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- by Roger McEowen***

Overview

The Tax Reform Act of 1986¹ created the passive loss rules.² The rules were enacted to prevent individuals from using tax shelters to reduce tax liability on their tax return by offsetting losses from passive activities (mere investment activities) against other taxable income. Passive losses are subject to stringent rules regarding deductibility – losses from passive activities can only be deducted against income from passive activities.³ In turn, for taxpayers involved in passive activities, IRS has the power to recharacterize passive activities as non-passive.⁴

An activity is considered a passive activity, and the passive loss rules are invoked, if the activity involves a trade or business and the taxpayer does not materially participate in the activity “on a basis which is regular, continuous and substantial.”⁵ As mentioned above, the passive loss rules prevent deductions (losses) from passive trade or business activities, to the extent they exceed income from all passive activities, from being deducted against other income (non-passive activity gains).⁶ So, in order to deduct losses from trade or business activities, a “taxpayer” must materially participate in the activity. In other words, the taxpayer must be involved in the business activity on a regular, continuous and substantial basis. That’s a tough test for many individual taxpayers to meet.

While IRS regulations set forth several material participation tests for individual taxpayers,⁷ IRS has never issued regulations addressing the material participation requirement for non-grantor trusts (as well as estates).⁸ For pass-through entities, material participation is determined with respect to each

member of the entity, with reference to the tax year of the entity.⁹ For closely held C corporations (and personal service corporations), material participation is generally required by shareholders with aggregate ownership of more than 50 percent in value of the corporation’s outstanding stock.¹⁰ Also, C corporations (but not personal service corporations) meet the test if the corporation’s business activities are exempt from the at-risk rules under I.R.C. §465(c)(7) – which attribute the activities of employees to the corporation.¹¹

So, for a non-grantor trust, who is the “taxpayer”? For purposes of the passive loss rules, the statute defines a “taxpayer” as “any individual, estate, or trust,”¹² or any closely held C corporation¹³ as well as any personal service corporation.¹⁴ Thus, while the statute is clear that a trust (rather than a trustee) is the taxpayer whose material participation is decisive, the statute is silent on how to determine if the test has been satisfied. In other words, since the trust can only act through other people to satisfy the material participation test, who are the key other people whose activity counts?

The longstanding IRS position has been that only the trustee of a trust can satisfy the material participation test. While that position was rejected by a federal court in 2003, the IRS has continued to maintain its position with pronouncements in 2007, 2010 and 2013.

The *Mattie K. Carter Trust* Case

Mattie K. Carter Trust v. United States,¹⁵ involved a testamentary trust established in 1956. A trustee, who had been in place since 1984, managed the trust assets, including, initially, a one-half interest

in a ranch that the trust had operated since 1956. The trust acquired the balance of the ranch in 1992 upon the death of Mattie's husband. The ranch covered 15,000 acres and included cattle ranching operations in addition to oil and gas interests. The trust employed a full-time ranch manager and other employees who performed essentially all of the ranch's activities. The trustee also devoted a great deal of time and attention to ranch activities. The trust claimed deductions for losses it incurred in connection with the ranch operations for 1994 and 1995 of \$856,518 and \$796,687 respectively. In 1999, IRS issued a deficiency notice disallowing the deductions because of the passive loss rules. The trust paid the disputed tax in full (plus interest) and filed for a refund, which IRS denied. The trust then sued for a refund in federal district court.

The issue before the court was whether the trust materially participated in the ranching operations or was otherwise "passively" involved. IRS conceded during trial that its existing regulations (Treas. Reg. §1-469-5T) applied only to individuals.¹⁶

Furthermore, IRS couldn't cite any caselaw to support its position, instead relying on a "snippet" of legislative history that states, "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."¹⁷ But, that language simply restates the obvious and doesn't say that a fiduciary's participation is the *only* way a trust can satisfy the material participation test. The trust, on the other hand, maintained that trust was the taxpayer, not the trustee, and that material participation should be determined by assessing the trust's activities through its fiduciaries, employees and agents. The trust also maintained that, as a legal entity, it could participate only through the actions of those individuals. Their collective efforts on the ranching operations during 1994 and 1995, the trust argued, were regular, continuous and substantial.

The court agreed with the trust, and noted that the IRS's argument that the trust's participation in the ranch operations should be measured by referring to the trustee's activities had no support within the plain meaning of the statute.¹⁸ Since the statute was clear on the matter, legislative history was irrelevant (and it is not helpful to the IRS's position anyway). The court stated that the IRS view was "arbitrary, subverts common sense, and attempts to create ambiguity where there is none."¹⁹ As such,

the trust's participation in the ranch operations involved an assessment of the activities of those who labored on the ranch, or otherwise conducted ranch business on the trust's behalf. Their collective activities during the times in question were regular, continuous and substantial enough to constitute material participation (the court also noted, based on the evidence, that the trustee would have satisfied the test personally under the facts of the case). Thus, the trust's losses were not passive losses, the IRS had improperly disallowed the ranching losses as passive activity losses, and the trust was entitled to a refund of the overpaid taxes with interest. IRS did not appeal.

Recent Developments

So, what has IRS learned from its judicial defeat on the issue? Apparently, not a great deal. As of May 2013, they still haven't issued regulations for non-grantor trusts and continue to maintain their position on the issue.

2007 Tech. Advice Memo. In an undated Technical Advice Memorandum (TAM)²⁰ released on Aug. 17, 2007, IRS again took the position that a trust satisfies the material participation test only if the fiduciary is involved in the operations of the trust's business activities on a regular, continuous and substantial basis. Under the facts of the TAM, a testamentary trust acquired an interest in an LLC. The trustees provided services to the LLC encompassing a range of administrative and operational activities for the LLC's business. The will establishing the trust provided for the appointment of special trustees for part or all of the trust property. A contract between the trust and the special trustees stated that the special trustees' involvement in the LLC's business is intended to satisfy the material participation test requirement under the passive loss rules. The special trustees reviewed operating budgets, analyzing a tax dispute, preparing and examining financial documents and negotiating the sale of the trust's interests in the LLC to a new partner. Ultimate decision-making authority remained solely with the trustees, however. IRS restated its disagreement with the *Mattie K. Carter* decision,²¹ holding firm to its position that only the trustee can satisfy the test. IRS determined that the special trustees did not have the discretionary power to act on behalf of the trust, even though they were deeply involved in the trust's business activity. As such, the trustees'

involvement in the business was not regular, continuous and substantial, and the trust did not materially participate in the LLC's business.

2010 Private Letter Ruling. In a Private Letter Ruling released in late July of 2010, IRS again took the position that the only way a trust can establish material participation under the passive loss rules is through the trustee.²² According to the IRS, the trustee must be involved in the operations of the activity on a regular, continuous and substantial basis. In the ruling, IRS did not even refer to the *Mattie K. Carter Trust* case²³ or, for that matter, the 2007 Tech. Advice Memo. Instead, IRS based its entire rationale on the "snippet" of legislative history that the court in *Mattie K. Carter Trust* had deemed irrelevant.

2013 Tech. Advice Memo. In a Tech. Adv. Memo. released in late April of 2013,²⁴ the IRS continued to reiterate its position that the only way a trust can satisfy the material participation test is through the trustee's participation in the trust's activity *as the trustee*. Under the facts of the Tech. Adv., two trusts each had an interest in an S corporation with the balance of the interests in the S corporation owned by the taxpayer. The S corporation owned another corporation which was a qualified subchapter S subsidiary which the taxpayer was the president of and was directly involved in daily operations as the president. The trusts had income from their interests in the S corporation. The taxpayer, the taxpayer's spouse, children and grandchildren were all beneficiaries of the trusts and the taxpayer was a special trustee of the trusts and controlled all of the decisions regarding the disposition of the S corporation stock and the voting of that stock. However, taxpayer was not able to distinguish between time spent conducting business as corporate president and time spent as the special trustee. The IRS took the position that the trusts did not materially participate in the S corporation business. As a result, the trusts' share of research or experimental expenses incurred by the S corporation, in computing alternative minimum taxable income, had to be amortized over 10 years. The IRS claimed (without any basis and entirely out of thin air) that only the participation of the taxpayer *as the trustee of the trusts acting in a fiduciary capacity* counts toward the material participation test. The taxpayer couldn't count any time spent participating in the trust business as corporate president. IRS ignored the interrelated

role of the taxpayer as special trustee and corporate president for purposes of the material participation test.

The IRS position will make it likely impossible for trusts to avoid the new (as of 2013) Obamacare 3.8% Medicare surtax on passive sources of income.²⁵ That tax kicks in at \$11,950 of trust income (according to the IRS, although the statute is not clear) for 2013.²⁶

Note: Technical Advice Memoranda and Private Letter Rulings have no authoritative authority. However, they do signal the position that the IRS will take on audit. Also, the 2013 Technical Advice was issued at a time when the U.S. Tax Court is considering the issue of how a trust can satisfy the material participation test.²⁷

The Correct Approach

The *Mattie K. Carter*²⁸ court essentially got the matter decided correctly, but didn't quite go far enough to nail down the rationale. The part of I.R.C. §469 applicable to closely held C corporations (other than personal service corporations) ties material participation for I.R.C. §469 purposes to the exemption under I.R.C. §465 of active businesses from the at-risk rules under I.R.C. §465(c)(7).²⁹ Those rules attribute the activity of employees to the entity.³⁰ Similarly, under the statute³¹ a trust is an entity and, like a corporation, looks to the activities of employees and agents to conduct its business.

In the 2010 Private Letter Ruling³² IRS cited a sentence in a Senate Report in 1986 to bolster its conclusion that only the trustee's actions matter for purposes of applying the passive loss rules - "the activities of [employees]...are not attributed to the taxpayer."³³ Unfortunately, IRS didn't cite its own regulation on the matter that *does* attribute the activities of employees to an entity.³⁴ So, the ruling is contrary to the IRS' own regulatory position on the issue. Apart from the statutory rationale, to require a fiduciary to be the sole means of satisfying the material participation test would make material participation by corporate fiduciaries (i.e., a bank trust department or a private trust company) impossible. That couldn't have possibly been the intent of I.R.C. §469.

Conclusion

Clearly, IRS needs to finalize a regulation concerning the application of the passive loss rules to trusts. When a government agency is told that its litigating position has “no support within the plain meaning of the statute” and “subverts common sense,” the agency has a responsibility either to appeal the court’s decision or develop reasonable regulations rather than continue maintaining its judicially-rejected position.

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¹ Pub. L. No. 99-514, §501(a), 100 Stat. 2233 (1986), adding I.R.C. §469.

² I.R.C. §469.

³ *Id.*

⁴ Treas. Reg. §1.469-2T(f).

⁵ I.R.C. §§469(c)(1); 469(h)(1).

⁶ See note 3, *infra*.

⁷ Temp. Treas. Reg. §§1.469-5T(a)(1)-(7)

⁸ Temp. Treas. Reg. §§ 1.469-5T(g); 1.469-8. Grantor trusts are not subject to the passive activity loss rules. Temp. Treas. Reg. §1.469-1T(b)(2). Instead, the grantor, personally, is subject to the rules, and it is the grantor’s material participation that is the key. See Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 242, n. 33, 100th Cong., 1 st Sess. (1987).

⁹ Temp. Treas. Reg. §1.469-2T(e)(1).

¹⁰ I.R.C. §469(h)(4)(A); Temp. Treas. Reg. §1.469-1T(g)(3)(i).

¹¹ I.R.C. §469(h)(4)(B). Under I.R.C. §465(c)(7)(C), the at-risk rules don’t apply if, (i) during the entire 12-month period ending on the last day of the taxable year, the corporation had at least 1 full-time employee substantially all the services of whom were in the active management of the such business; (2) the corporation had at least 3 full-time, non-owner employees substantially all of the services of whom were services directly related to such business; and (3) the amount of the deductions attributable to the corporation which are allowed to the business under I.R.C. §§ 162 and 404 for the tax year exceed 15 percent of the corporation’s gross income.

¹² I.R.C. §469(a)(2)(A).

¹³ I.R.C. §469(a)(2)(B).

¹⁴ I.R.C. §469(a)(2)(C).

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

¹⁶ Indeed, a subsection in the Temporary Regulation has been reserved for material participation by trusts and estates, but has never been promulgated. See Temp. Treas. Reg. §1.469-5T(g).

¹⁷ S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986).

¹⁸ I.R.C. §469(a)(2)(A).

¹⁹ See, e.g., *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d (N.D. Tex. 2003). IRS did not appeal the court’s decision (probably because the court also stated that the trustee, in any event, satisfied the material participation test)

²⁰ Tech. Adv. Memo. 200733023 (Aug. 17, 2008).

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

²² Priv. Ltr. Rul. 201029014 (Apr. 7, 2010).

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

²⁴ Tech. Adv. Memo. 201317010 (Jan. 18, 2013).

²⁵ I.R.C. §1411.

²⁶ Rev. Proc. 2013-15.

²⁷ *Frank Aragona Trust v. Comr.*, No. 15392-11 (filed Jun. 29, 2011).

²⁸ *Id.*

²⁹ See note 11 *infra*., and accompanying text.

³⁰ *Id.* Treas. Reg. §1.469-1T(g) adopt the I.R.C. §465(c)(7)(C) route for corporate material participation.

³¹ I.R.C. §469(a)(2)(A).

³² 201029014 (Apr. 7, 2010).

³³ S. Rep. No. 99-313, at 735 (1986).

³⁴ Treas. Reg. §1.469-1T(g). Under I.R.C. §469(a)(2)(A), a trust is an entity.