

Material Participation by Trusts and Estates

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In this article, Williamson analyzes current law regarding the meaning of material participation under section 469 as it applies to trusts and estates and offers suggestions for proposed regulations in this area.

Whether an estate's or trust's losses are subject to the passive loss limitation rules of section 469 depends on whether the entity materially participates in the activity generating the loss. Unfortunately, for almost 30 years, the IRS has not provided regulatory guidance on the meaning of material participation in the context of estates and trusts.¹ Recently, this lack of guidance has become more acute with the enactment of section 1411, which adopts the passive activity loss rules to identify whether income from a trade or business is subject to the 3.8 percent tax on net investment income.² Finally recognizing the need for guidance, Treasury's 2014-2015 priority guidance plan for the first time lists "guidance regarding material participation by trusts and estates for purposes of section 469."

This article summarizes the current state of the law, noting the conflict between existing judicial and administrative interpretations of when a trust or estate is materially participating in an activity. In response to the IRS's request for comments on how

the term "material participation" should be applied to estates and trusts under section 469 and ultimately section 1411,³ this article urges that the hours of participation of the fiduciary, including the hours of the fiduciary's agents and employees, be counted as participation in measuring whether the estate or trust is materially participating in an activity.

Sections 469 and 1411

Section 469, enacted in 1986,⁴ allows for the deduction of specified passive losses only against passive income. Whether income or loss from an activity is passive is based on whether the taxpayer materially participates in its operations. For this purpose, a taxpayer is materially participating in an activity when the taxpayer's involvement in its operations is "regular, continuous and substantial."⁵ Losses from a passive activity are deductible against neither active income (salary and net earnings from self-employment) nor investment income (dividends, interest, and capital gain) until the activity's complete disposition by the taxpayer.⁶ Generally, all rental activities are considered passive.⁷

Section 1411, enacted in 2010,⁸ provides for a 3.8 percent tax on a taxpayer's NII when an individual's modified adjusted gross income exceeds specified thresholds beginning in 2013.⁹ For a trust or estate, the threshold is reached when the entity's taxable income reaches the highest marginal rate (39.6 percent) — \$12,300 in 2015.¹⁰ For this purpose,

³The preamble to the section 1411 regulations calls for regulations under section 469 to identify whether income received by an estate or trust from a trade or business is passive and therefore subject to the NII tax. T.D. 9644, 78 F.R. 72402 (2013).

⁴Tax Reform Act of 1986, P.L. 99-514, section 501.

⁵Section 469(h)(1).

⁶Section 469(d).

⁷Section 469(c)(2).

⁸Health Care and Education Reconciliation Act of 2010, P.L. 111-152, section 1402.

⁹\$250,000 for individuals filing a joint return, \$125,000 for a married filing separately return, and \$200,000 in all other cases. Section 1411(b). Modified AGI means AGI increased by the foreign earned income exclusion of section 911. Section 1411(d).

¹⁰Section 1411(a)(2). The tax is 3.8 percent of the lesser of the undistributed NII for the year or the excess of AGI over the dollar amount at which the highest tax bracket in section 1(e) begins for the tax year.

¹Reg. section 1.469-5T(g) reserves on rules on material participation of estates and trusts.

²Section 1411(c)(1).

NII includes not only interest, dividends, annuities, royalties, and rents but also income from any trade or business that is a passive activity under section 469.¹¹

Grantor Trusts

While neither the code nor regulations address what constitutes material participation by a trust or estate under section 469, for a grantor trust under sections 671 through 678, the legislative history of section 469 makes clear that the trust is disregarded and material participation is determined at the grantor level, applying the general regulatory tests applicable to individuals to measure participation in an activity.¹² The regulations provide that an individual materially participates in an activity in which he owns an interest when the work is done if:

1. The individual participates in the activity for more than 500 hours during the year.¹³
2. The individual's participation for the tax year constitutes substantially all of the participation in that activity of all individuals (including individuals who are not owners of interests in the activity) for that year.¹⁴
3. The individual participates in the activity for more than 100 hours during the tax year, and his participation in the activity for that 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 the year.¹⁵
4. The activity is a significant participation activity — that is, an activity in which the individual participates more than 100 hours¹⁶ — and his aggregate participation in all significant participation activities during the year exceeds 500 hours.¹⁷
5. The individual materially participated in the activity for any five tax years (whether or not consecutive) during the 10 tax years that immediately precede the tax year.¹⁸
6. The activity is a personal service activity in which the individual materially participated

for any three tax years (whether or not consecutive) preceding the tax year.¹⁹ For this purpose, a personal service activity includes the performance of services in health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.²⁰

7. Based on all the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the year,²¹ provided he participates for more than 100 hours during the year in that activity.²² For purposes of this facts and circumstances test, participation standards under the self-employment tax rules of section 1402 and the rules of section 2032A for valuing some farms under the estate tax are disregarded.²³ Also, management activities undertaken by the individual count only when he is the only person who performs management services for compensation and no other individual performs more hours managing the activity.²⁴

If the individual holds only a limited partner interest in an activity, only numbers 1, 5, and 6 above may be used to establish material participation.²⁵

An individual's participation may be counted in the above tests without regard to the capacity in which he does the work, as long as he owns an interest in the business.²⁶ However, work performed by an individual that is not customarily done by an owner of an activity and a principal purpose of which is to avoid the passive loss limitation rules is not treated as participation.²⁷ Also, involvement by an individual in his capacity as an investor in the business is not counted as participation unless he is also directly involved in the day-to-day management or operations of the business.²⁸ Thus, the individual's efforts in analyzing financial reports or preparing studies examining or evaluating the business activity does not count unless the effort is part of his daily management responsibilities.²⁹

¹¹Section 1411(c)(1)(A)(ii) and (c)(2)(A).

¹²Senate Finance Committee, "Tax Reform Act of 1986," S. Rep. No. 99-313, at 735, n.21. See also reg. section 1.1411-3(b)(1)(v) stating that a grantor trust is not subject to section 1411 and the trust's income and deductions are taken into account in determining the grantor's NII.

¹³Reg. section 1.469-5T(a)(1).

¹⁴Reg. section 1.469-5T(a)(2).

¹⁵Reg. section 1.469-5T(a)(3).

¹⁶Reg. section 1.469-5T(c)(2).

¹⁷Reg. section 1.469-5T(a)(4) and -5T(c)(1).

¹⁸Reg. section 1.469-5T(a)(5).

¹⁹Reg. section 1.469-5T(a)(6).

²⁰Reg. section 1.469-5T(d).

²¹Reg. section 1.469-5T(a)(7).

²²Reg. section 1.469-5T(b)(2)(iii).

²³Reg. section 1.469-5T(b)(2)(i).

²⁴Reg. section 1.469-5T(b)(2)(ii).

²⁵Reg. section 1.469-5T(e)(2).

²⁶Reg. section 1.469-5T(f)(1).

²⁷Reg. section 1.469-5T(f)(2)(i).

²⁸Reg. section 1.469-5T(f)(2)(ii)(A).

²⁹Reg. section 1.469-5T(f)(2)(ii)(B).

IRS Interpretations

In applying the above tests, the IRS has consistently ruled that for a non-grantor trust to materially participate in an activity, the trustee must be personally involved in the activity's operations on a regular, continuous, and substantial basis. The IRS bases its position on the legislative history of section 469, which states:

Special rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating.³⁰

The code defines a fiduciary as a "guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person."³¹ The term includes "persons who occupy positions of peculiar confidence toward others" and those who hold in a trust or an estate duties to others with a beneficial interest in the entity's property. These powers may be the right to receive and control income of another, and the power holder may be a committee or guardian of the property of incompetent persons or other beneficiaries.³²

In contrast, an agent is not a fiduciary. Thus, an "agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary."³³ And, in fact, the legislative history to section 469 states:

The fact that a taxpayer utilizes employees or contract services to perform daily functions in running the business does not prevent such taxpayer from qualifying as materially participating. However, the activities of agents are not attributed to the taxpayer, and the taxpayer must still personally perform sufficient services to establish material participation.³⁴

Thus, participation of an individual's employees or independent contractors is not attributed to the employer.

Applying these definitions, the IRS's audit technique guide instructs its agents to measure fiduciary material participation as follows:

If a business activity is owned by a trust, the examiner will need to determine if the material participation standard is met in order for losses to be fully deductible. Business may be conducted via Schedule C or form partnership, S Corporation or LLCs.

Section 469(h) requires regular, continuous, and substantial participation in the operations of the business to meet material participation and for losses to be fully deductible. There is no guidance in the regulations at this time for material participation of trusts and estates.

As an administrative proxy, we look to the seven tests in Reg. section 1.469-5T(a) for material participation, and generally will not raise an issue if the trustee meets one of the tests. However, as a technical matter, the tests apply to individuals, not to a trust or trustee. Thus, as a legal matter, the trustee must prove he works on a regular basis in operations, on a continuous basis, and on a substantial basis in operations, i.e., rise to the requirements of IRC section 469(h).³⁵

Thus, in TAM 200733023, relying on the Senate Finance Committee report, the IRS concluded that the sole means for a trust to establish material participation in an activity was for its fiduciary to be personally involved in the operations of the business. The memorandum reasoned that because a business generally has employees or other agents, attributing their participation to the fiduciary would invariably result in the trust materially participating in any activity. The memorandum also concludes that some special trustees with responsibility for the trust's business activities but lacking power to bind the trust to any course of action or otherwise control trust property were not fiduciaries and that their participation therefore did not count in meeting the hours tests for material participation in the regulations.

In LTR 201029014, the IRS was surprisingly generous in finding a trustee to be acting "in his capacity as such" regarding his involvement in a business. The trust was a partner in a partnership that owned all the stock of a corporation that in turn owned a second corporation. Despite the "in such capacity" phrase in the legislative history, the ruling concluded that the trustee's participation in the second corporation constituted material participation by the trust even though that involvement was

³⁰S. Rep. No. 99-313, at 735 (1986).

³¹Section 7701(a)(6).

³²Reg. section 301.7701-6(b)(1).

³³Reg. section 301.7701-6(b)(2).

³⁴S. Rep. No. 99-313, at 735 (1986).

³⁵IRS, "Passive Activity Loss ATG," at 6-7 (Dec. 2004).

in a capacity other than as a trustee, that is, as an officer or other employee of the corporation.

In an apparent effort to satisfy the “in such capacity” phrase in the Finance Committee report, the trust in TAM 201317010 named a special trustee who was actively involved in the trade or business of an S corporation owned by the trust. The special trustee, who was also president of a qualified subchapter S subsidiary (QSub) of the S corporation, had the power to sell or vote the S corporation stock. Because the special trustee’s powers were limited and his activity as president of the QSub was not the equivalent of being a fiduciary of the trust, the IRS refused to find that his involvement in the S corporation established material participation by the trust in the S corporation. Instead, the work of the special trustee and president was as an employee of the company and not in the role of a fiduciary. Consequently, the ruling concluded that the special trustee’s participation did not cause the trust to materially participate in the trade or business of the S corporation.

This result, however, is inconsistent with the treatment of individuals when their participation as employees in a trade or business is counted as material participation. In general, any work done by an individual in an activity in which he owns an interest when the work is done (without regard to the capacity in which the individual does the work) is treated as participation of the individual in the activity.³⁶ Nevertheless, perhaps because the special trustee did not own an interest in the trust or its business, the IRS refused to consider the trustee’s participation when it was not performed in a fiduciary capacity.

Judicial Authorities

These administrative interpretations that restrict material participation by an estate or trust only to work personally performed by the fiduciary and solely in the fiduciary’s capacity as such conflict with the two court decisions that have addressed the issue: *Carter Trust v. United States*³⁷ and *Aragona Trust v. Commissioner*.³⁸ In *Carter Trust*, the U.S. District Court for the Northern District of Texas concluded that material participation should be determined by reference to all persons who conducted business on behalf of a trust, including employees hired by the trustee. In the case, a testamentary trust owned a 15,000-acre cattle ranch and employed a full-time ranch manager as well as other full- and part-time employees to operate the business.

³⁶Reg. section 1.469-5(f)(1).

³⁷256 F. Supp.2d 536 (N.D. Tex. 2003).

³⁸142 T.C. 165 (2014).

Relying on the legislative history of section 469, the IRS asserted that material participation should be determined based solely on the activities of the trustee. Accordingly, counting only the trustee’s participation in the ranching activities, the IRS argued the trust did not materially participate in the ranching activity.

Noting the absence of regulations under section 469 regarding what constitutes material participation by a trust, the court held that the statutory language of section 469 — rather than its legislative history — should determine material participation. Under section 469, the material participation test is applied to the “taxpayer,” and because section 469(a)(2)(A) defines trusts as taxpayers, the court concluded that the material participation standard applies to the trust, not to the trustee. Thus, the court stated:

It is undisputed that the Carter Trust, not [the trustee], is the taxpayer. Common sense dictates that the participation of the 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 the Carter Trust.³⁹

Because a trust may act through its employees and agents as well as through its fiduciaries, the court held that activities of the trust’s employees and agents should be included in measuring trust participation to find that the trust was involved in the ranch business in a sufficiently regular, continuous, and substantial manner to constitute material participation.

While not directly applicable to estates and trusts, the court was sympathetic to the taxpayer’s analogy to the special rules for closely held corporations and personal service corporations, which look to the participation of the corporation’s employees and shareholders to cause the corporation to materially participate in a business. For some closely held C corporations⁴⁰ and personal service

³⁹*Carter Trust*, 256 F. Supp.2d at 541.

⁴⁰Section 469(a)(2)(B). A corporation is closely held for this purpose if at any time during the last half of the tax year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals using the attribution rules of section 544(a). Sections 469(j)(1), 465(a)(1)(B), and 542(a)(2).

corporations,⁴¹ section 469(h)(4) looks to the participation of the corporation's owners and employees to determine if the corporation materially participates in an activity.⁴²

Finally, the court noted that the trustee's activities regarding the ranch operations were sufficiently regular, continuous, and substantial to constitute material participation. Therefore, even if the court had accepted the legal standard urged by the IRS in looking solely at the trustee's participation, the trust would still have been found to materially participate in the ranch based on the trustee's involvement in the ranching operation in his capacity as a fiduciary.

In the only other judicial authority addressing material participation by a trust, the Tax Court in *Aragona Trust*, decided last year, considered the actions of trustees to determine whether the trust could qualify as a real estate professional under section 469(c)(7). While the Tax Court, unlike the district court in *Carter Trust*, did not address whether the activities of the trust's non-trustee employees were participation by the trustee and ultimately the trust itself, *Aragona Trust*, like *Carter Trust*, liberally interprets the meaning of material participation in circumstances in which fiduciaries will often be involved in trust operations other than in their fiduciary capacity.

In the case, rental real estate was held in a limited liability company that was wholly owned by the trust. While there were six trustees of the trust (five siblings and an attorney), only three of them managed the LLC. Although rental real estate activities

are per se passive, section 469(c)(7) sets out an exception for real estate professionals who spend at least 750 hours during the tax year working in real estate trades or businesses if those hours exceed more than half of the hours in all the taxpayer's trades or businesses.

Asserting that the trust could not be a real estate professional, the IRS argued that a trust is incapable of performing personal services and that the trustees' actions as managers and employees of the trust's LLC could not be attributed to the trust because their actions were not performed in their capacity as trust fiduciaries.

Rejecting this argument, the court held that a trust could in fact qualify as a real estate professional, reasoning that services performed by individual trustees on behalf of the trust may be considered personal services performed by the trust. The court then turned to analyzing whether the trustees' actions as employees or other agents of the LLC could be attributed to the trust to find it was materially participating in the rental activities of the LLC. The IRS argued that the trustees' actions were undertaken as employees, not as trustees, and could not be considered in determining whether the trust materially participated. While the court found it unnecessary to consider whether the activities of the trust's non-trustee employees should be disregarded, it stated the following:

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. . . . Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. . . . Therefore their activities as employees of [the LLC] should be considered in determining whether the trust materially participated in its real estate operations.⁴³

Taking into account the trustees' activities as employees of the trust's LLC, the court concluded that the trust materially participated in the real estate business of the LLC. Because the trustees

⁴¹Section 469(a)(2)(C). A C corporation is a personal service corporation if its principal activity is the performance of personal services and those personal services are substantially performed by employee-owners. Sections 469(j)(2) and 269A(b)(1). An employee-owner is any employee who owns, on any day during the tax year, any of the outstanding stock of the personal service corporation applying the attribution rules of section 318. Section 269A(b)(2).

⁴²These corporations will be treated as materially participating in an activity if one or more shareholders holding stock representing more than 50 percent (by value) of the outstanding stock of the corporation materially participate in that activity. Section 469(h)(4)(A). Also, a closely held C corporation will be treated as materially participating in an activity if (1) during the entire 12-month period ending on the last day of the tax year, the corporation had at least one full-time employee substantially all the services of whom were in the active management of that business; (2) during the entire 12-month period ending on the last day of the tax year, the corporation had at least three full-time, non-owner employees substantially all of the services of whom were services directly related to that business; and (3) the amount of the deductions attributable to the business that are allowable to the taxpayer solely by reason of sections 162 and 404 for the tax year exceeds 15 percent of the gross income from the business for that year. Sections 469(h)(4)(B) and 465(c)(7)(C).

⁴³*Aragona Trust*, 142 T.C. at 178-179 (citations and footnotes omitted).

remained subject to state law fiduciary duties to trust beneficiaries even when acting as employees of the LLC, the court found that the activities of the trustees as employees of the LLC should be taken into account in determining whether the trust materially participated in the LLC's trade or business.

Considerations for Regulations

Although the technical issues in *Carter Trust* and *Aragona Trust* differ, both cases stand as authority to count the participation of trustees in a non-fiduciary capacity, and in *Carter Trust*, to count the participation of employees and other agents of trustees for determining material participation by a trust or estate. The IRS in its rulings and in litigation has not accepted this position, but the courts have found that a trustee remains a fiduciary with responsibility to beneficiaries regardless of whether the services performed by the trustee are strictly performed as a fiduciary. Attempting to parse hours in various fiduciary and non-fiduciary capacities in an effort to enforce a strict "in such capacity" test is a futile exercise that would be easily manipulated and rendered unadministrable.

The purpose of the material participation standard in section 469 is to distinguish a taxpayer from a passive investor. While the legislative history of section 469 declares that the participation of agents and employees of an individual does not count as participation by the individual, the relationship and responsibilities of a fiduciary toward the beneficiaries of a trust or estate are sufficiently unique to permit employment relationships between the entity or fiduciary with third parties to be taken into account. Therefore, regulations to determine the participation of a trust or estate in an activity should take into account participation of agents and employees when the fiduciary lacks the skill or experience to fulfill his responsibilities to beneficiaries but nevertheless retains personal oversight and some involvement in the activity.

Including the participation of the fiduciary and his agents, regardless of the nature of that participation, satisfies the statutory test of regular, continuous, and substantial involvement intended by Congress to distinguish a taxpayer from a passive investor. If the ultimate test of the regulations is based on hours of participation, a trust or estate should be able to count the hours of its fiduciary and its employees or agents as long as those hours

further the trade or business of the estate or trust and are necessary, given the fiduciary's lack of skill or experience in the particular activity.

The IRS's position that hours of employees or other agents do not count was rejected by the district court in *Carter Trust*, and the Tax Court in *Aragona Trust* rejected the IRS's position that only hours of the fiduciary spent in the capacity of being a fiduciary count. The only feasible and enforceable alternative capable of administration by the IRS is to accept these decisions and issue regulations that adopt their conclusions.

Conclusion

This article has not addressed the many difficult and technical problems involved in drafting regulations to determine the meaning of material participation by a trust or estate under section 469 and in applying those regulations to the NII tax of section 1411.⁴⁴ But on the fundamental issue of whether the efforts of a trustee or executor in conducting the business of the trust or estate in a non-trustee capacity constitute participation by the trust or estate, the IRS should accept the reasoning of *Aragona Trust*. Similarly, the IRS should adopt the rationale of *Carter Trust* and permit the participation by employees or other agents of the trustee or executor in carrying on a trade or business as participation by the estate or trust itself.

The adoption of the reasoning of those court decisions will result in an administrable and practical standard that recognizes the realities fiduciaries face in fulfilling their responsibilities to beneficiaries of trusts and to heirs of estates.

⁴⁴See Donald T. Williamson, "The Impact of the Net Investment Income Tax on Trusts and Estates," 45 *Tax Adviser* 798 (2014).

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