The Estate Planner

Code Sec. 1411 Material Participation by Trusts & Estates (Part 1) —Current Status and Planning

By Lewis J. Saret

I. Introduction

This column, the first of a two-part column, concludes a series of interrelated columns dealing with the Code Sec. 1411, 3.8-percent net investment income tax (NIIT). This column deals with material participation of trusts and estates and recaps various planning suggestions that have been made to mitigate the NIIT.

II. Code Sec. 1411—Material Participation of Trusts and Estates

A. Relevance of Issue

Congress enacted the passive activity loss rules embodied in Code Sec. 469 and the regulations hereunder in 1986. Trusts and estates have had to determine whether they materially participate in activities since the enactment of Code Sec. 469 for purposes of the passive activity loss rules.

Effective January 1, 2013, Code Sec. 1411 imposes the 3.8-percent NIIT on net investment income (NII). As applied to trusts and estates, the NIIT is determined by applying a 3.8-percent tax for a tax year to the lesser of:

- the estate's or trust's undistributed net investment income (UNII); or
- the estate's or trust's adjusted gross income (AGI) above a certain threshold, which equals the dollar amount that begins the highest tax bracket for the year in question. The current threshold is approximately $11,950.[1]

Code Sec. 1411 excludes several types of income from NII, including nonpassive trade or business income (other than a business trading in financial instruments or commodities).[2]

The enactment of the NIIT, combined with the relatively low threshold at which the NIIT begins to apply to trusts and estates, has caused a resurgence in interest in the issue of what constitutes material participation in a trade or business by a trust or estate. The reason, of course, is that to the extent that the trust or estate receives income from an activity in which the trust or estate materially participates, the trust or estate avoids imposing NIIT on such income.

LEWIS J. SARET is the founder of the Law Office of Lewis J. Saret, in Washington, D.C. He concentrates his practice in the area of federal taxation, with particular emphasis on estate and business succession planning, and may be reached at *lewis.saret@gmail.com.*

Example 1. The Bennet Trust, a non-grantor trust, invests in Pemberley, a business activity, from which the Bennet Trust receives $1 million in 2014 and has no offsetting deductions. The Bennet Trust does not materially participate in Pemberley. Here, the Bennet Trust's potential NIIT liability due to income received from Pemberley equals $38,000.

Example 2. Same facts as Example 1 except that the Bennet Trust materially participates in Pemberley. Here, the NIIT does not apply to the income from Pemberley and the Bennet Trust avoids $38,000 in NIIT.

B. Relevant Legal Authority

i. Generally

Code Sec. 1411 applies the Code Sec. 469 rules to determine whether there is a passive activity.

Code Sec. 469 limits the deductibility of certain losses against other sources of income, such as salary, dividends, interest and capital gains. Congress intended that losses from activities in which the taxpayer does not materially participate (*i.e.,* passive activities) would be deductible only against the taxpayer's income from other passive activities,[3] until the disposition of the passive activity. All rental activities are deemed to be passive.[4] Congress granted the IRS authority to promulgate legislative regulations under Code Sec. 469.[5]

Code Sec. 469 applies to trusts and estates and trusts but does not provide any specific rules for its application.

Code Sec. 469(h)(1) defines material participation as an activity in which the taxpayer participates on a "regular, continuous, and substantial basis."[6]

Individuals can use one of seven tests to establish material participation to avoid passive income treatment. Specifically, these tests are as follows:

- The individual participates in the activity for more than 500 hours during the year.
- The individual's participation for the tax 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.
- The individual participates in the activity for more than 100 hours during the tax year, and such individual's participation in the activity for the tax 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.
- The activity is a "significant participation activity" and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours.
- 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.
- The activity is a "personal IRS activity" and the individual materially participated in the activity for any three tax years (whether or not consecutive) preceding the tax year.
- Based on "all of the facts and circumstances" the individual participates in the activity on a "regular, continuous, and substantial basis" during such year and the individual participates for more than 100 hours during the year in such activity.

The rules are not as clear regarding material participation by trusts or estates. Additionally, regulations addressing passive activity rules for trusts and estates have never been written.

The IRS's position is that trusts and estates are not treated as individuals for this purpose (*e.g.,* the 500-hour rule does not apply).

The IRS's position is also that the trustee must be involved directly in the operations of the business on a "regular, continuous, and substantial" basis. In this regard, the IRS points to the legislative history of Code Sec. 469, which states very simply:

> 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 if an executor or fiduciary, in his capacity as such, is so participating.[7]

For a grantor trust or a qualified subchapter S trust (QSST), for which the beneficiary is treated as the owner for income tax purposes, material participation of the grantor (or the QSST's beneficiary) is determinative.[8]

The remainder of this section will summarize the key authorities addressing this issue, including the following:

- Legislative history of Code Sec. 469, material participation requirement concerning trusts and estates
- *M.K. Carter Trust*
- TAM 200703023
- TAM 201029014
- TAM 201317010
- *Frank Aragona Trust*

Part two of this column will analyze the key authorities discussed above and provide suggestions for planners and tax preparers who must take a position re material participation by trusts and estates and tax returns.

ii. Legislative History of Code Sec. 469

The Senate Report that accompanied the 1986 Tax Reform Act, which included Code Sec. 469, indicates that an estate or trust materially participates in an activity "if an executor or fiduciary, *in his capacity as such,* is so participating. ... "[9] This distinction is important because it forms a significant part of the IRS's position regarding material participation of trusts.

iii. M.K. Carter Trust[10] *(Mattie Carter Trust case)*

1. Generally. The *Mattie Carter Trust* case was the first court case to address material participation for trusts under the passive activity rules. While important, especially because it was the sole court case addressing trust and estate material participation up until the *Frank Aragona* case, discussed below, it was limited in that it was a Federal District Court case and because the IRS has rejected its holding.

2. Facts. The Mattie K. Carter Trust (the "Carter Trust") was a testamentary trust established in 1956. The trustee, Fortson, had served in that role since 1984. As trustee, Fortson managed the Carter Trust's assets, including the Carter Ranch ("ranch"), which the Trust operated since 1956.

The ranch, which covered approximately 15,000 acres, included substantial cattle ranching operations and oil and gas interests.

At all relevant times, the Carter Trust employed a full-time ranch manager and other full- and part-time employees who performed essentially all of the activities for the ranch. For the years in question (*i.e.,* 1994 and 1995), the ranch manager was David Rohn ("Rohn"), who managed the ranch's day-to-day operations, subject to Fortson's approval.

Rohn was "charged with overall management of livestock production and the management and conservation of pasture lands, as well as the supervision and direction of the other employees of the Trust involved in the Ranch operations."

Fortson, as trustee of Carter Trust, dedicated a substantial amount of time and attention to ranch activities. In this regard, the opinion quoted the following testimony:

> 4. I was chosen to be Trustee because of my extensive business, managerial, and financial experience. My duties include reviewing and approving all financial and operating proposals for the Ranch and the Trust, budget and budgeting for the Ranch, all investment decisions for the Trust, asset acquisition and sales, supervising all employees and agents of the Trust and the Trust's service providers, reviewing all financial information, and responsibility for all banking relationships of the Trust. My duties and responsibilities as Trustee routinely require a significant percentage of my time and attention, and I maintain regular office hours during which I am consulted regarding any Trust matter that arises.
>
> 7. I have delegated certain aspects of the operation and management of the Ranch. It was necessary for the Ranch to employ someone with extensive experience in the management and operation of a large, active cattle ranch. . . . Now, the Trust employs a full-time ranch manager, who is responsible for the day-to-day operations of the Ranch, subject to my approval. ...
>
> 8. I routinely discuss management issues pertaining to the Ranch with the ranch manager. ...
>
> 12. I have also delegated oversight responsibility for the Ranch to Benjamin J. Fortson III. Mr. Fortson III is a beneficiary of the Trust and takes a very active, hands-on role in supervising the Ranch manager and general Ranch operations. He spent well in excess of 500 hours engaged in Ranch operations and management at the Ranch in both tax years 1994 and 1995.

The Carter Trust claimed deductions in 1994 and 1995, which were disallowed as passive activity losses by the IRS.

3. Legal Issue Presented. In the *Mattie Carter Trust* case, the IRS argued that the "material participation" of a trust in a trade or business, within the meaning of Code Sec. 469(h)(1), should be determined by evaluating only the activities of the trustee in his capacity as such. In contrast, Carter Trust urged that, because the trust (not the trustee) is the taxpayer, "material participation" in the ranch operations should be determined by assessing the activities of Carter Trust, through its fiduciaries, employees and agents.

4. Holding and Analysis. The court held that that the Carter Trust's material participation in the ranch operations should be determined by reference to the persons who conducted the business of the ranch on the Carter Trust's behalf, including Fortson. Applying this standard, it concluded that the collective activities of those persons with relation to the ranch operations during relevant times were regular, continuous and substantial so as to constitute material participation.

> **Note.** The court also issued an alternative basis for its holding. Specifically, it stated that Fortson'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 relevant times. In other words, it held that even applying the IRS's standard, namely that material participation is determined by looking solely at the activities of the trustee, solely in its capacity as trustee (as opposed to any other capacity in which the person operating as trustee may operate), the Carter Trust satisfied the material participation requirement.

In reaching its holding, the court noted that Code Sec. 469 says that a trust is a taxpayer,[11] and that a taxpayer is treated as materially participating in a business if its activities in pursuit of that business are regular, continuous and substantial.[12]

The court also stated that "[i]t is undisputed that Carter Trust, not Fortson, 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."

Finally, the court rejected the IRS's position that the Trust's participation in the ranch operations should be analyzed by reference solely to the Trustee's actions in his capacity as such, stating the following:

> Such position "finds no support within the plain meaning of the statute. Such a contention is arbitrary, subverts common sense, and attempts to create ambiguity where there is none. The court recognizes that IRS has not issued regulations that address a trust's participation in a business ... and that no case law bears on the issue. However, the absence of regulations and case law does not manufacture statutory ambiguity. The court has studied the snippet of legislative history IRS supplied that purports to lend insight on how Congress intended section 469 to apply to a trust's participation in a business. Nevertheless, the court only resorts to legislative history where the statutory language is unclear."

5. Takeaways. The *Mattie Carter* case generally stands for the proposition that material participation is determined by reference to all persons who conduct business on behalf of a trust, regardless of whether those activities were conducted by employees or fiduciaries.

The *Carter* opinion's impact is limited to some extent by the fact that the decision is that of a federal district court. It has also been limited by the fact that the IRS has consistently rejected the analysis of the *Carter* opinion.

iv. TAM 200733023

1. Facts. The Trust in TAM 200733023 was a testamentary trust, which acquired an LLC interest. The LLC engaged in a business activity.

The Will that created the Trust provided for the appointment of a special trustee "as to part or all of the trust property." The Will also stated that, except as specifically limited by the appointing instrument, the special trustee "shall have all of the rights, titles, powers, duties, discretions, and immunities of the trustees. ..."

The Trustees contracted with Special Trustees to perform several tasks related to the business. The contract entered into between the Trust and Special Trustees explicitly stated that Special Trustees were being appointed as special trustees pursuant to the Will and that their involvement in trust business was intended to satisfy the material participation standard of Code Sec. 469(h)(1).

The contract also provided that Special Trustees "will not possess the capacity to legally bind or commit the Trust to any transaction or activity" and that "[the Trust] acknowledges that it retains all decision making responsibilities related to [the Trust's] financial, tax, or business matters."

Time logs submitted by the Trust indicate that Special Trustees spent most of their work hours reviewing operating budgets, analyzing a tax dispute that arose among the partners, and preparing and analyzing other financial documents. The logs evidence repeated contacts with Trustees relating to these issues. In addition, Special Trustees appear to have spent a considerable number of hours negotiating the sale of the Trust's interests in the LLC to a newly-admitted partner. Consistent with the contractual provisions described above, Trust submitted that, while Trustees relied heavily upon the recommendations of Special Trustees, ultimate decision-making authority remained vested solely with Trustees.

2. Legal Issues Presented. The key issue presented in TAM 200733023 was how does a trust establish material participation for purposes of the passive activity loss limitation of Code Sec. 469?

3. Ruling and Analysis.

a. General Analysis re Material Participation. In TAM 200733023, the IRS explicitly stated that "the sole means for Trust to establish material participation ... is if its fiduciaries are involved in the operations of Business on a regular, continuous, and substantial basis."

In reaching its ruling, the IRS rejected the holding of the *Mattie Carter* case, that in determining material participation for trusts, the activities of the employees of the trust should be included in determining whether the trust's participation is regular, continuous and

substantial. Instead, the IRS reasoned that because a business will generally involve employees or agents, a contrary approach would result in trusts always being treated as materially participating in trade or business activities, thus rendering the Code Sec. 469(h)(1) requirements superfluous.

Therefore, under the analysis used in TAM 200733023, the IRS looked solely to the activities of the trustee in its capacity as such, not to the Trustee's agents or employees.

b. Special Trustee. The IRS also looked at the role of the Special Trustee as part of its analysis and concluded that the Special Trustee was not a fiduciary for material participation purposes.

In reaching its conclusion, the IRS cited to the following authorities:

- Rev. Rul. 69-300, 1969-1 CB 167 (noting that "where the bank or individual is vested with broad discretionary powers of administration and management, a fiduciary relationship exists within the meaning of Code Sec. 7701(a)(6) of the Code")
- Rev. Rul. 82-177, 1982-2 CB 365, as modified by Revenue Ruling 92-51, 1992-2 CB 102 (ruling that a fiduciary relationship does not exist for Code Sec. 7701(a)(6) purposes where a bank merely holds money for an estate and pays interest on the account, but performs no administrative duties)
- *J.H. Anderson,*[13] (court held that because bank did not have discretionary powers, the agreement created an agency relationship rather than a trust)

The IRS concluded that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. In the facts of TAM 200733023, although the Special Trustees were heavily involved in the operational and management decisions of business, they were ultimately powerless to commit the Trust to any course of action or control the Trust property without the express consent of Trustees. The IRS continued by stating that the Special Trustee's services performed were indistinguishable from those expected of other nonfiduciary business personnel, and noted that if nonfiduciaries can be classified as fiduciaries simply by attaching different labels to them, the material participation requirement as applied to trusts would be meaningless.

v. TAM 201029014

1. Facts. In TAM 201029014, the Trust was a complex trust. A was the beneficiary and a trustee of the Trust.

Among other things, the Trust held a partnership interest in B.

B wholly owned C, which wholly owned D. In other words, D was two tiers below B.

2. Legal Issues Presented. The issue presented in TAM 201029014 was whether the Trust could materially participate in D's activities if the trustee was involved in D's activities on a regular, continuous and substantial basis.

3. Ruling and Analysis. In TAM 201029014, the IRS ruled that the Trust could (*i.e.,* theoretically) materially participate in D's activities if the trustee was involved in D's activities on a regular, continuous and substantial basis. However, it did not rule whether the trustee did in fact materially participate in D's activities.

In reaching its ruling, the IRS reiterated its position that a trust may materially participate in business activities only if the trustee is involved in the business entity's operations on a regular, continuous and substantial basis.

One of the key issues in this ruling was that the business activity in question was two tiers below the entity owned by the trust. Therefore, some commentators have concluded that if the IRS's position that a trustee could only materially participate based solely on its activities in its capacity as fiduciary, then it would be difficult to have material participation present. Here, the IRS said that the trustee could, again theoretically (although that word was not used in the TAM), materially participate. Having said that, it declined to say whether the trustee did in fact materially participate in D's activities.

vi. TAM 201317010

1. Facts. In TAM 201317010, two identical trusts, Trust A and B (the "Trusts") were created on the same date. Each Trust owned an interest in Company X, which was an S corporation. Company X wholly owned Company Y, a qualified subchapter S subsidiary.

B was the sole trustee of the Trusts since their creation. A, who also owned the interests in Company X not owned by the Trusts, was designated as special trustee and served in this capacity since the creation of the trusts. Article XI of the trust agreements, which appoints A as a special trustee of the Trusts, stated that:

> [t]he Special Trustee shall control the following activities relating to Company X and Company Y common stock owned by any trust created hereunder: all decisions regarding the sale or retention of such stock and all voting of such stock.

The trust agreements did not grant any further fiduciary powers over the Trusts' assets or with respect to the operations or management of the Trusts to A as the Special Trustee.

A also served as president of Company Y and, as such, was directly involved in the day-to-day operations of its trade or business activities.

TAM 201317010 stated that A was unable to differentiate his time spent as president of Company Y, as Special Trustee of the Trusts, and as a shareholder of Company X.

B, as Trustee of Trust A and Trust B, was not involved in the operations of the relevant activities of either Company X or Company Y on a regular, continuous and substantial basis.

2. Legal Issues Presented. The IRS asserted that the Trusts did not materially participate in the relevant activities of Company X. Specifically, the IRS asserted that B's participation in the relevant activities of Company X and Company Y that counts towards meeting the material participation requirements of Code Secs. 56(b)(2)(D) and 469(h)(1) is only that which was performed in the relevant activities in B's fiduciary capacity as Trustee of Trust A and Trust B. In addition, the IRS asserted that A's participation in the relevant activities of Company X and Company Y also count towards these requirements, *but only* to the extent that A participated in those activities in *A's fiduciary capacity* as Special Trustee of Trust A and Trust B.

The IRS asserted that A's time spent serving as president of Company Y did not count towards meeting the material participation requirement because A was not the Trustee of the Trusts nor was A an employee of the Trustee. Specifically, because the trust agreements limited the powers of the Special Trustee to certain delineated acts, the Special Trustee did not possess broad or unlimited discretionary authority to bind the Trusts to any course of action without the express consent of the Trustee.

In making this assertion, the IRS rejected the taxpayer's argument that, because A was a Special Trustee, his involvement in Company Y's relevant activities should be considered for purposes of determining whether the Trusts materially participate.

The IRS also rejected the taxpayer's argument that because A's roles of Special Trustee, individual shareholder, and President of Company Y were all interrelated, it was impossible to differentiate A's time into the different capacities for which A serves and that A was, in fact, fulfilling A's obligations for these various capacities simultaneously and, therefore, A's total time spent involved in the operations of the relevant activities of Company X and Company Y should count towards meeting the material participation requirements.

3. Ruling and Analysis. In TAM 201317010, the IRS ruled that the Trusts did not materially participate in the relevant activities of Company X or Company Y.

In reaching its ruling, the IRS again rejected the holding of the *Mattie K. Carter Trust* case and instead stated that it believed that the standard annunciated in the legislative history is the proper standard to apply to trusts for material participation purposes under Code Sec. 469(h). As a result, it explicitly stated that "the sole means for Trust A and Trust B to establish material participation in the relevant activities of Company X and Company Y is *if the fiduciaries, in their capacities as fiduciaries, are involved in the operations of the relevant activities of Company X and Company Y on a regular, continuous, and substantial basis* (emphasis added)**."**

Concerning the special trustee, the IRS stated, consistent with TAM 200733023, that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust, citing to *J.H. Anderson*.[14] Here, it noted that while A was involved in the day-to-day operations and management decisions of Company X and Company Y, A's powers as Special Trustee were restricted by Article XI of the trust agreements. As Special Trustee, A lacked the power to commit the trusts to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of the Trusts and, therefore, did not count for purposes of determining whether the Trusts materially participated in the trade or business activities of Company X and Company Y under Code Sec. 469(h).

The IRS noted that A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions did not rise to the level of being "regular, continuous, and substantial" within the meaning of Code Sec. 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y.

vii. Frank Aragona Trust[15]

1. Facts. In *Aragona,* the trust owned rental real-estate properties and was involved in other real-estate business activities such as holding real estate and developing real estate. Its principal place of business was in Michigan.

In 1979, Frank Aragona formed the trust as grantor and trustee. His five children were beneficiaries, sharing equally in the trust income.

Mr. Aragona died in 1981 and was succeeded as trustee by six trustees, consisting of his five children and one independent trustee. Paul V. Aragona, one of the children, was appointed as executive trustee. Although the trustees formally delegated their powers to the executive trustee, in order to facilitate daily business operations, the trustees acted as a management board for the trust and made all major decisions regarding the trust's property.

During 2005 and 2006, the board met every few months to discuss the trust's business.

Three of the children—Paul V. Aragona, Frank S. Aragona, and Annette Aragona Moran—worked full time for Holiday Enterprises, LLC ("Holiday"), a Michigan LLC that was wholly owned by the trust and treated as a disregarded entity. Holiday managed most of the trust's rental real-estate properties. It employed several people in addition to Paul V. Aragona, Frank S. Aragona, and Annette Aragona Moran, including a controller, leasing agents, maintenance workers, accounts payable clerks and accounts receivable clerks.

In addition to receiving a trustee fee, Paul V. Aragona, Frank S. Aragona and Annette Aragona Moran each received wages from Holiday.

The trust instrument gave the independent trustee the power to distribute the principal of the trust under limited circumstances.

The trust conducted some of its rental real-estate activities directly, some through wholly owned entities, and the rest through entities in which it owned majority interests and in which Paul V. and Frank S. Aragona owned minority interests. It conducted its real-estate holding and real-estate development operations through entities in which it owned majority or minority interests and in which Paul V. and Frank S. Aragona owned minority interests.

Table 1 summarizes the activities of the six trustees on behalf of the trust during 2005 and 2006.

During the 2005 and 2006 tax years, the trust incurred losses from its rental real-estate properties, which it reported on its trust income tax returns, Forms 1041, *U.S. Income Tax Return for Estates and Trusts.* On its returns, the trust treated its rental real-estate activities, in which it engaged both directly and through its ownership interests in a number of entities, as nonpassive activities.

TABLE 1.

Name of trustee	Role	Annual trustee fee
Salvatore S. Aragona	Full-time dentist; limited involvement in trust's business	$72,000
Paul V. Aragona	Executive trustee; full-time employee of Holiday Enterprises, LLC	72,000
Anthony F. Aragona	Disabled; limited involvement in trust's business	72,000
Frank S. Aragona	Full-time employee of Holiday Enterprises, LLC	72,000
Annette Aragona Moran	Full-time employee of Holiday Enterprises, LLC	72,000
Charles E. Turnbull	Independent trustee; attorney with O'Reilly Rancilio, P.C.; limited involvement in trust's business	14,400
Total		374,400

In a deficiency notice, the IRS determined that the trust's rental real-estate activities were passive activities, which increased its passive-activity losses for 2005 and 2006 and decreased its allowable deductions.

2. Legal Analysis.

a. Legal Framework. The court first analyzed whether the Code Sec. 469(c)(7) exception applied to the trust. In doing so it first noted that a trust's passive activity losses are disallowed, citing to Code Secs. 496(a)(1), (a)(2) and (d)(1). The court also noted that a passive activity is any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate.[16]

The court then proceeded to note that under Code Sec. 469(c)(2), any rental activity is considered a passive activity, even if the taxpayer materially participates in the activity.[17] However, there is an exception to this rule under Code Sec. 469(c)(7), which provides that Code Sec. 469(c)(2) does not apply to the rental real-estate activity of taxpayers who meets the requirements of Code Sec. 469(c)(7)(B).

Code Sec. 469(c)(7)(B) consists of two tests, both of which the taxpayer must meet in order to use the Code Section 469(c)(7) exception.[18]

The first test is met if more than one-half of the "personal services" performed in trades or businesses by the taxpayer during the tax year is performed in real-property trades or businesses[19] in which the taxpayer materially participates.[20]

The second test is met if the taxpayer performs more than 750 hours of "services" during the year in real-property trades or businesses in which the taxpayer materially participates.[21]

Code Sec. 469(c)(7)(D)(i) provides that in the case of a closely held C corporation, such a corporation satisfies the Code Sec. 469(c)(7)(B) requirements if more than 50 percent of the gross receipts of that corporation for that tax year are derived from real property trades or businesses in which the corporation materially participates. Therefore, the determination of whether a closely held C corporation meets the requirements of Code Sec. 469(c)(7)(B) does not involve the one-half-of-personal-services test and the 750-hour test.

The Court noted that the Code Sec. 469(c)(7)(B) exception can only be met by taxpayers who materially participate in real-property trades or businesses because the applicable tests all presuppose that the taxpayer materially participates in real-property trades or businesses.[22]

Under Treasury regulations, to be a "qualifying taxpayer" a taxpayer must own at least one interest in rental real estate and satisfy the requirements of Code Sec. 469(c)(7)(B).[23] In this regard, the court called attention to two aspects of the regulation. First, Reg. §1.469-9(b)(4), provides, in part, that "[p]ersonal services means any work performed by an individual in connection with a trade or business." Second, Reg. §1.469-9(c)(2) provides that "[a] closely held C corporation meets the requirements of paragraph (c)(1) of this section by satisfying the requirements of section 469(c)(7)(D)(i)."

b. Can a Trust Qualify for Code Sec. 469(c)(7) Exception? For the Code Sec. 469(c)(7) exception to apply, there must be "personal services performed by the taxpayer."[24] In *Aragona,* because "[p]ersonal services" are defined by regulation as "work performed by an individual in connection with a trade or business," the IRS contended that a trust cannot perform personal services and as a result a trust cannot qualify for the Code Sec. 469(c)(7) exception.[25]

The court rejected this argument, stating that "[w]e conclude that a trust is capable of performing personal services and therefore can satisfy the section 469(c)(7) exception."

c. Did Trust Materially Participate in the Real Estate Trades or Businesses? The court next focused on the key issue for purposes of this article, namely, whether the trust materially participated in real-property trades or businesses. The court held that the trust did materially participate in its real property trade or businesses for the reasons discussed below.

The court started its analysis by noting that Code Sec. 469(h) provides that a taxpayer is treated as materially participating in an activity only if it is involved in the operations of the activity on a basis which is regular, continuous and substantial. It also noted that the Treasury Department had interpreted Code Sec. 469(h) in the form of regulations for individuals and certain types of corporations. However, it also noted, that Code Sec. 469 does not provide a method for determining how a trust may materially participate in an activity, and that the Treasury has never issued regulations for determining whether trusts materially participate in an activity.[26]

Next, the court noted that the IRS argued that in determining whether a trust is materially participating in an activity, only the activities of the trustees can be considered and the activities of that trust's employees must be disregarded. In support of this argument, the IRS cited the legislative history of Code Sec. 469, which states that a trust "is treated as materially participating in an activity * * * if an executor or fiduciary, in his capacity as such, is so participating."[27] The IRS also noted that the Senate committee report also stated that "the activities of * * * [employees] are not attributed to the taxpayer."[28]

The court stated that, based on the foregoing arguments, the IRS's position was that the activities of the trust's nontrustee employees and the activities of the three trustees who are employees of Holiday should be ignored for purposes of determining whether the trust materially participated in the real property trade or business activities.

Regarding the trustees, the IRS argued that the activities of these three trustees should be considered the activities of employees and not fiduciaries because (1) the trustees performed their activities as employees of Holiday, and (2) it is impossible to disaggregate the activities they performed as employees of Holiday, and the activities they performed as trustees.

It should be noted that the IRS explicitly rejected *M.K. Carter Trust,* discussed above, which held that the activities of the trust's nontrustee employees (and of the trustee) are considered in determining whether the trust materially participated in ranching activity.

The court noted that if it accepted the IRS's arguments that it should ignore the activities of the 20 or so nontrustee employees and the three trustee-employees (Paul V. Aragona, Frank S. Aragona and Annette Aragona Moran) that would leave only the relatively insignificant activities of the trustees who are not employees (Salvatore S. Aragona, a dentist; Anthony F. Aragona, who is disabled and unable to work and Charles E. Turnbull, an outside attorney who is the independent trustee).

The court then concluded that, even if the activities of the trust's nontrustee employees should be disregarded, the activities of the trustees–including their activities as employees of Holiday—should be considered in determining whether the trust materially participated in its real-estate operations. The reasons the court gave for this conclusion were as follows:

- The trustees were required by Michigan 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.[29]
- The trustees were not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust.[30] Therefore their activities as employees of Holiday should be considered in determining whether the trust materially participated in its real-estate operations.

Caution. The court explicitly did not decide whether the activities of the trust's nontrustee employees should be disregarded.

Applying the foregoing analysis to the facts of the *Aragona Trust* case, the court stated that after considering the activities of all six trustees in their roles as trustees and as employees of Holiday, it concluded that the trust materially participated in its real-estate operations. The reasons given were as follows:

- Three of the trustees participated in the trust's real-estate operations full time.
- The trust's real-estate operations were substantial.
- The trust had practically no other types of operations.
- The trustees handled practically no other businesses on behalf of the trust.

The court rejected the IRS's argument that because Paul V. Aragona and Frank S. Aragona had minority ownership interests in all of the entities through which the trust operated real-estate holding and real-estate development projects and because they had minority interests in some of the entities through which the trust operated its rental real-estate business, some of these two trustees' efforts in managing the jointly held entities were attributable to their personal portions of the businesses, not the trust's portion. Despite two of the trustees' holding ownership interests, the court concluded that the trust materially participated in the trust's real-estate operations for the following reasons:

- Frank S. and Paul V. Aragona's combined ownership interest in each entity was not a majority interest—for no entity did their combined ownership interest exceed 50 percent.
- Frank S. and Paul V. Aragona's combined ownership interest in each entity was never greater than the trust's ownership interest.
- Frank S. and Paul V. Aragona's interests as owners were generally compatible with the trust's goals—they and the trust wanted the jointly held enterprises to succeed.
- Frank S. and Paul V. Aragona were involved in managing the day-to-day operations of the trust's various real-estate businesses.

Note. Part 2 of this column will analyze the key authorities discussed above and provide suggestions for planners and tax preparers who must take a position re material participation by trusts and estates and tax returns. Among other things, Part 2 will examine the following issues:

- In light of above authorities, whose participation is relevant to determine whether a trust or estate materially participates in a trade or business?
- In light of the above authorities, what types of participation in a trade or business is considered when determining whether a trust or estate materially participates?
- How is the relevant type of participation in a trade or business measured for purposes of determining whether a trust or estate materially participates?
- How do material participation rules apply to trusts or estates with multiple fiduciaries and/or a corporate fiduciary?
- How does a trust beneficiary's material participation impact the analysis of whether a trust materially participates in a trade or business?

III. Planning Strategies for Mitigating the NIIT

Several prior columns have covered the NIIT as it applies to individuals, trusts and estates. In this final column on the NIIT, this section summarizes several strategies that can be utilized by individuals, trusts and estates to mitigate and manage exposure to the NIIT.

Recall that for individuals, Code Sec. 1411(a) imposes the NIIT on the lesser of either:

- an individual's Net Investment Income (NII), or
- the excess of Modified Adjusted Gross Income (MAGI) over the threshold amount.

And for trusts and estates, the NIIT is imposed on the lesser of either:

- undistributed Net Investment Income (UNII), or
- the excess of Adjusted Gross Income (AGI) over the threshold amount.

Thus, a key consideration when exploring planning strategies is to determine whether the NIIT would be imposed on a taxpayer's NII or excess MAGI (or UNII versus excess AGI for trusts and estates). If the NII or UNII amount will be the trigger, clients and their advisors should consider strategies that reduce or eliminate NII or UNII. If the NIIT would be imposed on excess MAGI or AGI, opportunities to reduce or defer any type of income should be explored.

A. Strategies for Reducing NII and UNII

i. Tax-Exempt Bonds

Interest generated by tax-exempted bonds, in particular municipal bonds, is not included as taxable income under the provisions of Code Sec. 1411 since the bonds are tax-exempted generally. Thus, advisors should consider rebalancing a client's portfolio to include more municipal bonds as a way to reduce NII. This strategy may be especially useful for trusts, since the income threshold for trusts ($12,150 for 2014) is significantly lower as compared to the threshold for

individuals (ex. $200,000 for a single taxpayer[31]). However, when recommending this strategy, planners should first determine whether switching from taxable to tax-exempt bonds would produce a higher after-tax return.

ii. Tax-Deferred Annuities

Placing high-income producing investments in tax-deferred annuities is another strategy that can be used to minimize NIIT exposure by removing the investment income from current calculations of NII. For clients who are currently in their higher income earning years, the opportunity to shift the income from such investments to years where earnings will be significantly lower may seem particularly attractive. However, planners should advise clients that the future distributions from the annuities would count towards NII. Consequently, planners should carefully consider how such distributions might later impact their client's NIIT exposure.

iii. Life Insurance

The use of life insurance as a strategy for reducing NII should also be considered. As with tax-deferred annuities, growth in a life insurance policy cash value is tax deferred, which makes using income-producing assets to pay premiums an attractive strategy. The flexibility of policy distributions also helps to shift income out of high earning years to years where the taxpayer might not be close to exceeding the NIIT income threshold amount. Additionally, life insurance offers three other benefits in the NIIT planning context[32]:

1. Distributions would not be included in the NII of the policyholder until they exceed the basis of the policy.
2. Loans from the policy up to the amount of basis are not included in NII.
3. The death benefit would not be included in the NII of the policy's beneficiary.[33]

When determining the effectiveness of life insurance as a planning strategy, planners should consider the costs and benefits beyond the mitigation of NIIT exposure. Such considerations include the general expenses of a life insurance policy, as well as restrictions on maturity and gain recognition that may be subject to the NIIT. If these accumulated costs outweigh the benefits gained from this strategy, then utilizing life insurance might not be the best planning opportunity.

iv. Tax Shelters

1. Rental Real Estate. Although rental income is included in the calculation of NII under Code Sec. 1411, rental income may be reduced by associated expenses, such as depreciation, up to the limits imposed by the passive activity loss rules.[34]

Caution. Even though depreciation deductions from rental property do significantly reduce taxable investment income, planners should be aware that any net gain on sales of the property is subject to the NIIT. Since a material portion of this gain will result from depreciation recapture, periodic depreciation deductions serve more as a deferral of taxable income, instead of a permanent reduction in taxable income.

2. Oil and Gas Investments. Investments in oil and gas partnerships also help to reduce NII. Intangible drilling and developments costs from the investment are 100 percent deductible and can be used to reduce NIIT liability.[35] Furthermore, the taxpayer may be allowed a depletion allowance and depreciation deductions which will offset income generated from the investment itself.[36] However, oil and gas investments come with a high degree of risk, which make them among the least attractive planning strategies, even if the benefits could be highly rewarding.

3. Real Estate Investment Trusts. Trusts that are not classified as "trusts" for federal income tax purposes, such as Real Estate Investment Trusts (REITs), are not subject to the NIIT. Consequently, any dividend income generated by investments in REITs is not includable in calculations for NIIT liability.[37] This makes investing in REITs a good planning opportunity for reducing NII.

v. Qualified Retirement Plans

Increasing investments in any of the qualified retirement plans listed in Code Sec. 1411(c)(5) that are excluded from the calculation of NII is another great opportunity to reduce NII. Qualified retirement plans include qualified pension plans, qualified annuity plans, traditional IRAs and Roth IRAs. Although income from qualified retirement plans is not included in NII, it is still included in the calculations of MAGI. Therefore, too great of an increase in income from qualified retirement plans may actually result in surpassing the taxpayer's threshold amount and lead to an increased NIIT liability.

vi. Converting Passive Activity Income

Another method for reducing NII is to reduce passive activity income and convert it into salary. However, as explained earlier in this column, the requirements for "material participation" by a trust are still unclear. That being said, successfully converting passive income to salary could substantially decrease NII and UNII. Note that although income converted from passive activity is not included in NII and UNII, it will still be included in AGI. Therefore converting may or may not affect the taxpayer's amount of taxable income (especially for trusts

and estates), depending on how much MAGI and NII the taxpayer had relative to the threshold.

vii. Capital Loss Harvesting

Planners should discuss with clients how year-end loss harvesting of business or capital losses might be an effective and appropriate strategy to offset capital gains on other assets in order to reduce NII.

viii. State Income Tax Deduction

Another strategy for reducing NII is to remember to allocate allowable deductions against such income when applicable. The Code Sec. 1411 Final Regulations list several deductions that when properly allocated may be allowed against NII, one of which is state income taxes.[38] The Final Regulations provide that taxpayers may use any reasonable method to determine what portion of the deduction for state income taxes is properly allocable to NII.[39]

ix. Trust and Estate Specific Strategies

1. Discretionary Distributions.[40] Since the NIIT only applies to undistributed NII for trusts and estates, a planning opportunity exists to reduce UNII by making distributions to beneficiaries. Moreover, with such a low threshold for taxable income, fiduciaries of estates and trusts now have a greater impetus to distribute more of their NII to beneficiaries. However, there are numerous considerations that planners must balance when advising trustees on discretionary distributions. Some of these include the nature of the trust itself and whether distributions might be exposed to claims from a divorcing spouse or creditor. Moreover, planners should also consider whether distributions that reduce the NIIT liability for the trust might result in an increased NIIT liability for beneficiaries.

2. Fiscal Year Choice. Estates and a very small number of trusts can choose their fiscal year. Recall that estate distributions are deemed to be distributed on the last day of the estate's fiscal year.[41] Advisors should carefully consider whether such flexibility could allow for planning opportunities to mitigate NIIT exposure for the estate and/or defer deemed NII distributions to beneficiaries.

3. 65-Day Rule. Fiduciaries should be sure to take advantage of their ability to elect to use the 65-day rule. The rule provides that for the tax year the rule is elected, if within the first 65 days of such tax year of an estate or trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding tax year.[42] This election allows the fiduciary to make a more informed decision about whether or not it is advantageous to make distributions that might minimize the trust or estate's NIIT.

4. Trustee's Fees. Reg. §1.652(b)-3(b) provides that for trusts, deductible items not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must also be allocated to tax-exempt income (if any). Trustee fees are an example of such items.[43] Consequently, trustees can use the allocation of trustee fees as an opportunity to increase the amount of NII deemed distributed while concurrently reducing the trust's NIIT exposure.[44]

B. Strategies for Reducing MAGI and AGI

i. Roth IRA Conversions

Unlike other qualified retirement plans, Roth IRAs have no minimum required distributions, and their withdrawals are tax-free. These qualities make Roth conversions an effective strategy for reducing a taxpayer's AGI/MAGI over the long term. However, Roth IRA conversion income is considered taxable income and thus increases MAGI. Therefore, when suggesting Roth conversions as a planning strategy, planners should consider the cost and benefits of a Roth conversion including the following:

- The current tax rate
- Future tax rates
- The availability of funds to pay income tax on the conversion
- The client's time horizon[45]

This strategy might be most effective for clients who expect their income to exceed threshold amounts later in retirement due to Social Security benefits and required distributions from other qualified plans.

ii. Charitable Giving

Charitable planning is useful tool for reducing MAGI, especially the following three methods: (1) gifts to charities, (2) charitable remainder trusts (CRTs), and (3) charitable lead trusts (CLTs).

1. Direct Gifts to Charities. Gifting directly to a charity may cause an immediate charitable income tax deduction, resulting in a reduction in the donor's MAGI.

2. Charitable Remainder Trusts. CRTs allocate a portion of net income as interest income received by the beneficiaries and then release the remaining portion to a charity. This also creates an immediate charitable income tax deduction on the portion released, which can be used to offset NII. CRTs are particularly significant as a planning strategy since they are tax-exempt entities. This means the trust has the option to sell contributing assets tax-free and reinvest the profit elsewhere. The trust's income is spread out over annual payments throughout the trust

term, helping to keep the beneficiary's MAGI below the threshold. However, beneficiaries may still be subject to NIIT when they receive distributions.

3. Nongrantor Charitable Lead Trusts. CLTs behave like CRTs in reverse in that instead of a certain amount of income initially allocated to the trustee, a portion is allocated to a charity, with the remainder passing to noncharitable beneficiaries at the trust's termination. The CLT receives a deduction for each annual distribution to the charitable beneficiary, some of which can be allocated to its NII. In essence, the CLT offsets NII against charitable deductions, so that such investment income is no longer taxable to the donor. This strategy is typically only effective for high net worth clients who can afford (and desire) to make generous contributions to charities.

iii. Installment Sales

Installment sales offer another planning opportunity for reducing a taxpayer's MAGI. In an installment sale, the payment for the asset is spread out over a period of years rather than received as a lump sum. This in turn stretches capital gains and taxable MAGI across multiple years, allowing taxpayers to more easily remain below the NIIT threshold amount.

iv. Above-the-Line Deductions and Exclusions

One of the easiest ways to decrease taxable income is to increase "above-the-line" deductions that will reduce AGI and MAGI. Common above-the-line deductions and exclusions include the following:

- Contributions to qualified retirement plans and IRAs
- IRA deductions
- Health Savings Account (HSA) and Flexible Spending Account (FSA) deductions
- The deductible portion of the self-employment tax
- Student loan interest deduction
- Moving expenses
- Deferred compensation[46]

IV. Conclusion

While regulations for the NIIT have been forthcoming, as this column demonstrates, there are still several areas that require guidance. Moving forward, it is important for both planners and clients to keep in mind that the NIIT is still fairly new, and consequently, effective planning strategies for mitigating the tax are still developing.

ENDNOTES

1 Code Sec. 1411(a)(2).
2 Code Sec. 1411(c)(1)–(2).
3 Code Sec. 469(d).
4 Code Sec. 469(c)(2). However, Congress later provided an exception for certain real estate professionals in Code Sec. 469(c)(7).
5 Code Sec. 469(l)(1).
6 Code Sec. 469(h) provides, in its entirety, as follows:

> For purposes of this section—
>
> (1) In general
>
> 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—
>
> (A) regular,
>
> (B) continuous, and
>
> (C) substantial.
>
> (2) Interests in limited partnerships
>
> Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.
>
> (3) Treatment of certain retired individuals and surviving spouses
>
> A taxpayer shall be treated as materially participating in any farming activity for a taxable year if paragraph (4) or (5) of section 2032A (b) would cause the requirements of section 2032A (b)(1)(C)(ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year.
>
> (4) Certain closely held C corporations and personal service corporations
>
> A closely held C corporation or personal service corporation shall be treated as materially participating in an activity only if—
>
> (A) 1 or more shareholders holding stock representing more than 50 percent (by value) of the outstanding stock of such corporation materially participate in such activity, or
>
> (B) in the case of a closely held C corporation (other than a personal service corporation), the requirements of section 465 (c)(7)(C) (without regard to clause (iv)) are met with respect to such activity.
>
> (5) Participation by spouse
>
> In determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer shall be taken into account.

7 S. Rep. No. 99-313, at 735.
8 *See* General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, at 242, n.33.
9 S. Rep. No. 313, 99th Cong., 2d Sess. 735 & n. 287, *reprinted at* 1986-3 CB 735 (emphasis added).
10 *M.K. Carter Trust,* ND-TX, 2003-1 USTC ¶50,418, 256 FSupp2d 536.
11 Code Sec. 469(a)(2)(A).
12 Code Sec. 469(h)(1).
13 *J.H. Anderson,* CA-6, 42-2 USTC ¶9786, 132 F2d 98.
14 *Id.*
15 *Frank Aragona Trust*, 142 TC 9, Dec. 59,859 (2014).
16 Code Sec. 469(c)(1).
17 Code Sec. 469(c)(4).
18 Regulatory guidance regarding the Code Sec. 469(c)(7) exception is found in Reg. §1.469-9.
19 Code Sec. 469(c)(7)(C) defines the term "real property trade or business" as any real-property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.
20 Code Sec. 469(c)(7)(B)(i).
21 Code Sec. 469(c)(7)(B)(ii).
22 Code Sec. 469(c)(7)(B)(i) and (ii); *see also* Code Sec. 469(c)(7)(D), Reg. §1.469-9(c)(3).
23 Reg. §1.469-9.
24 Code Sec. 469(c)(7)(B)(i).
25 *See* Reg. §1.469-9(b)(4).
26 *See* Reg. §1.469-5T(g), Temporary Income Tax Regs., 53 FR 5727 (Feb. 25, 1988) (reserving a place for a regulation to be titled "Material participation of trusts and estates").
27 S. Rep. No. 99-313, at 735 (1986), 1986-3 CB (Vol. 3) 1, 735.

[28] The Senate committee report stated: "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 such agents are not attributed to the taxpayer, and the taxpayer must still personally perform sufficient services to establish material participation."

[29] Mich. Comp. Laws §700.7302 (2001) (before [*26] amendment by 2009 Mich. Pub. Acts No. 46); *see also Butterfield Est.,* 418 Mich 241, 341 NW2d 453, 459 (Mich 1983) (construing Mich. Comp. Laws §700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws §700.7302).

[30] *Cf. Butterfield Est.,* 341 NW2d at 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 [*i.e.,* duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy.")

[31] Code Sec. 1411(b).

[32] These benefits are only for non-MEC policies.

[33] Steven Lamb & Brian Walsh, *Planning Strategies for the Medicare Surtax*, Nov. 19, 2013.

[34] Code Sec. 469.

[35] Code Secs. 263(c)and 469(c)(3).

[36] Code Sec. 611.

[37] *Planning Considerations for the 3.8% Medicare surtax*, Shepard Schwartz & Harris LLP, Spring 2014.

[38] Regs. §1.1411-4(f)(3)(iii).

[39] Regs. §1.1411-4(g). For a discussion on possible reasonable methods *see* John Goldsbury, The 3.8% Surtax on Trusts and Estates.

[40] For an in-depth discussion on ways to minimize NII through discretionary distributions *see generally* John Goldsbury, The 3.8% Surtax on Trusts and Estates, *supra.*

[41] Code Sec. 662(c).

[42] Code Sec. 663(b).

[43] Reg. §1.652(b)-3(c).

[44] For examples on how trustee fee allocations can affect NII *see* John Goldsbury, The 3.8% Surtax on Trusts and Estates, at 12-30.

[45] Steven Lamb & Brian Walsh, *Planning Strategies for the Medicare Surtax*, Nov. 19, 2013.

[46] Steven Lamb & Brian Walsh, *Planning Strategies for the Medicare Surtax*, Nov. 19, 2013; Shepard Schwartz & Harris LLP, *Planning Considerations for the 3.8% Medicare Surtax,* Spring 2014.