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Material Participation by Trusts: Questions Remain After *Frank Aragona Trust*

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Nongrantor trusts that own and operate real estate rental activities were given a boost by the Tax Court, which overrode IRS opposition and held that the actions of the trustees could be taken into account for purposes of determining material participation under the passive loss rules. The new NII tax also could be affected by the court's decision.

The Tax Court's recent decision in *Frank Aragona Trust*, 142 TC No 9, Tax Ct Rep Dec (RIA) 142.9, 2014 WL 1257607, holds that a trust can avoid having its rental activities treated as passive activities if it satisfies the exception for real estate professionals under Section 469(c)(7). The decision represents a significant taxpayer victory for at least two reasons.

First, the court rejected the Service's position that, as a matter of law, trusts could never qualify for the exception. If the IRS had prevailed, all rental activities of trusts[1] would have been treated as per se passive activities.

Second, the Tax Court held that activities of trustees who were also employees or shareholders in companies through which the trust conducted its real estate trade or business activities can be considered in determining whether the trust materially participated in such activities. The IRS had argued that only the activities of trustees in their capacity as trustees could be considered. This holding is very important to trusts that conduct activities through entities, such as LLCs or corporations, because in many instances one or more of the trustees will be employees, officers, managers, or shareholders in such entities. In most cases, it would not be possible to disaggregate the activities the person performs in each of these separate roles.

As will be discussed in more detail below, the court's decision could have been clearer with respect to some of these points. In addition, the opinion leaves several issues concerning material participation by trusts under the passive activity rules unanswered. Nevertheless, the court is to be commended for the reasonable and practical approach it adopted with respect to these issues.

PASSIVE LOSS RULES AND NONGRANTOR TRUSTS

Section 469(a) disallows the use of passive activity losses and passive activity credits for any tax year to any individual, estate, trust, closely held C corporation, or personal service corporation.[2] Section 469 generally operates to prohibit the use of passive activity losses to offset active business and portfolio income.[3]

A "passive activity loss" is defined as the amount, if any, by which a taxpayer's aggregate losses from all passive activities for a tax year exceed the taxpayer's aggregate income from all passive activities for such year.[4] In general, a "passive activity" is any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate.[5]

Passive activity losses disallowed under these rules are carried forward and treated as a deduction allocable to such activity in the next tax year.[6] If a taxpayer disposes of its entire interest in a passive activity during a tax year in a fully taxable transaction other than to a related party, any net loss remaining (after offsetting any net gain or income for such tax year from all of the taxpayer's other passive activities) is treated as a loss from a nonpassive activity; thus, the use of the loss is no longer limited by the passive activity loss rules.[7]

Section 469(h)(1) provides that a taxpayer "materially participates" in an activity only if the taxpayer is involved in the operations of the activity on a basis that is regular, continuous, and substantial. For an individual, this qualitative standard has largely been replaced by quantitative tests set forth in the Regulations.[8]

Treasury and the IRS have not promulgated Regulations addressing material participation by trusts and estates.[9] Until

Regulations are promulgated, there is no statutory or regulatory guidance addressing how a trust may establish material participation, other than the regular, continuous, and substantial language of Section 469(h)(1).

The discussion of material participation by trusts in the legislative history of Section 469 is extremely limited. The Senate Report states that a trust materially participates in a trade or business if "an executor or fiduciary, in his capacity as such, is so participating."[10] The TRA '86 Blue Book states that it is unlikely a trust will be considered to materially participate in a trade or business activity."[11]

These brief statements do not appear to be entirely consistent and are difficult to reconcile. Moreover, they relate only to material participation by trusts in trade or business activities. As discussed below, rental activities (which were the type of activities at issue in *Frank Aragona Trust*) generally must satisfy more restrictive requirements than other types of trade or business activities to avoid being classified as passive activities for purposes of Section 469.

MATERIAL PARTICIPATION BY NONGRANTOR TRUSTS IN TRADE OR BUSINESS ACTIVITIES

Material participation by trusts in trade or business activities other than rental activities have previously been addressed in *Mattie K. Carter Trust*, 91 AFTR 2d 2003-1946, 256 F Supp 2d 536 (DC Tex., 2003), and by the IRS in TAM 200733023 (the "2007 TAM") and TAM 201317010 (the "2013 TAM"). Although *Mattie K. Carter Trust* and the TAMs do not specifically address material participation by trusts in rental activities, they provide important background on standards applicable to the determination of material participation by trusts and therefore are briefly discussed below.

Mattie K. Carter Trust

In *Mattie K. Carter Trust*, the court held that a trust's material participation in ranching operations should be determined by reference to the collective activities of the persons who conducted the business of the ranch on the trust's behalf, including the activities of employees who were not trustees. The court explicitly rejected the Service's position that material participation of a trust should be determined based solely on the activities of the trustees in their capacity as such.

The trust at issue (the "Carter Trust") was a complex testamentary trust established by will in 1956. Benjamin J. Fortson, Jr., as the trustee, was responsible for managing the assets of the Carter Trust, which included a 15,000-acre ranch used for substantial cattle ranching operations. Mr. Fortson was also heavily involved in the ranching business, reviewing all financial and operating proposals, making investment decisions (which included asset acquisitions and sales, handling banking operations, and performing various other duties). According to Mr. Fortson's testimony, his duties and responsibilities as trustee routinely required a significant amount of his time and he maintained regular office hours during which he was consulted regarding matters concerning the Carter Trust.

During the years at issue in the case, David Rohn was the ranch manager and he was responsible for managing the ranch's day-to-day operations, subject to Mr. Fortson's approval. Mr. Rohn was responsible for overall management of livestock production and pasture lands as well as the supervision and direction of the other employees of the Carter Trust involved in ranch operations.

Mr. Fortson delegated oversight responsibility for the ranch and supervision of Mr. Rohn to his son, Benjamin J. Fortson III. Benjamin J. Fortson III was a beneficiary of the Carter Trust. According to Mr. Fortson, his son spent more than 500 hours engaged in ranch operations and management of the ranch during the tax years at issue in the case. The Carter Trust recognized substantial losses for 1994 and 1995, which the IRS disallowed under the passive activity loss rules.

The Service argued that material participation of a trust in a trade or business should be determined by evaluating only the activities of the trustee in his capacity as such. According to the IRS, Mr. Fortson's activities failed to satisfy the requirements for material participation. The Carter Trust argued that because the trust, rather than its trustee, was the taxpayer, material participation should be determined based on the activities of the Carter Trust's fiduciaries, employees, and agents, rather than based on the activities of the trustee alone. The Carter Trust contended that as a legal entity, it could participate in an activity only through the actions of its fiduciaries, employees, and agents, and that the collective efforts of these persons satisfied the requirements for material participation because their activities were regular, continuous, and substantial.

The court found that it was undisputed that the Carter Trust was the taxpayer and that common sense dictated that "the participation of the Carter Trust in the ranch operations should be scrutinized by reference to the trust itself." This required 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."

The court stated that the Service's position that only activities of the trustee should be taken into account had no support within the plain meaning of Section 469. The absence of Regulations or case law addressing the issue of material participation of a trust in a trade or business did not make the statute ambiguous. Because Section 469 unambiguously supported the Carter Trust's position on its face, the court refused to consider the Service's argument that the legislative history of Section 469 supported its position. The court held that the material participation of the Carter Trust in its ranch operations should be determined by reference to the persons who conducted the business of the ranch on behalf of the Carter Trust and that the collective activities of those persons satisfied the requirements for material participation.[12]

The 2007 TAM

The IRS has refused to follow M*attie K. Carter Trust* and has continued to assert that the determination of whether a trust materially participates in a trade of business is made based solely on the activities of trustees in their capacity as trustees.

In TAM 200733023, the Service considered whether the activities of a “special” trustee could be considered for purposes of material participation. The taxpayer was a testamentary trust that acquired an interest in an LLC that engaged in a trade or business. The trust asserted that its trustees provided services to the LLC that included a range of administrative and operational activities relating to the trade or business of the LLC.

The will creating the trust allowed the trustee to appoint “special trustees” with respect to part or all of the trust’s property. The trustee exercised this power by contracting with special trustees to perform a number of tasks related to the business of the LLC. Under the contracts, the special trustees had no capacity to bind the trust. The special trustees spent most of their time reviewing operating budgets, analyzing a tax dispute among the members of the LLC, and preparing and analyzing other financial documents. The special trustees also spent a significant amount of time negotiating a sale of the trust’s interest in the LLC.

The IRS distinguished the activities of “special” trustees from those of “fiduciary” trustees[13] by saying that the “special” trustees were appointed solely to perform certain contractual acts intended to satisfy the material participation standard of Section 469(h). The Service concluded that material participation with regard to an activity for a nongrantor trust is based on whether trustees who act as fiduciaries meet the material participation test. The IRS found that the special trustees were not acting as fiduciary trustees, and therefore the activities of the special trustees should be disregarded. Finding that the “fiduciary” trustees did not meet the material participation threshold, the IRS determined that the trust’s income was passive.

The 2007 TAM has been criticized on the ground that in addition to continuing to make the same arguments that were rejected in *Mattie K. Carter Trust*, the IRS provided no support for its determination that the actions of the “special” trustees should be disregarded.[14] Although the “special” trustees spent their time dealing with matters directly related to the trust, the Service discounted their involvement as not being directly related to the trust’s day-to-day operations.

The 2013 TAM

In TAM 201317010, the IRS again addressed the issue of how material participation in a trade or business activity by a trust is determined. The passive activity loss rules were not directly at issue in the 2013 TAM. Rather, the issue was whether certain research and development expenses had to be amortized over a ten-year period for alternative minimum tax purposes under Section 56(b)(2)(D). The issue of material participation by a trust arose because Section 56(a)(2)(D) cross-references the definition of material participation found in Section 469(h)(1).[15]

The facts set forth in the 2013 TAM were as follows. Trust A and Trust B were complex trusts, each of which owned an interest in Corporation X, which was an S corporation. Corporation X owned 100% of the stock of Corporation Y, which was a qualified Subchapter S subsidiary. Individual A owned the remaining interests in Corporation X and served as the president of Corporation Y. A, A's spouse, and A's grandchildren were the beneficiaries of Trust A and Trust B. B served as the trustee of both trusts. Individual C settled Trust A and Individual D settled Trust B.

Each of the trusts appointed A as a special trustee with the authority to control all decisions regarding the sale of the stock of Corporation X and Corporation Y and regarding the voting of such stock. Beyond this authority, A did not have any further fiduciary powers over the trust's assets or with respect to the operations or management of the trusts. A could not differentiate his time spent as president of Corporation Y, as special trustee, or as a shareholder of Corporation X.

The IRS again refused to follow *Mattie K. Carter Trust*. It reasserted, based on the legislative history, that only activities of trustees in their capacity as such should be considered for purposes of determining whether a trust materially participates in a trade or business activity. Despite A's involvement in the day-to-day business operations of the company, the IRS determined that he performed his functions as an officer of the company, rather than as a trustee. Further, the Service said that his powers as a special trustee were limited, based on the fact that he could not direct or control trust property. Thus, the IRS essentially disregarded A's actual involvement in the business operations. Because the activities of the other trustee, B, were not sufficient to constitute material participation, the IRS concluded that the material participation requirement was not satisfied.

As can be seen in these two TAMs, the IRS has remained adamant that material participation by a trust in a trade or business activity can be accomplished only through the material participation of a trustee. Furthermore, the trustee must be able to control the trust property and must not be restricted in power, when compared to the other trustees (i.e., the trustee cannot be a "special" trustee with more limited powers than the other trustees). Activities of a trustee in his capacity as an officer or employee of an entity owned by the trust are not counted, and it is the responsibility of the taxpayer to keep adequate records to document in which capacity he or she is acting.

MATERIAL PARTICIPATION BY NONGRANTOR TRUSTS IN RENTAL ACTIVITIES

"Rental activities," including rental real estate activities, generally are treated as per se passive activities regardless of whether the taxpayer materially participates in such activities.[16] A "rental activity" is defined as any activity in which payments are principally for the use of tangible property.[17]

In 1993, Congress enacted Section 469(c)(7) and created an important exception to the rules treating real estate rental activities as per se passive activities.[18] The determination of whether a taxpayer qualifies for the exception is made separately for each tax year. To qualify for the exception for a tax year, a taxpayer must materially participate in the real property trade or business by satisfying both of the following requirements:[19]

(1) More than one-half of the personal services performed in trades or businesses by the taxpayer during such tax year must be performed in real property trades or businesses in which the taxpayer materially participates (the "personal services requirement").[20]
(2) The taxpayer must perform more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates (the "750 hour requirement").[21]

A "real property trade or business" includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.[22] A "trade or business" is broadly defined and includes any interest in real estate, including any interest in real estate that gives rise to deductions under Section 212.[23] A taxpayer can avoid having an interest in a rental real estate activity treated as such, however, if the taxpayer groups the rental activity with a nonrental real estate trade or business activity, based on the fact that (1) the rental activity is insubstantial in relation to the business activity, or (2) each owner of the trade or business activity has the same proportionate ownership interest in the rental activity.[24]

Regulations provide that only a "qualifying taxpayer" is entitled to claim the benefit of the exception under Section 469(c)(7). A qualifying taxpayer is a taxpayer that owns at least one interest in rental real estate and that satisfies the personal services requirement and the 750 hour requirement.[25] Reg. 1.469-9(b)(4) defines "personal services" as "any work performed by an individual in connection with a trade or business."

Thus, a taxpayer who spends a significant amount of time working in real estate is likely to have all of his real estate activities classified as nonpassive activities. If the taxpayer has multiple real estate activities, he must separately satisfy the requirements for the exception under Section 469(c)(7) for each real estate activity, unless the taxpayer makes an irrevocable election (a "grouping election") to treat all interests in rental real estate as one activity.[26] Finally, it is important that the taxpayer maintain contemporaneous documentation to record his time and substantiate his involvement in the particular business activity.[27]

As discussed above, the Service contended in the TAMs that only the material participation of a trust's fiduciary trustees, acting in their capacity as trustees, could result in nonpassive trade or business income for the trust. The IRS has adopted an even more restrictive standard with respect to rental activities of trusts, stating explicitly that a trust cannot meet the special material participation test of a real estate professional in Section 469(c)(7) . In CCA 201244017, the IRS stated:

It is our position that a trust cannot meet the qualifying tests of 469(c)(7)(B) because those tests are intended to apply only to individuals. Only individuals are capable of performing "personal services" (as defined in section 1.469-9(b)(4)), and the statute specifically states that the personal services must be performed *by the taxpayer*. Section 469(c)(7)(D)(i) provides a separate "gross income" test for closely held C corporations to qualify for treatment under section 469(c)(7), but the statute otherwise does not provide any rules for trusts, estates, or personal service corporations. We believe this position is not only supported by a plain reading of the statute and regulations, but by the legislative history for section 469(c)(7) which explicitly states that this provision is intended to apply to individuals and closely held C corporations. We believe it is clear that trusts, estates, and personal service corporations do not fall within the definition of "individuals" for this purpose. (Emphasis in original.)

The Tax Court recently had an opportunity to address a nongrantor trust's material participation in rental real estate activities, and to clarify the disparate guidance provided by *Mattie K. Carter Trust*, which determined that activities by both trustees and employees can be considered for determination of a trust's material participation, and the TAMs released by the IRS, which countered that only the activities of a trustee, acting in his capacity as such, is to be considered.

Frank Aragona Trust

The Frank Aragona Trust (the Trust) owned rental real estate and was involved in other real estate holding and development activities. Its principal place of business was in Michigan. When Frank Aragona, the settlor and original trustee of the Trust, died, he was succeeded as trustee by six trustees, which included his five children who were also trust beneficiaries.

One of the children, Paul, served as the executive trustee and was responsible for the day-to-day operations of the Trust. In addition, three of the trustees worked as full-time employees for Holiday Enterprises LLC, an entity wholly owned by the Trust and which managed most of the Trust's rental real estate properties.

The Trust conducted some of its real estate activities directly. The rest of its real estate activities were conducted through various entities in which the Trust owned majority interests; the minority interests in these entities were owned by Paul Aragona and his brother, Frank. The Trust had generated losses which it treated as nonpassive and it used the losses to offset nonpassive income.

The two primary issues before the court were (1) whether a trust can qualify for the Section 469(c)(7) exception, and (2) if so, whether the Trust qualified for the exception. The Tax Court held that a trust can qualify for the Section 469(c)(7) exception and that the Trust did qualify for the exception. In rendering its opinion, the court considered the statutory language of Section 469, the Regulations issued under Section 469, and the legislative history of Section 469.

The court discussed the special rule in Section 469(c)(7) for taxpayers in a real property business, saying that the Section 469(c)(7)(B) requirements (i.e., the personal service requirement and the 750 hour requirement) can be met only by a taxpayer who materially participates in a real property trade or business, as defined in Section 469(c)(7)(C).

The IRS asserted, as it had in the 2007 TAM and the 2013 TAM, two arguments as to why the exception under Section 469(c)(7) did not apply. The Service argued that a trust cannot qualify for the exception under Section 469(c)(7). Because "personal services" are defined by the Regulations as "work performed by an individual in connection with a trade or business," the IRS contended that a trust cannot perform personal services and therefore cannot qualify for the exception under Section 469(c)(7).

The Service also argued that the legislative history of Section 469(c)(7) clearly provided that the real estate exception does not apply to trusts. The IRS cited a House Ways and Means Committee report which stated that Section 469(c)(7) "applies to individuals and closely held C corporations."[28] The report also stated that an "individual taxpayer" meets the exception "if more than half of the personal services the taxpayer performs in a trade or business are in real property trades or businesses in which he materially participates." Since only individuals and closely held C corporations were mentioned by the Committee, the IRS contended that Congress did not intend for the exception to apply to trusts.

The Tax Court rejected the Service's argument that a trust is incapable of performing "personal services." The court observed that a trust is an arrangement in which trustees manage assets for the trust's beneficiaries. If 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. Accordingly, the court concluded that a trust is capable of performing personal services and could, therefore, satisfy the Section 469(c)(7) exception.

In support of its conclusion, the court added that if Congress wanted to exclude trusts from the Section 469(c)(7) exception, it could have done so by limiting the exception to "any natural person," as it had done in other provisions of the passive activity loss rules under Section 469.[29] Instead, it used the term "taxpayer" in Section 469(c)(7), which suggested that Congress did not, in fact, intend to exclude trusts from the Section 469(c)(7) exception.

In light of its conclusion, the court stated that it was not necessary to consider the taxpayer's arguments that (1) the word "individual" in Reg. 1.469-9(b)(4) should be interpreted to include a trust or (2) that the Regulation was not applicable to trusts.

The Tax Court next rejected the Service's argument that the legislative history of Section 469(c)(7) demonstrated that trusts cannot qualify for the exception. The court said that while the Ways and Means Committee report stated that the exception applied to individuals and closely held C corporations, it did not state that the exception applied only to these two types of taxpayers. Accordingly, the legislative history did not compel the conclusion that only individuals and closely held C corporations could qualify for the exception. Similarly, while the legislative history indicated that an individual can qualify for the exception by meeting the personal services requirement and the 750 hour requirement, this did not mean that other types of taxpayers could not qualify for the exception.

The court also rejected the Service's argument that even if some trusts can qualify for the exception under Section 469(c)(7), the taxpayer did not qualify because it had not materially participated in its real estate trade or business activities. The personal services requirement and the 750 hour requirement both require that the taxpayer materially participate in the real estate trade or business activities. Thus, a taxpayer cannot satisfy either requirement unless he or she materially participates in real estate trade or business activities. The court ruled that because there was no regulatory or statutory guidance for determining material participation by trusts, it must make the determination of whether a trust materially participates in an activity based on whether it is involved in the operations of the activity on a basis that is regular, continuous, and substantial.

In reaching this conclusion, the court noted there were special rules in Section 469(h)(4) for determining whether certain types of corporations have met the material participation tests. In a footnote, the court stated that while certain trusts may be considered corporations (e.g., business or commercial trusts under Reg. 301.7701-4(b)), the IRS had not taken the position in this case that the Trust should be treated as a corporation. Therefore, the standards for material participation applicable to a closely held C corporation were not relevant.

The IRS argued that in determining whether a trust is materially participating in an activity, only the activities of the trustees could be considered and the activities of the Trust's 20 nontrustee employees had to be disregarded.[30] The Service also contended that the activities of the three trustees who were employed by Holiday Enterprises LLC should be disregarded because (1) the activities were performed as employees of Holiday Enterprises LLC and (2) it was impossible to disaggregate the activities they performed as employees from their activities as trustees.[31]

The court said 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 Enterprises LLC, should be considered in determining whether the Trust materially participated in its real estate operations. The court further reasoned that Michigan law, to which the Trust was subject, provided that "[t]rustees are not relieved of their duties of loyalty to the beneficiaries by conducting activities through a corporation wholly owned by the trust." Accordingly, the court concluded that the trustees' activities as employees of Holiday Enterprises LLC should be considered in determining whether the Trust materially participated in its real estate operations. The court found that these activities satisfied the material participation requirements. It was, therefore, unnecessary for the court to decide whether the activities of the Trust's nontrustee employees should be disregarded.[32]

Two of the trustees owned minority interests in one or more of the entities through which the Trust operated its real estate holding and real estate development projects. The IRS had further argued that these trustees' management efforts were attributable to their personal business activities rather than the Trust's business activities. The court rejected this argument based on the following considerations:

(1) The two trustees' combined ownership interest in each entity was a minority interest.
(2) The two trustees' ownership interests were never greater than the Trust's ownership interest.
(3) The two trustees' interests as owners were compatible with the Trust's interests.
(4) The two trustees were involved in the day-to-day operation of the Trust's various real estate businesses.

Thus, the court held that the activities of these two trustees should be considered for purposes of material participation even though they were also minority shareholders in entities owned by the Trust.

The court held, based on the activities of the six trustees of the Trust in their roles as trustees and as employees of Holiday Enterprises LLC that the Trust materially participated in its real estate operations. Normally, the court would have engaged in two additional analyses before concluding that the Trust's activities were not passive activities. First, it would have analyzed whether the Trust satisfied the personal services requirement and 750 hours requirement for the exception under Section 469(c)(7). Second, assuming the Trust satisfied both of these requirements and therefore qualified for the exception under Section 469(c)(7), the court would have considered whether the Trust materially participated in its rental real estate activities.[33] In *Frank Aragona Trust*, however, the IRS limited its arguments to whether trusts are barred from qualifying under Section 469(c)(7) and whether the Trust materially participated in its real property trades or businesses. Since the IRS had not challenged whether the Trust had satisfied the personal service requirement and 750 hour requirement of Section 469(c)(7)(B) or had materially participated in its rental real estate activities, the court did not have to consider these issues.

ANALYSIS

Frank Aragona Trust represents a significant victory for taxpayers, since it refutes the Service's position that a trust can never qualify for the exception under Section 469(c)(7). Had the IRS prevailed in this argument, rental real estate activities of trusts would automatically be treated as passive activities and would be subject to the limitations of the passive activity loss rules. The case also affirms that activities of trustees can be considered for purposes of material participation even if the trustee is also an employee or minority shareholder of an entity through which the trust conducts its activities.

The Tax Court's decision is also important because application of the new 3.8% net investment income (NII) tax to a trust often turns on whether the income of the trust is from a passive activity. The Health Care and Education Reconciliation Act of 2010 (P.L.111-152, 3/30/10) added Section 1411 to the Code, which imposes a tax on individuals, estates, and trusts that have net investment income above certain threshold amounts.[34] "Net investment income" includes income derived from a passive activity, as determined under Section 469.[35] The 3.8% NII tax applies to the higher of the trust's undistributed net investment income or the trust's AGI over a threshold amount (the threshold is $7,500, per Section 1(e)).[36] The interaction of Section 1411 and Section 469 has generated increased interest among taxpayers and their advisors as to the standards applicable to material participation by trusts. Taxpayers seeking to reduce their exposure to the NII tax must consider their overall tax situation.[37]

The decision in *Frank Aragona Trust* leaves a number of important questions regarding material participation by trusts unanswered. The Tax Court found that the activities of the trustees alone were sufficient to establish that the Trust materially participated in its real property trades or businesses. The court did not address the issue of whether the activities of nontrustee employees of the Trust can be considered in determining material participation. Thus, *Mattie K. Carter Trust* remains the sole authority holding that activities of nontrustee employees can be considered for purposes of material participation. Some practitioners, along with the IRS, however, have questioned the reasoning in that case.[38]

In addition, the sole issue before the court in *Mattie K. Carter Trust* was whether activities of employees and agents employed directly by a trust should be considered for purposes of material participation. Because the Carter Trust owned the ranch directly, rather than through a corporation or LLC, the court had no occasion to consider the activities conducted by the same persons in other capacities, such as in the capacity of a shareholder or officer of a corporation owned by a trust. Since the Tax Court in *Frank Aragona Trust* determined it was not necessary to address this issue, it considered only the activities of the trustees for purposes of material participation. Accordingly, whether activities of nontrustee employees employed by trusts indirectly through an entity count towards material participation remains an open issue. For this reason,trusts that conduct activities through entities may wish to consider whether it is prudent to employ persons in dual capacities, so that they are employed by the trust in addition to being employed by the entities owned by the trust.

As noted above, the Tax Court stated in a footnote that it did not consider the effect of Section 469(c)(7)(D)(ii), which provides that for purposes of Section 469(c)(7)(B) personal services performed as an employee are generally not treated as performed in real property trades or businesses.[39] The IRS had limited its arguments and had not cited this provision in its brief. Notably, Section 469(c)(7)(D)(ii) does not apply if the employee is a 5% owner in the employer. In some cases, however, this provision could be asserted by the IRS as a means of distinguishing *Frank Aragona Trust*.

The Tax Court also found that the participation of three of the six trustees was sufficient to establish that the Trust materially participated in the real property trades or businesses, although it stated that all of the trustees participated in significant decisions involving the business. An interesting issue is whether one or more employees of a particular real estate activity indirectly owned by a trust through another entity can be added as trustees in order to satisfy the material participation test. Arguably, employees could be added as trustees in order to satisfy the material participation requirement; the trust document, however, must allow this action and the employees should not be limited in their duties as trustees.[40] Otherwise, the IRS may assert that they are not fiduciary trustees and their activities should be disregarded.

Frank Aragona Trust can be read to support the distinction between fiduciary trustees and special trustees drawn by the IRS in the 2007 TAM and 2013 TAM. Admittedly, this distinction was not an explicit issue in the case. Nevertheless, the court held that the Trust materially participated based on the activities of the six trustees. Although some of these trustees had limited duties, acting similarly to a board of directors, the court was careful to state that all of the trustees were fiduciaries under Michigan law (to which the Trust was subject).

In addition, the court's conclusion that the activities of trustees who also were employed by entities owned by the Trust could be considered in determining material participation was explicitly based on the fact that the trustees had a fiduciary duty to the Trust under Michigan law even when acting as employees of an entity controlled by the Trust. This conclusion also suggests that the extent to which activities of "special trustees" may be taken into account may turn on whether they are fiduciaries under the law of the state statute governing the trust.[41]

The court's reliance on Michigan law is significant for another reason. The court held that the activities of the trustees performed in their capacity as employees of an entity owned by the Trust should be counted toward material participation based on the fact that Michigan law provides that trustees are not relieved of their duty of loyalty to beneficiaries by conducting activities through a corporation wholly owned by a trust. While it is likely that most state laws similarly impose fiduciary duties on trustees who also perform activities as employees, the extent to which relevant state law must be consulted in determining whether activities of persons who act in dual capacities can be considered is not entirely clear under the court's decision.

In concluding that trusts are capable of performing personal services, and therefore can qualify for the exemption for real estate professionals, the Tax Court stated that "[i]f the trustees are individuals, and they work on a trade or business as part of their trustee duties," then "their work can be considered." While there is no indication that the court intended that corporate trustees should be treated differently from trustees who are natural persons, the full significance of this statement is unclear. While there is arguably no logical reason to distinguish between the activities of a corporate trustee and an individual trustee, the IRS could rely on this language to assert that the court's holding that trusts may perform personal services applies only to trusts with individual trustees. While the better view is that the court was not seeking to distinguish between individual and corporate trustees, the ambiguity created by this statement is unfortunate.

Although the Tax Court did not need to analyze whether the Trust satisfied the personal services requirement, the 750 hour requirement, or whether the taxpayer materially participated in its rental real estate activities, taxpayers subject to the passive activity rules and Section 1411 should keep in mind the importance of maintaining adequate records on the time spent on each of their activities. Taxpayers bear the burden of establishing material participation. In many cases, IRS victories in passive activity loss cases can be traced to inadequate recordkeeping.[42] As was discussed at the recent ABA Tax Section meeting in Washington, D.C., the Service is likely to scrutinize taxpayers' time records to ensure compliance with the requisite material participation time thresholds.[43]

The IRS had also argued that since two of the trustees had ownership interests in entities owned by the Trust, at least a portion of their activities should be disregarded because some of their efforts in managing the jointly held entities were attributable to their personal portions of the business. The Tax Court rejected this argument, but on a narrow basis.

First, the trustees owned only a minority interest in each of the entities in their individual capacities-for no entity did their combined ownership interests exceed 50%. Second, their combined ownership interest in each entity was never greater than the Trust's ownership interest. Third, their interests as owners were generally compatible with the Trust's goals-they and the Trust wanted the jointly held enterprise to succeed. Fourth, the trustees who owned the interests were involved in managing the day-to-day operations of the Trust's various real estate businesses. It is, therefore, unclear whether the Tax Court might have excluded some of the activities of the trustees who also owned interests in the entities owned by the Trust if some or all of these factors were not satisfied.

In footnote 11 of its opinion, the Tax Court said that the IRS had not asserted that trusts that materially participate in a real estate trade or business should be treated as corporations. Under the check-the-box Regulations, business trusts are generally classified as corporations, rather than trusts, for tax purposes. While the IRS does not appear to generally take the position that a trust engaged in a real estate business through ownership of a limited liability company or other entity should be treated as a corporation, this argument was not an issue in this case.

Although not specifically addressed in *Frank Aragona Trust*, when planning to take advantage of the Section 469(c)(7) exception from the passive activity loss rules for real estate professionals, it is important to keep in mind that the determination of whether a taxpayer materially participates in an activity is made on an activity-by-activity basis, unless the taxpayer makes an affirmative election to aggregate its real estate activities. Accordingly, taxpayers should carefully consider whether they need to make an affirmative election to take advantage of the exception, particularly if they are able to qualify for the "fresh start" opportunity to regroup their activities.[44]

CONCLUSION

It remains to be seen whether the IRS will appeal or issue a nonacquiescence in *Frank Aragona Trust*. It is hoped that the Service will accept the court's holding and focus instead on issuing additional guidance on material participation by trusts, which taxpayers sorely need.

Despite the many unanswered questions, Frank Aragona Trust is an important case and a significant taxpayer victory. The opinion provides important and necessary guidance to trusts and their advisors with regard to the activities required to meet the material participation test. Meeting the material participation test will gain added importance, too, with the potential application of the NII tax for nongrantor trusts that do not annually distribute their income.

Practice Notes

The Tax Court in *Frank Aragona Trust* considered only the activities of the trustees for purposes of material participation, after determining that it was not necessary to address the issue of whether activities conducted by trustees in other capacities, such as in the capacity of a shareholder or officer of a corporation owned by a trust, counted as material participation. Accordingly, whether activities of nontrustee employees employed by trusts indirectly through an entity count towards material participation remains an open issue. For this reason, taxpayers may wish to consider whether it is prudent to employ persons in dual capacities, so that they are employed both by the trust and an entity owned by the trust.

The court's conclusions are also important for determining whether trust income is subject to the 3.8% NII tax. Trusts that have not already done so should consider whether to take advantage of the election under Section 1411 to regroup their activities and the election under Section 469(c)(7) to treat all interests in rental activities as one activity.

[1] The discussion in this article relates solely to nongrantor trusts. Because grantor trusts are disregarded entities, material participation in the grantor trust context is determined by reference to the activities of the grantor.

[2] See Section 469(a); Temp. Regs. 1.469-1T(a)(i) and (b). As the limitations on the use of passive activity credits were not at issue in Frank Aragona Trust, the discussion in this article will focus on the rules applicable to passive activity losses and will not discuss the rules applicable to passive activity credits.

[3] Section 469(e).

[4] Section 469(d)(1); Temp. Reg. 1.469-2T(b).

[5] Section 469(c)(1); Temp. Reg. 1.469-1T(e)(1)(i). For purposes of Section 469, business activities are generally defined as any activities that either (1) involve the conduct of a trade or business within the meaning of Section 162, (2) are conducted in anticipation of the commencement of a trade or business, or (3) involve research or experimental expenditures. See Section 469(c)(5) and Regs. 1.469-1(e)(2) and 1.469-4(b)(1).

[6] Section 469(b); Temp. Reg. 1.469-1T(c)(6); Reg. 1.469-1(f)(4).

[7] Section 469(g)(1). Special rules apply to the determination of the portion of such losses treated as nonpassive if an interest

in an activity is transferred by reason of the death of the taxpayer or in an installment sale. See Sections 469(g)(2) and (3).

[8] Temp. Reg. 1.469-5T(a) provides that an individual materially participates in an activity if he or she meets any of the following safe harbor tests: (1) the individual participates in the activity for more than 500 hours during the year; (2) the individual's participation in the activity for the tax year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interest in the activity) for such year; (3) 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; (4) the activity is significant participation activity, and the individual's aggregate participation in all significant activities during such year exceeds 500 hours; (5) the individual materially participated in the activity for any five of the previous ten tax years; (6) the activity is a personal service activity and the individual materially participated in the activity for any three tax years (whether or not consecutive) preceding the tax year; and (7) based on all the facts and circumstances the individual participates in the activity on a regular, continuous, and substantial basis during such year. Special rules apply to limited partners and LLC members that are treated as limited partners. Under these special regulatory rules, limited partners can materially participate only if they meet (1), (5), or (6) of the above safe harbor tests. See Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (1987) (the "TRA '86 Blue Book"), page 237, noting that under relevant state laws, maintenance of limited liability status precludes a limited partner from being active in the partnership's business. These rules were not applicable in Frank Aragona Trust or the TAMs and CCA discussed below, and therefore are beyond the scope of this article.

[9] Temp. Reg. 1.469-5T(g) is "reserved."

[10] S. Rep't No. 99-313, 99th Cong., 2d Sess. 735 (1986).

[11] See the TRA '86 Blue Book, *supra* note 8, at page 242, fn 33. The Supreme Court recently considered the status of Blue Books and decided they are not on a par with committee reports. See generally VanDenburgh, Hamilton, and Walsh, "*Woods*: More Than Just Another Victory for the Government in Offsetting-Option Tax Shelters," 120 JTAX 298 (June 2014).

[12] Nevertheless, the court held in the alternative that it would have reached the same conclusion if it had considered only the activities of the trustees. This raises the issue of whether the court's primary holding-that the activities of employees of the trust who were not trustees could be considered in determining material participation-should be deemed dicta. The better view is that it should not, and that the court's alternative

holding should be viewed as clarification. While the IRS declined to follow this case in the TAMs, it did not assert that the court's primary holding was dicta. Mattie K. Carter Trust was cited only in a footnote in Frank Aragona Trust, and it was cited there only to note that the IRS disagreed with the result.

[13] In distinguishing the "special" trustees from a "fiduciary" trustee, the Service referred to Section 7701(a)(6), which defines a fiduciary as a "guardian, trustee, executor, administrator ... or any person acting in any fiduciary capacity for any person." The IRS then cited several cases describing typical trustee powers and noted the "special" trustees did not have such powers.

[14] See, e.g., Shop Talk, "Trust's Material Participation in an Activity Can Be Only Through Its Trustees" 107 JTAX 251 (October 2007).

[15] Section 56(b)(2)(D) provides an exception from capitalization for certain research and experimental expenditures. If the taxpayer materially participates (within the meaning of Section 469(h)) in an activity, the general capitalization rule of Section 56(b)(2) does not apply to any amount allowable as a deduction under Section 174(a) for expenditures paid or incurred in connection with such activity.

[16] Sections 469(c)(2) and (4).

[17] Section 469(j)(8). Reg. 1.469-9(b)(3) defines "rental real estate" as any real property used by customers or held for use by customers in a rental activity. An activity is a "rental activity" for a tax year if (1) during such year, tangible property held in connection with the activity is used by customers or held for the use of customers, and (2) the gross income attributable to the conduct of the activity during the tax year represents amounts paid or to be paid for the use of the tangible personal property. In the case of an activity where property is held by or for the use of customers, the expected gross income attributable to the conduct of the activity during the tax year is used. In addition, for purposes of the gross income requirement, the determination of whether gross income represents amounts paid or to be paid for the use of tangible property is made without regard to whether the use of the property is pursuant to a lease, service, or other arrangement that is not denominated as a lease. See Temp. Reg. 1.469-1T(e)(3)(i). The Regulations provide for exceptions to the definition of a rental activity, but these exceptions were not at issue in Frank Aragona Trust and are beyond the scope of this article.

[18] In addition, natural persons are permitted to use up to $25,000 of passive activity losses (or the deduction equivalent amount of passive activity credits) a year from rental real estate activities with respect to which the individual "actively participated" during the tax year free of the limitations imposed by the passive activity loss rules. The benefit of the exception is phased out for taxpayers with AGI above $100,000. See Section

469(i) and Reg. 1.469-9(j). As the exception is available only to natural persons and not to trusts, it will not be discussed further in this article.

[19] Regs. 1.469-9(c)(3) and 1.469-9(b)(2).

[20] Section 469(c)(7)(B)(i); Reg. 1.469-9(c)(1).

[21] Section 469(c)(7)(B)(ii); Reg. 1.469-9(c)(1).

[22] Section 469(c)(7)(C); Reg. 1.469-9(b)(2).

[23] Regs. 1.469-9(b)(1) and (2). Section 212 provides a deduction for ordinary and necessary expenses incurred for the production of income.

[24] Reg. 1.469-9(b)(3); Regs. 1.469-4(d)(1)(i)(A) and (C). In general, the passive activity loss rules permit one or more trade or business activities or rental activities to be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of Section 469 based on all the facts and circumstances; see Regs. 1.469-4(c)(1) and (2). Nevertheless, rental activities may not be grouped with a trade or business activity unless (1) the activities being grouped together constitute an appropriate economic unit under all the facts and circumstances and (2) either (a) the rental activity is insubstantial in relation to the trade or business activity, (b) the trade or business activity is insubstantial in relation to the rental activity, or (c) each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which event the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity. See Reg. 1.469-4(d)(1)(i).

[25] Reg. 1.469-9(c). In the case of a closely held C corporation, these requirements are treated as met for a tax year if more than 50% of the gross receipts of the corporation for that year are derived from real property trades or businesses in which the corporation materially participates. Personal services performed as an employee are not treated as performed in real property trades or businesses unless the employee also is a 5% owner.

[26] Section 469(c)(7)(A). The election is made by filing a statement with the taxpayer's original return for the tax year. In Rev. Proc. 2011-34, 2011-24 IRB 875, the IRS announced a procedure that allows taxpayers to make late elections to treat all interests in rental real estate as a single activity. The election can be made by attaching the statement required by Reg. 1.469-9(g)(3) to an amended return for the taxpayer's most recent tax year. The election can be made only if all of the following requirements are met: (1) the taxpayer failed to make an election under Reg. 1.469-9(g) solely because the taxpayer failed to timely meet the requirements in Reg. 1.469-9(g); (2) the taxpayer filed consistently with having made

an election under Reg. 1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election; (3) the taxpayer timely filed each return that would have been affected by the election if it had been timely made; and (4) the taxpayer has reasonable cause for the failure to meet the requirements in Reg. 1.469-9(g). The taxpayer should carefully consider the grouping election since it is a "one-time" election and can be beneficial in helping the taxpayer meet the material participation threshold. See also Reg. 1.469-11(b)(3), which provides a limited opportunity for taxpayers to reconsider their grouping if they are subject to the Section 1411 net investment income tax.

[27] See Temp. Reg. 1.469-5T(f)(4).

[28] H. Rep't No. 103-111,103d Cong., 1st Sess. (1993), 1993-3 CB at 190.

[29] See Section 469(i).

[30] It is not entirely clear from the decision whether any of these employees were employed directly by the Trust or whether they were all employed by entities owned by the Trust.

[31] In fn. 16 of its opinion, the Tax Court said it did not need to consider the effect of Section 469(c)(7)(D)(ii), which provides that for purposes of Section 469(c)(7)(B) personal services performed as an employee are generally not treated as performed in real property trades or businesses, as the IRS had limited itself in challenging the taxpayer's position and the Service did not cite Section 469(c)(7)(D)(ii) in its brief.

[32] The Tax Court cited Mattie K. Carter Trust, discussed in the text above.

[33] For purposes of the analysis of whether the taxpayer qualifies for the exception under Section 469(c)(7), the relevant inquiry is whether the taxpayer materially participated in his *real estate trade or business activities*. A taxpayer who qualifies for the exception must then show that he materially participated in his *rental real estate activities* in order to have those activities classified as nonpassive activities.

[34] See generally Seago, Orbach, and Schnee, "Working With the Unearned Income Medicare Tax," 118 JTAX 108 (March 2013).

[35] Section 1411(c).

[36] Section 1411(a)(2).

[37] Characterizing income as nonpassive is not always favorable. If taxpayers have suspended passive losses, characterizing income as nonpassive for purposes of Section 1411 generally will leave the taxpayer unable to use passive losses against such income. The NII tax applies to undistributed net investment income of trusts. Thus, trusts can distribute their net investment income and avoid application of the NII tax at the trust level, but the beneficiaries receiving such distributions must separately consider

whether receipt of the distribution causes them to be subject to the NII tax. See Keator, “Rental Real Estate and the Net Investment Income Tax,” 119 JTAX 60 (August 2013).

[38] See Freda, “’Frank Aragona’: The New Face of Trust Material Participation Authority in 2014”, BNA Daily Tax Report, 1/28/14, page S-16 (noting that many observers believe the decision in Mattie K. Carter Trust went too far and was not well-reasoned).

[39] See note 30, *supra*.

[40] See Freda, *supra* note 37, where a commentator suggested that adding a co-trustee who is an employee could make the determination of material participation “elective.”

[41] As has been noted, the Service’s argument is difficult to reconcile with basic trust law, which should treat all trustees as having a fiduciary duty to the trust. See e.g., McManus, “Tax Court: Frank Aragona Trust Eligible for Passive Activity Exception,” BNA Daily Tax Report, 3/28/14, page K-2.

[42] See, e.g., Bugarin, TC Summ Op 2013-61, 2013 WL 3811484; Merino, TC Memo 2013-167, RIA TC Memo ¶2013-167.

[43] See Beyoud, “Good Records Key to Avoiding Fight Over Net Investment Income Tax Exemption Claim,” BNA Daily Tax Report, 5/12/14, page G-6.

[44] See Reg. 1.469-11(b)(3)(iv)(A), which provides, “[i]f an individual, estate, or trust meets the Eligibility Criteria, as defined in [Reg. 1.49-11(b)(3)(iv)(B)], such individual, estate, or trust, in the first taxable year beginning after December 31, 2013, in which section 1411 would apply to such taxpayer, may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year.”