For example, an executor who also serves as a full-time employee in the trade of business would be a material participant in the trade or business activity.

[118] ABA Comments at 86-87; Schmolka, *Passive Activity Losses of Trusts and Estates: The Regulations (If I Were King)*, 58 Tax L. Rev. 191 n. 172 (2005).

executors based on whether they are likely to be materially participants in the decedent's trades or businesses. Instead, we recommend that Regulations provide for continuity after a decedent's death.

The Regulations could state, simply, that for a period of two years after the decedent's death, an estate is treated as materially participating in any activity in which the decedent materially participated in the 12 months before her death, under the rules of Regulation section 1.469-5T.[119] Such a rule would be similar to others which recognize that an estate is, in some respects, a continuation of the decedent,[120] and is consistent with the general principle that death, while it does create a new taxpayer (namely, the decedent's estate), is not a disposition of the decedent's property for income tax purposes.[121] In our view, a two-year rule would provide a reasonable period, during a temporary and involuntary transition, to transfer or otherwise dispose of a decedent's interests in a trade or business without triggering, in many cases, a semi-automatic change in the tax character of the decedent's income and losses.

M. Limiting Disparate Results Under the Medical Insurance Taxes

We have noted in a prior report[122] that the legislative history to Section 1411 confirms, that the net investment income tax was intended by Congress to parallel the other two sets of existing medical insurance taxes. For taxable years beginning in 2012, all three taxes are

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119 A rule in the converse is not necessary. In the event that the fiduciaries of an estate do begin materially participating in a trade or business in which the decedent was not a material participant, the activity should be treated as non-passive.

120 For example, an estate is a permitted S corporation shareholder under Section 1361(b)(1)(B). Section 469 itself recognizes a form of relief for estates, in that, for two years, an estate is permitted the $25,000 passive activity allowance if the decedent actively participated in rental real estate activities.

121 Rev. Rul. 73-183.

122 *See* New York State Bar Association Tax Section, Report on the Proposed Regulations under Section 1411, Report No. 1284 (May 15, 2013) at pg. 48.

imposed at the same rate on income over a specified threshold (which is the same in all three cases). [123]

Although the statutory scheme has certain gaps, it seems clear that Congress generally intended that Section 1411 apply to the income of an individual that was not otherwise subject to the other two existing hospital taxes. We acknowledge that the recommendations we have made in this Report might leave some gaps in this area where a trust is found to materially participate. Appropriate efforts (which may be statutory) should be made to limit the circumstances under which the income would escape one of these three taxes.

[123] The Medicare hospital insurance taxes imposed on wages, known as FICA H1 taxes, consist of a 1.45% tax on all wages payable by the employer, a 1.45% tax on all wages received by the employee, and 0.9% tax payable by the employee on wages above the threshold amount. Consequently, all wages above the threshold amount are subject to a combined 3.8% tax. Sections 3111(b), 3101(b)(1).

The Medicare hospital insurance tax imposed on net earnings from self-employment (or NESE), referred to as the NESE H1 tax, consists of a 2.9% tax on all NESE and a 0.9% tax on NESE in excess of the threshold amount. All NESE above the threshold amount therefore are subject to a 3.8% tax. Section 1401.

Similarly, the Medicare contribution tax on "net investment income," titled the "Medicare contribution tax on unearned income," consists of a 3.8% tax on net investment income.