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The American College of Trust and Estate Counsel

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September 24, 2015

Office of Associate Chief Counsel
(Passthroughs and Special Industries)
CC:PSI:B02
Room 5011
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Washington, DC 20224

Re: REG-130507-11 - Estates/Trusts

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel ("ACTEC") is pleased to submit comments on the material participation of trusts under the passive loss rules of Internal Revenue Code section 469, as requested in the preamble to Treasury Decision 9644 (Nov. 26, 2013). Our comments propose a way to integrate a trust's treatment as an entity for tax purposes with the fact that for state law purposes a trust is a relationship between one or more persons with fiduciary duties and one or more persons to whom those duties are owed.

ACTEC is a professional organization of approximately 2,600 lawyers from throughout the United States (and a small number from outside the United States). Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the field of trusts and estates and on the basis of having made substantial contributions to that field through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift, and generation-skipping transfer tax planning, fiduciary income tax planning, and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

Although Fellows of ACTEC who participated in preparing these comments and recommendations have clients who would be affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or to otherwise influence the development or the outcome of, the specific subject matter of these comments.

If you or your staff would like to discuss these comments, please contact Steven B. Gorin, chair of a joint task force of ACTEC's Business Planning Committee and Fiduciary Income Tax Committee, at (314) 552-6151 or sgorin@thompsoncoburn.com.

Respectfully submitted,

Bruce Stone

Bruce Stone
President

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Overview

The preamble to Treasury Decision 9644 (Nov. 26, 2013) requested comments on the material participation of trusts under the passive loss rules of Internal Revenue Code section 469.

ACTEC's recommendations describe standards for determining whether work in a trade or business activity (a "business" or "business activity") by a fiduciary (whether an individual or entity) of a trust or estate should count toward determining whether the trust or a estate is materially participating in the business. Participation has two components: the work must qualify as eligible to constitute participation,[1] and the work must be done by an owner.[2]

These standards are founded on certain basic underlying principles of trusts and estates and on our analysis, derived from our extensive professional experience in how trusts and estates actually operate and compare to other taxpayers subject to the passive loss rules.

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[1] Reg. § 1.469-5T(f) addresses this issue. Throughout, "Reg." refers to the U.S. Treasury Regulations, and "Code" refers to the Internal Revenue Code of 1986, as amended.

[2] Reg. § 1.469-5(f)(1) provides:

> *In general*. Except as otherwise provided in this paragraph (f), any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity.

Neither the final regulation nor Reg. § 1.469-5T(f) promulgate other paragraphs that qualify this rule.

The parentheticals at the end of Reg. § 1.469-5T(a)(2) and (3) imply that participation is done only by an owner.

To emphasize the ownership requirement, Reg. § 1.469-5T(k), Example (6) provides:

> The facts are the same as in example (5), except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in the activity for any taxable year prior to 1994 because D does not own an interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example (5) to which this example refers is Reg. § 1.469-5(k), Example (5):

> In 1993, D, an individual, acquires stock in an S corporation engaged in a trade or business activity (within the meaning of § 1.469-1(e)(2)). For every taxable year from 1993 through 1997, D is treated as materially participating (without regard to § 1.469-5T(a)(5)) in the activity. D retires from the activity at the beginning of 1998, and would not be treated as materially participating in the activity for 1998 and subsequent taxable years if material participation for those years were determined without regard to § 1.469-5T(a)(5). Under § 1.469-5T(a)(5) of this section, however, D is treated as materially participating in the activity for taxable years 1998 through 2003 because D materially participated in the activity (determined without regard to § 1.469-5T(a)(5)) for five taxable years during the ten taxable years that immediately precede each of those years. D is not treated under § 1.469-5T(a)(5) as materially participating in the activity for taxable years beginning after 2003 because for those years D has not materially participated in the activity (determined without regard to § 1.469-5T(a)(5)) for five of the last ten immediately preceding taxable years. [sic – closing parentheses absent in original]

The principles underlying our recommendations are:

1. ***Paralleling Taxation of Individuals***. A trust or estate is a management successor to a grantor or decedent, not an investment vehicle, and is taxed by rules adapted from the taxation of individuals. Therefore, we are guided predominately by the rules applied to individuals in considering how the material participation rules should apply to trusts and estates.

    a. The trusts and estates arena is a very different legal and practical environment than that which applies to the management, formation and operation of business entities. Unlike a corporation, LLC or partnership, the form of trust or estate that concerns us here is used to manage assets that by reason of death or other circumstances are no longer managed as the personal assets of the grantor or decedent. We are not addressing fixed investment trusts or grantor trusts used to invest in pools of marketable securities. Here the trust or estate has been set aside to benefit the grantor's or decedent's family or other beneficiaries.

    b. The tax rules for nongrantor trusts[3] and for estates in subchapter J of the Code parallel the taxation of individuals, as if the trust or estate were a natural person.

    c. The pass-through system applied to the taxation of the estate or trust beneficiaries is not automatic as in the treatment of partnership income and losses. It applies, with very limited exceptions, only when distributions are actually made. The beneficiaries are not investors in the estate or trust, and their rights are dependent on the terms of the will or trust instrument (which often are tied to births and deaths) and the trustee's discretion.

    d. The opportunities for income tax planning by contributing assets into a trust or estate are virtually non-existent. Unlike contributions to a business entity (which can often be made without triggering a tax), a contribution to a nongrantor trust cannot be made in exchange for an interest in the entity, so the opportunity for pooling assets to change the tax-oriented characteristics of a trust are limited (to those infrequent occasions when trusts with substantially identical terms and beneficiaries can be merged).

    e. For practical purposes, in our analysis we draw analogies to the taxation of individuals as well as entities (both pass-throughs and non-pass-throughs). When comparisons between entities and trusts-and-estates are used, it is for the purpose of demonstrating that the proposed rule in question does not offend generally recognized principles of taxation or common notions of what constitutes passive and nonpassive income. Nevertheless, we believe that the treatment of trusts and estates should be determined by rules that recognize that trusts and estates are different than any other types of taxpayers. In our opinion, it would be a mistake to fashion the rules for fiduciaries as if a trust or estate were "just like" a corporation or partnership, or as if a trustee or executor (or personal

[3] "Nongrantor trust" means a trust to the extent that its activity is not taxed to a deemed owner under subpart E of subchapter J of the Code.

representative or administrator) were "just like" a shareholder or partner. They are not "just like" one another. Analogies do not provide equivalence. The unique characteristic of a trust (or estate) is the fiduciary relationship undertaken to manage assets as a successor owner to an individual, and not to establish a business venture for "associates." As the Code recognizes already, the closest analogy is to a natural person, but even here there is a difference because an individual does not owe a fiduciary obligation to himself or herself in the management of an ownership interest in a trade or business.

2. ***Fiduciary Activity Determines Participation***. In view of the special nature of trusts and estates, we propose that the determination of material participation should turn on the activity of the fiduciaries (the executors, trustees or other fiduciaries) rather than on the activity of the beneficiaries, at least for income or loss reported by the trust or estate and not passed out to the beneficiaries by reason of distributions.

    a. By "fiduciaries" we mean trustees, executors and other positions of authority that both act for the trust or estate AND have fiduciary obligations to the beneficiaries. Those are the positions whose activities most naturally constitute the activities of the trust or estate, because the fiduciary obligation is its distinguishing characteristic.

    b. Under the governing documents and state law, those positions might be called by names other than trustee, executor or personal representative, such as special trustee, protector, or investment director, but labels should not control; instead, authority and duties should control, consistent with the Service's general recognition that substance should prevail over form.

    c. Fiduciaries cannot eliminate their duties – every action they take is subject to their obligations to the beneficiaries. Therefore, we propose that the work such persons do should count as work of the trust or estate, even if done in another capacity, such as while serving as a business executive, unless it is clear that in performing the work in question the person is not bound by a fiduciary obligation to the beneficiaries under the law governing the trust or estate.

    d. Our proposals do not attribute to the trust or estate any work done by beneficiaries (even if those beneficiaries are employees in the business), at least when characterizing tax items reported by the trust or estate and not passed out to the beneficiaries. The beneficiaries benefit from the fiduciary's activities but are not fiduciaries. A necessary exception is made for qualified subchapter S trusts ("QSSTs," or "QSST" in the singular) because the subchapter S operations are automatically attributed to the beneficiaries, more like the treatment of partnerships under subchapter K.

3. ***Active Fiduciaries***. In our analysis, in order to count toward the material participation of the trust or estate, the party working in the business should have a material fiduciary power over the business. Thus, once the fiduciaries are identified as the relevant parties whose work could be considered, it is still necessary to determine whether their fiduciary role in fact applies to the business interest owned by the trust or estate.

a. Our proposal excludes fiduciaries whose responsibilities for the trust or estate are solely ministerial (e.g., transmitting information concerning claims) or unrelated (e.g., management of a trust's non-business assets).

b. The power held by each fiduciary need not be a controlling power over the business in order for that person's work to qualify in determining material participation. This aspect is similar to a limited partner or S corporation shareholder (with voting or nonvoting stock) who has no authority to control the business, but who can nevertheless materially participate by engaging in work for the business that goes beyond the activities of a passive investor.

4. ***Avoiding Complexity and Promoting Consistent Results***. We have endeavored to avoid proposing rules that require multiple levels of criteria or heavy reliance on state fiduciary law on issues in which the rules are not reasonably clear or consistent across the various jurisdictions. Rather, we are proposing specific rules that can be administered with consistent results and without undue complexity and cost.

   a. For example, while focusing on the activities of fiduciaries, we avoided drawing distinctions based on the degree of fiduciary obligation.

   b. We found it necessary, as a general rule, to aggregate the activities of multiple fiduciaries, in order to avoid inconsistent results as between, for example, a trust that has a single trustee for the entire period as compared to a succession of trustees.

5. ***Any Type of Fiduciary Can Materially Participate***. Whether a fiduciary is an individual or an entity (and what type of entity) does not determine the fiduciary's authority or fiduciary duties and therefore is not relevant in determining the fiduciary's material participation.

6. ***Work by Independent Contractors Not Counted; Work by Employees May Be Counted***. In order to maintain consistency with the treatment of individual investors, we believe that work done by independent contractors ordinarily should not count toward a trust's or estate's participation. In contrast, in our proposal, work in the business by employees of a fiduciary should count whenever the employer's fiduciary responsibility to the beneficiaries for that particular work is the same, whether done directly or by employees. The work should be considered the work of the trust or estate whenever performed in a fiduciary capacity.

   a. Individual owners cannot count work done by independent contractors as material participation, and we see no reason to treat fiduciaries differently. Indeed, the responsibility of the fiduciary who engages an independent contractor for the contractor's work is often limited by the governing law or documents as long as the contractor has been properly selected and supervised. However, in some situations an independent contractor might be granted fiduciary authority and be subject to fiduciary duties to the beneficiaries, in which case the independent contractor's work would be considered the trust's or estate's work.

b. We believe that work done by the employees of a fiduciary should count as work of the trust if the fiduciary-employer is responsible to the beneficiaries for the employees' work under the same fiduciary obligations that would apply to work performed directly by the fiduciary.[4]

7. ***Tacking Work of Successors; Change in Grantor Trust or Nongrantor Trust Status***. We suggest that, because the passive loss rules look to participation over the course of a year or over the course of several years, a person's work as a fiduciary should tack to successor fiduciaries. In the case of nongrantor trusts, our focus is on treating the fiduciary as the continuing embodiment of the trust, consistent with our emphasis on the fiduciary obligation representing the core characteristic that distinguishes a trust from other legally recognized relationships or associations. Changes in the tax status of a trust from grantor trust to nongrantor trust (and *vice versa*) present special issues, and these should be addressed in a manner consistent with the role of the fiduciary in the broader application of the rules. Estates require a somewhat different treatment, because the role of a fiduciary for an estate usually is more limited and less active, as a matter of law and custom. The activity of the estate fiduciary after the owner's death should still determine whether the activity of the estate (or posthumously formed trust) is passive or nonpassive, but the activity of the owner while alive should be attributed to the fiduciary when making the determination.

8. ***Real Estate Professional Exception Test***. In lieu of applying the tests under Code section 469(c)(7)(B), a closely held C corporation may utilize an alternative test under Code section 469(c)(7)(D)(i) to determine whether or not that entity qualifies for the real estate professional exception. This alternative test recognizes, in principle, that a non-pass-through corporation with a high concentration of real estate is unlikely to act like a passive investor, in light of the duties owed to its shareholders.

   a. We see no reason why a test similar to the 50% gross receipts test under Code section 469(c)(7)(D)(i) should not be available to a trust or estate. Ordinarily trustees and executors owe to beneficiaries duties that are substantially more stringent than those owed by corporate directors or officers to shareholders. Moreover, a trust or estate that is concentrated so much in real estate, despite the fiduciary law and custom towards asset diversification, is clearly acting in a manner equivalent to a real estate professional, and is not acting in a manner one would expect of a mere passive investor.

   b. For purposes of applying Code section 469(c)(7)(B), when multiple trusts or estates (with a common qualifying fiduciary) own interests in a real estate trade or business, a fiduciary's work in that trade or business should count for each trust or estate in full, without allocating those hours among the trusts or estates. This approach is in concert with other principles described in this overview, and would promote consistency in applying those principles.

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[4] We do not expect this approach to lead to abusive tax planning; but, if necessary, an anti-abuse exception could be adopted once it were to become clear how and why it was needed, rather than drawing distinctions now based merely upon form or on artificial criteria.

9. ***ESBTs and QSSTs***.

   a. The fiduciary income tax of an electing small business trust ("ESBT," or "ESBTs" in the plural) is computed as if it were two separate entities. However, under state law and for all other legal and practical purposes, an ESBT is a single trust. We are not aware of any compelling reason why the determination of the character (passive or nonpassive) of an ESBT's income under the federal passive loss rules should deviate from state law determinations of what constitutes a trust and foundational state-law definitions of trust income.

   b. When a QSST sells its S corporation stock, the sudden automatic turn-off of grantor trust status merits special attention under the passive loss rules.

10. ***Income in the Hands of the Beneficiary***. Once a determination is made at the trust or estate level that income is from an active trade or business, such characterization carries through to the beneficiary level. However, if the trust or estate does not materially participate in the business (i.e., the income is passive), but makes a distribution to a beneficiary who is active, fairness requires that the beneficiary's participation in the business count and serve to recharacterize the income as nonpassive. We believe this approach produces an equitable result for the government and for the taxpayer, avoids the creation of passive income (thus avoiding offsetting passive losses in line with the theory behind the existing recharacterization rules), and minimizes confusion in administering the rules.

List of Recommendations

Recommendation 1. When the "Work" of the Fiduciary is the Work of the Trust or Estate.

We propose that work in a business activity should be considered work attributable to a trust or estate in determining its material participation if performed by a person who is a "qualifying fiduciary".[5] To qualify under our proposal, the person must hold a "substantial related fiduciary power" and personally owe fiduciary duties to the beneficiaries with respect to the power.

   a. A "substantial related fiduciary power" means a material power to influence or direct the business activity in an ownership capacity, such as the voting of stock or the exercise of another kind of authority over management of the business entity owned by the trust or estate; or a direct power to manage the business, such as in a proprietorship; or a power to participate in a decision to sell or expand the business or to change the management of a managing entity. This is intended to

[5] In this context, a "trustee" includes the trustee of a trust (other than a grantor trust or a trust treated as an association taxable as a corporation for purposes of federal income taxation). We believe the considerations relevant to formulating rules for a trustee would also apply to an executor or personal representative or administrator of a decedent's estate, except as noted. The rules should also be similar for other parties who succeed to management of assets in a fiduciary capacity, such as a guardian of an individual, a conservator of an individual's estate, or a receiver for an individual or juridical business or nonbusiness entity. In the case of a guardian or conservator of an individual, for example, the fiduciary acts for and as the individual, and therefore its work in that capacity should be ascribed to the individual for purposes of material participation. Most importantly, unlike for a mere agent, the actions are subject to a fiduciary duty.

distinguish the power from a ministerial duty and power (such as to collect accounting data or to report to other trustees on the filing of claims against a trust or a business owned by a trust) or a duty and power that is unrelated to the trust's or estate's ownership of the business activity (such as a power to manage other assets unrelated to the business).

b. The person should qualify even if (i) the person is not named as a trustee or other traditional fiduciary but instead holds some other position with fiduciary duties towards the beneficiaries, or (ii) the person is not empowered to exercise all of the trust's or estate's ownership rights over the business.

c. The person should qualify even if the person does not have a right to control the trust's or estate's exercise of the power, as long as the person participates in the exercise of the power as a fiduciary. If the power exists, it should not matter whether the person's exercise of the power controls the trust's or estate's actions or is shared with others (such as when the power is shared by three people and is exercised by majority vote).

d. The person should qualify even if the trust or estate does not have a right to control the business as to general matters (e.g., the trust is a minority common shareholder) or special matters (e.g., the trust has special rights under a partnership agreement to approve major decisions along with two other preferred holders, and only one of the co-trustees exercises those rights as a special trustee).

e. A fiduciary duty should be recognized even if it is limited by waivers or exculpatory protections set forth in the trust document or will or under governing law, provided that a judicial or nonjudicial remedy is nonetheless available to the beneficiaries if the breach of fiduciary duty constitutes bad faith or reckless misconduct (or a substantially equivalent standard).

f. For these purposes, the words "business" or "business activity" simply mean a trade or business activity described in Reg. section 1.469-1(e)(2) or 1.469-4(b)(1), or both, without regard for how the business is organized for operating the activity. These comments identify what distinguishes the work of a trustee or other fiduciary, and these recommendations identify how such a person should be treated in determining material participation as compared to an individual taxpayer. How the business itself is organized (e.g., corporation, limited liability company, partnership, proprietorship) can of course affect how the material participation rules apply in the final result, but that is not the purpose of these comments.

Recommendation 2. Aggregation of All Work by Qualifying Fiduciaries.

We propose that all work done in a business activity by qualifying fiduciaries during a taxable year be added together for that taxable year of the trust or estate for purposes of determining material participation, even if done by persons whose role in the trust or estate is not singular and comprehensive, such as serving as a co-trustee, or as a fiduciary for part of the year, or as a trustee when the trustee powers are divided among specialized trustees.

Recommendation 3. *Work by Independent Contractors*.

We propose that work done in the business by an independent contractor engaged by the trust or estate not be attributed to the trust or estate, unless the independent contractor itself owes fiduciary duties directly to the beneficiaries and is exercising a substantial related fiduciary power that binds the trust or estate.

Recommendation 4. *Work by Employees of Fiduciary Entity or Individual*.

We propose that work done by an employee of a fiduciary count as work of the trust or estate if under the governing state law and documents the work is performed in a fiduciary capacity; that is, if the fiduciary-employer is subject to the same fiduciary obligations to the beneficiaries as to the employee's work as would apply if the work were done directly by the fiduciary rather than by the employee. This same rule would apply whether the trustee or other fiduciary is an individual or an entity qualified to serve as a fiduciary under state law. The rule would include all such employees whether or not they are personally participating in the exercise of a "substantial related fiduciary power" as described in Recommendation 1.

Recommendation 5. *Multiple Trusts*.

We propose that, if more than one trust or estate owns an interest in a business and they have at least one qualifying fiduciary in common, all of that person's work in the business counts for each trust or estate in full, without allocating those hours among the trusts or estates.

Recommendation 6. *Tacking to the Participation of the Decedent or a Predecessor Fiduciary*.

We propose that a person's work as trustee should tack to successor trustees and to successor nongrantor trusts of which that person is trustee. This tacking would apply when the passive loss rules look to participation over the course of a year or over the course of several years, even if the trust has converted over that time from a grantor trust to a nongrantor trust or from a nongrantor to a grantor trust. We propose that a decedent's estate be treated as a continuation of the decedent's activities while alive, for the purpose of counting work as participation over the time period in question.

Recommendation 7. *Exception for Real Estate Professional; Alternative Test and Anti-Abuse Requirement for Multiple Trusts*.

In determining whether a trust or estate qualifies as a real estate professional under Code section 469(c)(7), we propose that the two tests under subparagraph (B) of that section continue to apply, and that an alternative test, similar to that available to closely held C corporations (see Code section 469(c)(7)(D)(i)), be available to trusts and estates engaged in one or more real estate businesses.

Additionally and similar to Recommendation 5, we propose that, when multiple trusts or estates own interests in a real estate trade or business, the fiduciary's work in that trade or business count for each trust or estate in full, without allocating those hours among the trusts or estates, for purposes of meeting the tests under Code section 469(c)(7)(B)(i) and (ii). As an anti-abuse requirement, the trusts or estates must have the same settlor or decedent, as the case may be, or have settlors or decedents who are "members of a family," as defined substantially in Code section 1361(c)(1)(B).

Recommendation 8. *ESBTs and QSSTs*.

Although the fiduciary income tax of an ESBT is computed as if it were two separate entities, in substance it is one trust and we propose that it be treated as one trust for purposes of determining the character of its income under the passive loss rules. The determinations to which this proposal applies include whether an activity is passive and whether passive income should be recharacterized under the passive loss rules.

Furthermore, we propose that the passive or non-passive character of the sale of stock by a QSST be based on the beneficiary's participation.[6]

Recommendation 9. *Recharacterization of Income in Hands of Active Beneficiary*.

When a trust or estate materially participates, significantly participates, or is a real estate professional, in a taxable year with respect to an activity, that characterization should carry through in the beneficiary's hands with respect to the taxable income of the trust or estate from the activity allocated to the beneficiary from the taxable year. We propose that, if the trust or estate does not materially participate, does not significantly participate, and is not a real estate professional in an activity such that the income therefrom is passive, but taxable income from the activity is allocated to a beneficiary, then the beneficiary's work in the activity is counted to determine whether the beneficiary materially participates, significantly participates, or is a real estate professional with respect to taxable income from the activity allocated to the beneficiary in the beneficiary's taxable year.

Background and Discussion

Section 1. *Trusts Compared with Business Entities*

When the taxpayer is taxed as a trust, one has already concluded that the taxpayer is not a collection of associates engaged in a joint enterprise. Instead, the taxpayer is managed by one or more fiduciaries for the benefit of the beneficiaries. Analogies to business entities generally do not apply to trusts in this context.

Regulations define trusts:[7]

> *Ordinary trusts*. In general, the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the

[6] On February 26, 2014, we submitted comments on the net investment income tax suggesting an approach consistent with that proposed here. See http://www.actec.org/Documents/misc/ACTEC-Recommendations-for-REG-130843-13-regarding-the-Net-Investment-Income-Tax_02_26_2014.pdf.

[7] Reg. § 301.7701-4(a).

> voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

The regulation makes a clear distinction between a trust, created to protect beneficiaries, and an association, which is a joint enterprise. Indeed, if a person creates a trust for that person's own benefit, generally the trust will be disregarded under the grantor trust rules.[8] Furthermore, a business trust, created by the beneficiaries simply as a device to carry on a profit-making endeavor that normally would have been carried on through a corporation or partnership, might be treated as a business entity.[9] However, if the beneficiaries did not create the trust, the trust

[8] *See* Code § 677.

[9] Reg. § 301.7701-4(b) elaborates:

> [T]he fact that the corpus of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association or partnership. The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real character of the organization if the organization is more properly classified as a business entity under § 301.7701-2.

Rev. Rul. 88-79, 1988-2 CB 361 treated as a business entity the following arrangement:

> Six individuals formed an organization, O, in Missouri, under the terms of an Agreement styled "Royalty Trust Agreement" (Agreement). O was formed for the purpose of buying, holding, and selling oil and gas royalty interests. The six individuals, referred to in the Agreement as the managers, contributed cash to O in exchange for certificates of beneficial interest. The managers of O collectively have substantial assets other than their interests O. Certificates of beneficial interest were sold also to members of the general public pursuant to a public offering registered with the Securities and Exchange Commission. The agreement refers to these public investors as participants. The certificates of beneficial interest represent the right to share in the profits and losses of O and the right to a share of the assets of O upon its liquidation. The managers own 10 percent of the certificates of beneficial interest, and the participants own the remaining 90 percent.
>
> The Agreement provides that the investment activity of O is to be controlled and managed solely by the managers. The managers will determine the timing and amount of distributions from O to the certificate holders. Although the Agreement designates a commercial bank to serve as a trustee of O, the trustee does nothing more than hold legal title to the assets of O. The managers may replace the trustee with another bank at any time.
>
> ….
>
> Under the terms of the Agreement, O has associates and an objective to carry on business and divide the gains therefrom, and, therefore, O is not classified as a trust for tax purposes. Rather, it is classified as a partnership or as an association….

Rev. Rul. 98-37, 1998-2 CB 133, obsoleted Rev. Rul. 88-79 in light of Reg. § 301.7701-4(a), but note 10 indicates that Reg. § 301.7701-4(a) was not intended to change the principles of prior law.

will not be considered a business entity merely because the trustee engages in business operations.[10]

A trust that constitutes a pooling of assets that are actively managed is at risk for being treated as a business entity.[11] For example, the Service ruled that a trust formed by a couple and their grandchildren would not qualify as a charitable remainder trust (or be taxed as any type of trust), because the grantors would be deemed associates who pooled their assets with an object to carry on business and divide the gains therefrom.[12] It also ruled that a trust and subtrusts created for the purpose of exploiting certain patents, which would distribute to the grantors the royalties received from licensing the patents (net of administration expenses and other required payments), were a partnership.[13]

Section 2. What Is a Fiduciary?

The Code defines "fiduciary" as a "guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person."[14] The regulations provide that the term "applies to persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators. A fiduciary is a person who holds in trust an estate to which another has a beneficial interest, or receives and controls income of another" and also includes a "committee or guardian of the property of an incompetent person."[15] An agent in a commercial setting is usually not considered a fiduciary. As the regulations elaborate, an "agent having entire charge of property, with authority to effect and execute leases with

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[10] We are unaware of any case addressing this issue after the adoption of Reg. § 301.7701-4(a). The regulation's preamble, T.D. 8697, provides:

> The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts and business entities, although restated, are not changed by these regulations.

The last major pre-1997 case, *Bedell Trust v. Commissioner*, 86 T.C. 1207 (1986), *acq*. 1987-2 C.B. 1, held:

> We cannot find, where one person has created an entity, unilaterally distributed interests in it to others, and then restricted their ability to transfer their interests, that there exists "a voluntary association of individuals for convenience and profit", which characteristic is the very essence of an association. *Blair v. Wilson Syndicate Trust*, 39 F.2d 43, 46 (5th Cir. 1930)….
>
> We conclude that the beneficiaries, who neither created nor contributed to the trust, whose interests in the trust are not transferable, and only a few of whom participate in the trust affairs, are not associates and their trust is not an association.

The court further commented:

> We understand that the Government regarded this case as a test case in respect of testamentary trusts and trusts engaged in the conduct of a business, and that high levels in the IRS were active in pressing the matter. It is difficult to imagine a more unsuitable vehicle than this case for any such purpose, and we think it regrettable that extensive misguided efforts were exerted to such a fruitless end in this litigation.

[11] See generally HOWARD M. ZARITSKY, NORMAN LANE & ROBERT DANFORTH, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS, ¶ 1.07 The Income Tax Meaning of "Trust" (3rd ed.).

[12] I.R.S. Priv. Ltr. Rul. 9547004 (Nov. 24, 1995).

[13] I.R.S. Priv. Ltr. Rul. 200219017 (May 10, 2002).

[14] Code § 7701(a)(6). Code § 7701(a) applies to Code § 469 when not otherwise distinctly expressed or manifestly incompatible with that section's intent.

[15] Reg. § 301.7701-6(b)(1).

tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary" under this definition.[16]

Section 3. Who Acts in a Fiduciary Capacity?

A trust or estate is a fiduciary relationship as to property, when persons holding legal title to the property owe fiduciary duties to the beneficiaries.[17] The common understanding is that acting in a "fiduciary capacity" means acting while subject to fiduciary duties. A trustee or executor is subject to numerous fiduciary duties, including:

- the duty to take and keep control of the property;
- the duty to administer the trust or estate at a reasonable cost;
- the duty of loyalty to avoid conflicts of interest;
- the duty of care in investments including standards for managing risk, such as diversification;
- the duty to furnish information to the beneficiaries;
- the duty to deal impartially with beneficiaries.

Identifying the persons who are subject to fiduciary duties toward the beneficiaries is a matter of state trust law, rather than federal tax law. The federal revenue law "creates no property rights, but merely attached consequences, federally defined, to rights created under state law."[18]

Identifying the persons subject to fiduciary duties, whose work could be counted as participation in a business, must necessarily be made on a case-by-case basis through a factual and legal inquiry. Ordinarily this process is simple: in most trust instruments, for example, there will be one or more trustees identified, and they would be the only fiduciaries. However, the rules must also accommodate those trusts in which, under modern trust law, fiduciary duties owed to beneficiaries may be divided or possessed jointly among multiple parties. Those parties may be individuals or entities, and it is not as simple as looking at titles such as "trustee." Fiduciary duties might be owed by a trust director,[19] advisor, protector, agent,[20] or others. In addition,

[16] Reg. § 301.7701-6(b)(2).

[17] George Gleason Bogert & George Taylor Bogert, The Law of Trusts And Trustees § 1; Restatement (First) of Trusts § 2 (1935); Restatement (Second) of Trusts § 2 (1959); Restatement (Third) of Trusts § 2 (2003).

[18] *See* Saltzman v. Comm'r, 131 F.3d 87, 89 (2d Cir. 1997) (citing United States v. National Bank of Commerce, 472 U.S. 713, 722 (1985) (quoting United States v. Bess, 357 U.S. 51 (1958)).

[19] Under the Uniform Trust Code the holder of the power to direct is presumptively acting in a fiduciary capacity with respect to the powers granted and can be held liable if the holder's conduct constitutes a breach of trust. *See* Unif. Trust Code § 808.

duties will not be defined strictly by the capacity in which an action is taken. When a person serves as trustee of a trust that owns a business, and also an officer or director of the business, the person may owe duties to the beneficiaries even when the action is taken in the capacity as officer or director, and not as trustee.[21]

The core question remains straightforward: Is the actor accountable to the beneficiaries while acting with respect to the business? If the answer is yes, the actor is subject to fiduciary duties to the beneficiaries and acts in a fiduciary capacity. The inquiry develops as follows:

(1) The starting point in the inquiry is the governing trust instrument. The governing instrument oftentimes will establish the positions that have fiduciary duties with respect to a business. In addition to the position of trustee, additional positions may, by way of example, include directors, advisors, or protectors. The instrument may also address the extent to which the trustee or executor may delegate its responsibilities to others, such as to other trustees or agents, and address whether the trustee or executor will be relieved of fiduciary duties when directed or upon delegation. The instrument may also seek to define or limit the duties of fiduciaries.

(2) The terms of the instrument must then be reconciled with state law that may limit, expand, or invalidate the trust terms. The trust terms may be modified (or vitiated) under state law, and the following examples are neither exclusive nor exhaustive. State law may or may not allow the settlor to completely exonerate any trustee or other fiduciary from accountability to the beneficiaries.[22] It is not unusual for a trust or will to protect a fiduciary from personal liability for negligence, especially if the fiduciary is an individual rather than a trust company; and, generally speaking, such a clause will be upheld under state law. However, an exculpatory provision is invalid as a general rule if it applies to fiduciary conduct that constitutes bad faith, willful or intentional wrongdoing, or actions taken with reckless indifference to the trust purposes and interests of the beneficiaries.[23] State trust law usually also mandates, or creates a

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[20] State law may authorize a trustee to delegate duties and powers of the trustee to an agent (reversing the common law rule prohibiting any delegation), and may subject the agent to duties to the beneficiaries. *See, e.g.,* UNIF. TRUST CODE § 807; UNIF. PRUDENT INVESTOR ACT § 9.

[21] The court in *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014) found that the person who was the trustee of the trust for which material participation was relevant was clothed with fiduciary duties to the trust while acting as an employee of its wholly owned limited liability company. Accordingly, the work performed as an employee of the wholly owned limited liability company counted toward satisfaction of material participation of the trust in the activity. *See also* AMY MORRIS HESS & GEORGE G. BOGERT, BOGERT TRUST AND TRUSTEES § 543 (Westlaw Dec. 2012 ed.) ("Where a trust holds all or a part of the stock of a corporation and the trustee either personally owns the balance of the stock or, by reason of the trust's stock ownership, becomes an officer and director of the corporation, the trustee may occupy one or more conflict of interest positions. His duty of undivided loyalty to the trust may be impaired by his personal interest as an individual stockholder or by his personal interest as an officer and director, or by both such personal interests. In such a case the trustee must be careful not to favor his individual interests or the interests of the corporation (or its other stockholders) at the expense of the trust and its beneficiaries. A number of court decisions illustrate the application of both trust and corporate standards towards the resolution of these conflict of interest problems").

[22] *See, e.g.,* RESTATEMENT (THIRD) OF TRUSTS § 96; UNIF. TRUST CODE § 1008. *See also* 35 DEL. LAWS § 3303 ("[N]othing contained in this section [dealing with the provisions of a governing instrument] shall be construed to permit the exculpation or indemnification of a fiduciary for the fiduciary's own wilful misconduct.")

[23] UNIF. TRUST CODE § 105(b).

default rule, as to whether a person, with authority to direct the trustee, is subject to fiduciary duties owed to beneficiaries.[24]

(3) State law may further provide that a trustee is accountable to the trust beneficiaries even when the trustee acts in another capacity (such as an employee or director) with respect to a business held as a trust asset.[25] While state law or the instrument may permit co-trustees to delegate responsibility among each other, in the absence of an enforceable trust term to the contrary, state law may impose on the delegating trustee a continuing duty to monitor the conduct of the co-trustee and act to prevent or seek redress for a serious breach of trust.[26] Alternatively, state law may also provide for the appointment of a special trustee with exclusive duties with respect to an asset, or may allow a settlor to establish this structure.[27] When state law allows a trustee to delegate duties and powers to an agent, the trustee may have a duty of care in making the delegation and an ongoing duty to monitor the agent and enforce the terms of the delegation.[28] The agent may also have fiduciary duties to the beneficiaries by accepting the delegation.[29]

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[24] *See, e.g.* UNIF. TRUST CODE § 808 ("A person, other than a beneficiary, who holds a power to direct is presumptively a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The holder of a power to direct is liable for any loss that results from breach of a fiduciary duty."); VA. CODE ANN. § 64.2-770 ("Notwithstanding anything in the trust instrument to the contrary, the trust director shall be deemed a fiduciary who, as such, is required to act in good faith with regard to the purposes of the trust and the interests of the beneficiaries. The trust director is liable for any loss that results from a breach of the trust director's fiduciary duty").

[25] See, e.g., RESTATEMENT (THIRD) OF TRUSTS § 78; UNIF. TRUST CODE §802(g) cmt. ("When the trust owns the entirety of the shares of a corporation, the corporate assets are in effect trust assets that the trustee determines to hold in corporate form. The trustee may not use the corporate form to escape the fiduciary duties of trust law"); *Fruehauf Trailer Corp. v. Street*, 431 B.R. 838 (Bankr. C.D. Cal. 2010) ("This Court rejects Defendant's position that the 'business judgment rule' applies to a trust. Once a trust relationship is established between a beneficiary and a trustee managing a corporation for a trust, the fiduciary standards of care apply to his conduct regarding the affairs of the corporation"); *Saltzman v. Comm'r*, 131 F.3d 87 (1997) ("[P]ursuant to the inexorable dictates of trust law, they also were acting in their capacities as trustees who owed the trust beneficiaries the absolute duty of undiluted loyalty. A trustee cannot 'alter his legal position by changing his cloak.' Although a trustee, in the course of his administration, may become an officer of a corporation, his duties as a corporate officer do not supplant or mitigate the duties he owes the trust beneficiaries"); *Matter of Butterfield*, 418 Mich. 241 (1983) ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy. To allow them to do so would inhibit the probate court's duty to supervise a testamentary trust"); *Matter of Moot*, 285 A.D. 785 (1955) ("[A] trustee whose conduct as officer and director is motivated by self-interest, to the injury of beneficiaries whose welfare should be his sole concern, is guilty of a breach of trust and should be surcharged"). A small number of cases, including *Rollins v. Rollins*, 294 Ga. 711 (2014) and *Estate of Halas*, 209 Ill.App.3d 333 (1991), have declined to apply a strict fiduciary standard of care to a fiduciary's actions as an officer, director, or manager of a business, where the court specifically found from the circumstances that the settlor did not intend that standard of care to apply.

[26] *See, e.g.,* 35 DEL. LAWS § 3322 (2015); FLA. STAT. ANN. § 518.112 (West 2007) and § 736.0807(2)(c) (West 2010); 760 ILL. COMP. STAT. 5/5.1(b) (2015).

[27] *See, e.g.,* UNIF. TRUST CODE § 808(b); 35 DEL. LAWS §3313 (2015); FLA. STAT. ANN. § 518.112 (West 2007) and 736.0808(2) (West 2010); 760 ILL. COMP. STAT. 5/16.3 (2015).

[28] *See, e.g.,* 35 DEL. LAWS § 3313(e) (2015); 760 ILL. COMP. STAT. 5/5.1(b) (2015).

[29] *See, e.g.,* 760 ILL. COMP. STAT. 5/5.1(b) ("The investment agent shall be liable to the beneficiaries of the trust to the same extent as if the investment agent were a designated trustee in relation to the exercise of non-exercise of the

There are many possible variations in modern trust construction and state law, but a handful of common examples may best illustrate how the intersection of the trust terms and state law will also affect the determination of whether a person is acting in a fiduciary capacity when participating in a business owned by a trust. In these examples, our proposed conclusion that a person is working in a fiduciary capacity means that the person's work counts as participation by the trust (if that work is of the type that qualifies as participation).

Example 1. Trustee takes actions with respect to a business (held in trust) both directly and through an agent. Under state law, both the trustee and the agent are each accountable to the beneficiaries for the agent's actions, and the trust terms do not effectively override the state law. The trustee and agent are both acting in a fiduciary capacity with respect to the business.

Example 2. The trustee takes actions with respect to a business (held in trust) both directly and through an employee of the trustee. Under state law, the trustee is accountable to the beneficiaries for the employee's actions as if the trustee had acted personally, but the employee is not accountable to the beneficiaries, and the trust terms do not effectively override the state law. Because the trustee is responsible for the employee's work to the same extent as if done directly by the trustee, the work is subject to a fiduciary obligation to the beneficiaries.

Example 3. Under the trust instrument, the trustee's actions with respect to the business held in trust are fully directed by a "trust director" who is accountable to the beneficiaries under the trust terms or state law (but not to the trustee), the trustee has no accountability to beneficiaries with respect to the business, and the trustee has no authority over the business other than tasks such as gathering information needed for the trust's recordkeeping and filing tax returns. State law does not invalidate the trust terms that completely eliminate the trustee's responsibility for the business or the director's actions. The trustee is not acting in a fiduciary capacity with respect to the business. The trust director is acting in a fiduciary capacity with respect to the business. The same result would apply if the trust director were called a special trustee or given any other label.

Example 4. Same facts as Example 3, except the trust terms that completely eliminate the trustee's liability are invalid under state law and the trustee has a duty to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries. The trustee and director (or special trustee, etc.) are acting in a fiduciary capacity with respect to the business.

Example 5. The trustee delegates all duties with respect to business to a co-trustee, other than ministerial duties. The co-trustee is accountable to the beneficiaries, but under the trust terms, the delegating trustee is relieved of all responsibility for the business and state law does not invalidate those trust terms. With respect to the business, the delegating trustee is not acting in a fiduciary capacity and the co-trustee receiving the delegation is acting in a fiduciary capacity. The delegating trustee would also be acting in a fiduciary capacity if under state law the delegating trustee nevertheless has a duty to monitor the co-trustee and redress a breach of trust by the co-trustee with respect to the business.

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investment function."); FLA. STAT. ANN. § 736.0807(2) (West 2010) ("In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.")

Example 6. The same individual personally serves as (a) a trustee of a trust that controls the business (or controls an entity that exercises its authority over the business) and (b) an officer of the business (or entity). Under state law, the trustee is accountable to trust beneficiaries for actions taken as an officer. The person is acting in a fiduciary capacity both when acting as a trustee and when acting as an officer with respect to the business.[30] The same result applies whether or not the individual controls the trust decisions as to the business and whether or not the trust controls the business.

Section 4. What Counts As Participation under Current Law

Material participation is determined generally under Code section 469(h) and the Temporary Treasury Regulations promulgated thereunder.[31] Subject to certain exceptions,[32] any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done is treated as participation of the individual in the activity.[33] The material participation rules are based on the number of hours the taxpayer participates in the activity.

4a. **Individuals**

An individual is treated as materially participating in an activity for the taxable year if and only if:[34]

(1) The individual participates in the activity for more than 500 hours during such year;
(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals

[30] We recognize that this conclusion is inconsistent with Technical Advice Memorandum 201317010 (April 26, 2013), though it is consistent with the Tax Court's holding in *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014). The TAM did not focus on the officer's fiduciary duties to the beneficiaries, nor did it focus on the fact that the trustee's rights with respect to the stock constituted all of the rights any shareholder generally would have. The TAM's approach makes it difficult for a trust owning shares in an S corporation to participate. This difficulty is not insurmountable. *See* Steven B. Gorin & Richard E. Barnes, *Trustee Material Participation in Businesses: A Surprising Way to Overcome TAM 201317010 and Avoid the NII Tax*, PROB. & PROP., March/April 2015, at 58. We respectfully suggest that the government not require taxpayers to go to the efforts described in that article (which also increases a taxpayer-trust's exposure to liability) in order to materially participate.

[31] *See e.g.*, Reg. §§ 1.469-5T(a) (material participation generally); 1.469-2T(f)(2) (anti-passive income generators); 1.469-2(f)(6) (self-charged rents); 1.469-7(c) (self-charged interest); and 1.469-5T(k), Example (1) (attribution).

[32] For example, work does not count as participation for purposes of the material participation test if the work is performed by an individual in the individual's capacity as an investor in the activity, unless the individual is directly involved in the activity's day-to-day management or operations. Such work includes: (1) studying and reviewing financial statements or reports on operations, (2) preparing or compiling summaries or analyses of the finances or operations for the individual's own use, and (3) monitoring the finances or operations in a non-managerial capacity. Reg. § 1.469-5T(f)(2)(ii). Additionally, providing to an entity legal, tax, or accounting services as an independent contractor or as an employee does not count as participation. See the Committee Reports for Senate Bill 99-313, P.L. 99-514.

[33] Reg. § 1.469-5(f)(1). As noted previously, the parentheticals at the end of Reg. § 1.469-5T(a)(2) and (3) seem to imply that participation is done only by an owner.

[34] Reg. § 1.469-5T(a).

(including individuals who are not owners of interests in the activity) for such year, if the owner is not a limited partner;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year, if the owner is not a limited partner;

(4) The activity is a significant participation activity[35] for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours, if the owner is not a limited partner;

(5) The individual materially participated in the activity (determined without regard to this clause) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances,[36] the individual participates in the activity on a regular, continuous, and substantial basis during such year, if the owner is not a limited partner.

An individual is not treated as a limited partner for the individual's taxable year if that individual also holds a general partner interest in the partnership at all times during the entity's taxable year.

Proposed regulations would treat an interest in an entity (such as in a limited liability company) as a limited partner interest in a limited partnership if:

(1) The entity in which such interest is held is classified as a partnership for federal income tax purposes under the check-the-box regulations; and

[35] Reg. § 1.469-5T(c) provides that an activity is a significant participation activity of an individual if and only if such activity is a trade or business activity (within the meaning of Reg. § 1.469-1T(e)(2)) in which the individual participates for more than 100 hours during the taxable year and would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to the significant participation activity rules.

[36] Reg. § 1.469-5T(b)(2) does not specify the facts and circumstances but applies the following rules in determining the facts and circumstances: The fact that an individual satisfies the requirements of any participation standard (whether or not referred to as "material participation") under any provision other than the passive loss rules shall not be taken into account in determining whether such individual materially participates for purposes of the passive loss rules. Furthermore, an individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under this "facts and circumstances" rule unless, for such taxable year: (1) no person (other than such individual) who performs services in connection with the management of the activity receives prohibited compensation (wages, salaries, or professional fees, and other amounts received as compensation for personal services actually rendered) in consideration for such services, and (2) no individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual. Finally, the individual must participate in the activity for more than 100 hours during the taxable year.

(2) The holder of such interest does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement.

A taxpayer's activities include those conducted through C corporations that are subject to Code section 469, S corporations, and partnerships.[37]

4b. **Nongrantor Trusts**

Although the Treasury Regulations do not address material participation by a nongrantor trust, the legislative history provides that "[a]n estate or trust is treated as materially participating in an activity (or as actively participating in a rental real estate activity) if an executor or fiduciary, in his capacity as such, is so participating."[38] The core question then is: when is a fiduciary acting in that capacity? As already indicated in these comments, we believe the actions should be considered taken in a fiduciary capacity whenever those actions are subject to fiduciary duties to the beneficiaries. As background to our analysis, we describe here the cases, rulings and other guidance to date that has addressed this question, explicitly or implicitly.

Whether material participation should be based only on actions taken directly by the trustee or whether actions by others, such as an agent, should be considered, was litigated in *Mattie K. Carter Trust v. United States*.[39]

In *Mattie Carter*, the Service argued that "material participation" should be based on the trustee's actions alone. However, the court agreed with the taxpayer that it should be tested by whoever participates on behalf of the trust, which in this case included two people to whom the trustee delegated functions: (1) a full-time ranch manager whose actions were subject to the trustee's approval, and (2) a beneficiary who supervised the manager and general ranch operations.

Technical Advice Memorandum 200733023 (Aug. 17, 2007) rejected the Court's holding in *Mattie Carter* and instead asserted:

> What is apparent from the line of authority in this area is that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. Although Trust represents that Special Trustees were heavily involved in the operational and management decisions of Business, Special Trustees — like the banks in Revenue Ruling 82-177 and *Anderson* — were ultimately powerless to commit Trust to any course of action or control Trust property without the express consent of Trustees. The contract between Trust and Special Trustees is explicit

[37] Reg. § 1.469-4(a). *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), applied this regulation to count activity through a C corporation that was subject to Code § 469 even though the regulation was promulgated in the context of grouping activities together. Presumably it reached that result because grouping of activities is mandatory to a certain extent; see Reg. § 1.469-4(d)(5)(i), which provides:

> *In general*. A C corporation subject to section 469, an S corporation, or a partnership (a section 469 entity) must group its activities under the rules of this section.

[38] S. Rept. No. 99-313, at 735 (1986), 1986-3 C.B. (Vol. 3) 1, 735.

[39] 256 F.Supp.2d 536 (N.D. Tex. 2003).

> on this point, and Trust itself has acknowledged that Trustees retained final decision-making authority with regard to all facets of Business. The services performed by Special Trustees appear to be indistinguishable from those that would be expected of other non-fiduciary business personnel. If advisors, consultants, or general employees can be classified as fiduciaries simply by attaching different labels to them, the material participation requirement of § 469 as applied to trusts would be meaningless.

Private Letter Ruling 201029014 (July 23, 2015) involved a trust that owned a partnership interest. The partnership was the sole owner of another entity, which in turn was the sole owner of the ultimate subsidiary. The ruling held that the trust may materially participate in the subsidiary's activities if the trustee is involved in the operations of the subsidiary's activities on a regular, continuous, and substantial basis. The ruling did not mention the *Mattie K. Carter Trust* case or address whether any formalities were needed to establish participation as the trustee rather than participation as an individual.

The Service's Audit Techniques Guide discusses the topic as follows, in part:[40]

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

Although the Audit Techniques Guide does not focus on whether the trustee's participation is in the trustee's fiduciary capacity, as stated below, Technical Advice Memorandum 201317010 (April 26, 2013) did focus on that issue, finding no material participation:

> Notwithstanding the decision in *Mattie K. Carter*, the Service believes that the standard annunciated in the legislative history is the proper standard to apply to trusts for purposes of § 469(h). Thus, 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*, [emphasis added] are involved in the operations of the relevant activities of Company X and Company Y on a regular, continuous, and substantial basis.
>
> A fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. *United States v. Anderson*, 132 F.2d 98 (9th Cir. 1942). Although the Trusts represent that 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 Trust A and Trust B 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

[40] Chapter 6, Exhibit 6.1.

> and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). 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 does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 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. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.

In contrast, the Tax Court recently held in *Frank Aragona Trust v. Commissioner*[41] that, when a nongrantor trust created its own LLC to manage a business and the trustees themselves were paid by the LLC for managing the business, the trust was able to count as participation the trustees' work as managers of the LLC. The court did not ignore the LLC (which was a disregarded entity for income tax purposes). In holding that the trustees were working for the trust (for income tax purposes), the court focused on the trustee's duties to the beneficiaries of the trust when working for the LLC.[42] Though distinguishable from TAM 201317010, the case challenges the premise of the TAM that a trustee who acts as an individual is not also serving as a trustee.

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[41] 142 T.C. 165 (2014). The petition, reply, and briefs are at:

http://tcinstitute.com/rv/ff0012e61ef3812cbb3202812343b05e2fbe2da8/p=3879220.

[42] The court said:

> Even if the activities of the trust's non-trustee employees should be disregarded,[15] 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 trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also *In re Estate of Butterfield*, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302). Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. *Cf. In re Estate of Butterfield*, 341 N.W.2d 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."). Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.[16]

(Footnotes to quoted excerpt:)

> [15]We need not and do not decide whether the activities of the trust's non-trustee employees should be disregarded.
>
> [16]We need not consider the effect of sec. 469(c)(7)(D)(ii), which provides that for purposes of sec. 469(c)(7)(B) personal services performed as an employee are generally not treated as performed in real-property trades or businesses. This rule has no application to the resolution of this case because, as we

4c. **Grantor Trusts**

The grantor of a grantor trust is treated as the owner of that trust for income tax purposes.[43] The Audit Techniques Guide states that "[s]ince tax law does not recognize a grantor trust as a separate taxable entity, the examiner should ignore the trust entirely and look to the grantor (individual taxpayer) to determine material participation." Similarly, QSSTs "are generally grantor trusts in which the grantor is frequently a parent and the beneficiary is a child. The examiner should look to the beneficiary (child) to determine material participation."[44] We agree with these principles.

4d. **Death, Trust Terminations, Gifts, and Changes in Grantor Trust Status**

If an interest in the activity is transferred by reason of the death of the taxpayer, generally losses are allowed to the extent such losses are greater than the excess (if any) of the basis of such property in the hands of the transferee, over the adjusted basis of such property immediately before the death of the taxpayer, but any losses to the extent of that excess are not allowed as a deduction for any taxable year.[45]

Code section 469(j)(12) provides that, when an estate or trust terminates, any passive losses suspended under Code section 469 will be permanently disallowed for deduction purposes, but will be added to the basis of the passive activity interest. Similarly, with regard to a gift of a passive activity interest, Code section 469(j)(6) requires a basis increase by the amount of the losses allocable to the passive interest, with no income tax deduction.

There is no clear guidance on how passive activity losses accumulated within a trust are treated when there is a change in grantor trust status. If, for instance, a nongrantor trust has accumulated passive losses and is transformed to a grantor trust, the losses could be treated in one of the following ways: (1) they could be suspended until disposition of the activity interest to an

explain *infra*, the IRS has confined its challenges to the trust's qualification for sec. 469(c)(7) treatment to two challenges: (1) that trusts are categorically barred from sec. 469(c)(7) treatment, and (2) the trust did not materially participate in real-property trades or businesses. Thus, we need not, and do not, determine how many hours of personal services were performed by the trust in real-property trades or businesses. We also note that the IRS does not cite sec. 469(c)(7)(D)(ii) in its brief.

[43] S. Rept. No. 99-313, at 735 (1986), 1986-3 C.B. (Vol. 3) 1, 735, fn 21. *See also* Reg. § 1.1411-3(b)(1)(v).

[44] The footnote to this statement in the Audit Techniques Guide reads "[s]ee IRC § 1361(d) in which the beneficiary elects to be treated as the owner of the trust for purposes of IRC § 678." Chapter 6, Exhibit 6.1. The guide supports these positions by referencing Treasury Regulation section 1.469-1T(b)(2), Revenue Ruling 85-13, 1986-1 C.B. 184, and The General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, Note 33, page 242 ("Similarly, in the case of a qualified electing Subchapter S trust (§ 1361(d)(1)(B)) that is treated as a grantor trust (*i.e.*, the beneficiary is treated as the owner for tax purposes), the material participation of the beneficiary is relevant to the determination of whether the S Corporation's activity is a passive activity with respect to the beneficiary.") Additionally, a footnote in the legislative history provides that one looks to the participation of the deemed owner of a grantor trust rather than to the trust's participation.

[45] Code § 469(g)(2).

unrelated party, (2) they could be disallowed as a deduction but added to basis, or (3) they could be lost.[46]

Application of the material participation safe harbors under Reg. section 1.469-5T is also uncertain with respect to a taxpayer's death or a change in grantor trust status. For example, paragraph (a)(5) of that section provides that an individual who materially participates in an activity (determined without regard to paragraph (a)(5)) "for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year," is treated as materially participating in that activity. However, there is no guidance as to whether material participation by an individual would, upon death, tack with respect to his estate or revocable trust, or whether it would tack in the circumstance in which the activity generating the loss is owned by the individual's grantor trust that becomes a nongrantor trust. Similarly, it is unknown whether the material participation of a trustee of a nongrantor trust would tack with regard to the grantor if that trust became a grantor trust.

Recommendations

Recommendation 1. When the "Work" of the Fiduciary is the Work of the Trust or Estate.

Recommendation

We propose that work in a business activity should be considered work attributable to a trust or estate in determining its material participation if performed by a person who is a "qualifying fiduciary". To qualify under our proposal, the person must hold a "substantial related fiduciary power" and personally owe fiduciary duties to the beneficiaries with respect to the power.

a. A "substantial related fiduciary power" means a material power to influence or direct the business activity in an ownership capacity, such as the voting of stock or the exercise of another kind of authority over management of the business entity owned by the trust or estate; or a direct power to manage the business, such as in a proprietorship; or a power to participate in a decision to sell or expand the business or to change the management of a managing entity. This is intended to distinguish the power from a ministerial duty and power (such as to collect accounting data or to report to other trustees on the filing of claims against a trust or a business owned by a trust) or a duty and power that is unrelated to the trust's or estate's ownership of the business activity (such as a power to manage other assets unrelated to the business).

b. The person should qualify even if (i) the person is not named as a trustee or other traditional fiduciary but instead holds some other position with fiduciary duties towards the beneficiaries, or (ii) the person is not empowered to exercise all of the trust's or estate's ownership rights over the business.

[46] If one posits that the economic loss should flow to the party bearing the loss, and that a change in trust status is likened to a (nontaxable) disposition, the premise underlying Code § 469(g) would suggest that the transfer of a passive activity to a related party is suspended until the activity interest out of which the loss arises is sold to an unrelated party. *See* Laura H. Peebles, *Feature: Estate Planning & Taxation*, TRUSTS & ESTATES, September 2008, at 17-18.

c. The person should qualify even if the person does not have a right to control the trust's or estate's exercise of the power, as long as the person participates in the exercise of the power as a fiduciary. If the power exists, it should not matter whether the person's exercise of the power controls the trust's or estate's actions or is shared with others (such as when the power is shared by three people and is exercised by majority vote).

d. The person should qualify even if the trust or estate does not have a right to control the business as to general matters (e.g., the trust is a minority common shareholder) or special matters (e.g., the trust has special rights under a partnership agreement to approve major decisions along with two other preferred holders, and only one of the co-trustees exercises those rights as a special trustee).

e. A fiduciary duty should be recognized even if it is limited by waivers or exculpatory protections set forth in the trust document or will or under governing law, provided that a judicial or nonjudicial remedy is nonetheless available to the beneficiaries if the breach of fiduciary duty constitutes bad faith or reckless misconduct (or a substantially equivalent standard).

f. For these purposes, the words "business" or "business activity" simply mean a trade or business activity described in Reg. section 1.469-1(e)(2) or 1.469-4(b)(1), or both, without regard for how the business is organized for operating the activity. These comments identify what distinguishes the work of a trustee or other fiduciary, and these recommendations identify how such a person should be treated in determining material participation as compared to an individual taxpayer. How the business itself is organized (e.g., corporation, limited liability company, partnership, proprietorship) can of course affect how the material participation rules apply in the final result, but that is not the purpose of these comments.

Discussion

Although a separate taxpayer for federal income tax purposes, a nongrantor trust is not an entity for state property or fiduciary law purposes, but is rather a form of ownership that separates the legal interest held by the fiduciary from the beneficial interest of the beneficiaries.[47] Thus, the trustees, rather than the "trust," work in an activity in which the trust owns an interest. How they participate will vary depending upon the number and type of trustees, whether there are fiduciaries not named as trustees, and how the governing state law and trust document allocates powers and duties.

Trustee arrangements vary widely and include sole trustees, multiple trustees, trustee(s) delegating to an agent, trustee(s) directed by another party, and trustees overseen by a protector. In each case, these positions may be filled by individuals or entities (which range from private trust companies to financial institutions with substantial trust departments). No one would contend that the material participation concept under the Code was designed to either advance or

[47] Some states, by statute, treat trusts as entities for certain purposes not relevant here.

hinder the freedom of settlors to select among these choices. Accordingly our recommendation is intended to adapt to a wide variety of trustee structures.

This approach is further made necessary by modern fiduciary and business practice that permits and even encourages specialized roles. In addition to the classic role of the trustee with comprehensive powers, many other fiduciary roles (and titles) are increasingly being employed – advisor, protector, director – with fiduciary duties attached to these positions under the governing instrument or state law. Obviously a single individual taxpayer necessarily exercises the totality of his or her ownership rights, but modern trust law permits the trust document to divide powers so that specified powers are to be exercised only by one of several fiduciaries. Furthermore, co-trustees who act in the business may have different positions when managing the business activity, each with a separate scope of authority, such as one trustee who sets the budget for the business activity and one trustee who manages the business based on that budget. It would not be unusual for two siblings active in a business in different positions to serve as co-trustees of trusts established by their parents that own the business. The trust might provide that one sibling's role as co-trustee is limited to approving only major decisions as to the business while the other co-trustee exercises more comprehensive authority. Even if co-trustees have plenary authority, over time their roles might evolve into more specialized roles. Authority can be shared or divided at both the trust level and the business level. We respectfully suggest that this division of duties should not place the trust in a worst tax position than it would be in if it had just one trustee.

Therefore the core objective of our Recommendation 1 is to avoid labels and rules suited for only a limited number of cases. Instead, we recommend considering whether a person who has a role at the trust and business level (1) personally owes fiduciary duties to the trust beneficiaries and (2) holds a "substantial related fiduciary power" under the trust. If a person satisfies both prongs, that person is a qualifying fiduciary: that is, the person's work should be counted as work of the trust in determining whether the trust is materially participating. The same principle would apply to estates. For simplicity, the discussion here will be framed in terms of trusts.

The existence of the fiduciary duty is what distinguishes the trustee or other fiduciary acting for the trust from an independent contractor (such as an independent management company for a rental property) who owes no such duty. [48] Thus under our recommendation a person who works in the business cannot be a qualifying fiduciary unless the person holds a substantial related fiduciary power under the trust, which means a power such as the voting of stock that the trust owns in the business entity that operates the business or that manages the operating entity, or the exercise of management rights in some other form, as compared to a ministerial duty and power or a duty and power that are unrelated to the trust's ownership of the business interest.

[48] In this context, we derive the meaning of "independent contractor" from agency law rather than under Code precedents. In using the term "fiduciary duty," we mean the duties that apply under trust law, subject to being modified by the trust instrument to some degree. Generally speaking a trustee is under a duty to act for the best interest of the trust beneficiaries and is responsible for all decisions relating to the trust, absent an authorized delegation or direction. A trustee is subject to numerous fiduciary duties, including: the duty to administer the trust; the duty of loyalty; the duty to take and keep control of trust property; the duty to make the trust property productive; the duty to exercise reasonable care and skill in selecting trust investments; the duty to preserve the trust property for the benefit of the beneficiaries; the duty not to delegate the administration of the trust; the duty to furnish information to the beneficiaries; and the duty to deal impartially with beneficiaries.

In our analysis as stated earlier the goal of the material participation regulations as applied to trusts should be to parallel the role of the individual owner while recognizing the division of title and authority in a trust, and we believe our fundamental recommendation meets that goal. To be a qualifying fiduciary, the fiduciary must have authority to exercise one or more substantial ownership rights of the trust <u>with respect to the business</u> and be legally obligated to exercise that authority for the benefit of the beneficiaries in a <u>meaningful</u> way. For example, the right to vote is such a substantial right even if the trust owns a non-controlling interest and the voting rights of the trust are allocated among multiple fiduciaries. This is consistent with existing law that allows the work of limited partners to qualify as participation even though they cannot exercise the partnership's voting rights as an owner and usually have limited voting rights as partners. Existing law also allows actively participating holders of nonvoting stock to count their hours as participation, and an equivalent rule should apply for trustees as well.

The fiduciary who holds this authority possesses a substantial related fiduciary power, even if that person cannot exercise all of the substantial rights over the business held by the trust. All of the work of all qualifying fiduciaries should be taken as a whole in determining the participation of the trust because in the aggregate they represent the actions of the trust. These persons are acting for the trust, and thus should not to be treated as if they were acting for their own account or were separate fiduciaries acting for separate trusts. Persons that owe fiduciary duties under the trust may further be working in various officer and director positions, and unless the work done by these persons is aggregated, the results will be inconsistent with the treatment applied to a single taxpayer owning a proprietorship or the treatment of individuals who are owners of pass-through entities and who take an active role in the business owned by the entity.

Under this recommendation, the work done in the business by a qualifying fiduciary would be considered work of the trust. This is a practical necessity in our view. It is difficult, if not impossible, to determine when work done by an individual in a business owned by the trust is work carried out as a trustee or individually. The law does not neatly separate those roles in distinguishing duties owed to trust beneficiaries.

(1) No rule allows the trustee to be involved with any trust business and simply "opt out" of his or her fiduciary obligations at any given time. Most state laws governing a trustee's fiduciary duties impose a continuing duty on the trustee to act in the best interest of the trust's beneficiaries at all times – even when not expressly acting on behalf of the trust. State laws are also notably vague or entirely silent as to how to resolve conflicting obligations when the person must act in dual roles without relying on a recusal.

(2) Because under state law the trust does not exist separate from the trustee, it is impossible for the trust to act other than through the trustee. The trustee does not act in the same agency capacity as a corporate officer, who is working <u>for</u> a corporation, but in effect the trustee <u>is</u> "the trust" (in this sense) and for that reason the trust cannot act other than through the trustee; and due to the ongoing fiduciary obligations, the trustee cannot effectively act as anything other than the trust when the business involved is a trust asset. In contrast, the general partner of a limited partnership controls the partnership, but is not the partnership itself. A trust does not exist independent of the trustee so the actions of the trustee are the actions of the trust.

(3) Because an individual who is a trustee of a trust that owns an interest in an activity does not stop being a fiduciary solely by reason of being in multiple roles (*e.g.,* an

individual owner of an interest in the activity, an officer or director of a corporation), and because that individual is "the trust," the work by the individual in the business activity may appropriately be included in the measure of the trust's participation in the activity. [49]We do not take the position that the capacity in which the work is done is irrelevant. The Senate Report accompanying the 1986 Tax Reform Act, which included Code section 469, states that an estate or trust is deemed to materially participate in an activity "if an executor or fiduciary, in his capacity as such, is so participating."[50] Instead we believe our recommended formulation can be used to properly define what work done in the business is to be considered work in that capacity as such and thus work of "the trust." The person doing the work must owe a fiduciary duty to the beneficiaries and must have the requisite related trust powers over the business or business interest.

As noted earlier, so long as the person participates in decisions as a fiduciary, the person does not need to have the right to control unilaterally the trust's exercise of the power in order for the person's actions to count as participation for the trust. If the power exists, the effectiveness of its exercise is not relevant. The power can be shared with others under the trust, whether they are co-trustees or other parties, and so long as the power truly exists, we do not believe it is practical to adopt a rule that measures the qualitative exercise of the power. This treatment is consistent with existing law that allows a limited partner or fractional owner of a business interest to qualify even if they cannot possibly control the interest as a matter of right.[51] Similarly the work of the person qualifies even if the trust does not have a right to control the business, either in general matters or as to the subject matter of the power, as long as the trust has powers at least equivalent to that of a limited partner or a minority shareholder.

We believe that the same result should apply even if the person's fiduciary duty is limited under trust law in some way, whether by waivers or exculpatory protections under the trust document or by governing law, provided that a judicial or nonjudicial remedy is nonetheless available to

[49] The trustee's role could lead to dual attribution, in which the trustee also owns a personal stake in the business. That person's work may constitute participation of both the person and the trust for purposes of the participation of each in a business owned in both capacities. This duality has been approved in *Schwalbach v. Commissioner*, 111 T.C. 215 (1998), which involved a shareholder's activities in the business of a personal service corporation dental practice owned with another dentist. The dental practice corporation was a taxpayer subject to Code § 469; his work in the practice was attributed to him for that purpose and also as an owner of realty leased to the corporation. There is conceptually no difference between that attribution, and the dual attribution described here, in which a person both individually and as trustee owns interests in a business activity. For example, when an individual owns the corporate general partner, is the sole limited partner, and works in the partnership's business as an employee of the corporate general partner, this work can cause not only the corporation but also the individual to materially participate. Reg. § 1.469-5T(k), Example (2).

[50] S. Rep. No. 99-313 (2d Sess. 1986), *reprinted in* 1986-3 C.B. (Vol. 3) 1, at 735.

[51] Certainly one could imagine in theory a trust in which a person who works in the business is brought on as trustee to help meet the material participation threshold even though the new trustee is likely to be outvoted by the existing trustees on trust decisions. This example does not, however, reflect an opportunity for abuse in practice. A coalition of the existing trustees is unlikely to be so consistent and persistent that the voting rights of the new trustee would be meaningless (*i.e.*, the other trustees will not always act in concert and in a way opposed by the new trustee). Moreover the new trustee has the right as co-trustee, if not the obligation, to seek a remedy in court if the other trustees actions are adversely affecting the trust. It would be difficult to justify a rule that requires owners who have substantial ownership rights to exercise them in certain permitted ways while in contrast allowing other types of owners to qualify even though they have virtually no meaningful ownership rights (such as a limited partner in a family real estate partnership).

the beneficiaries if the trustee acts in bad faith or with reckless disregard for the interest of the beneficiaries and the purposes of the trust (or violates a substantially equivalent standard). If that remedy is available, we do not recommend further testing of the strength of the fiduciary duties to the beneficiaries, since there are too many variations and subtle distinctions, and shifting interpretations and changing statutes, to make it possible to categorize and test different levels of judicial control over a fiduciary and the legal liability to the beneficiaries for breach of trust.

<u>Recommendation 2.</u> <u>Aggregation of All Work Done by Qualifying Fiduciaries</u>.

Recommendation

We propose that all work done in a business activity by qualifying fiduciaries during a taxable year be added together for that taxable year of the trust or estate for purposes of determining material participation, even if done by persons whose role in the trust or estate is not singular and comprehensive, such as serving as a co-trustee, or as a fiduciary for part of the year, or as a trustee when the trustee powers are divided among specialized trustees.

Discussion

As explained above, all of the work of all fiduciaries should be taken as a whole in determining the participation of the trust because in the aggregate they represent the actions of the trust. These persons are acting for the trust, and thus should not to be treated as if they were acting for their own account or were separate fiduciaries acting for separate trusts.

Similarly, the rules must recognize that there may be a succession of fiduciaries during the relevant period due to resignation, incapacity or death. The work of successive fiduciaries during the tax year should be aggregated as if performed by a single fiduciary; otherwise each of them would have to work an extra amount to qualify the trust even though they have all represented continuous fiduciary responsibilities to the beneficiaries, which the tax laws view as a single trust arrangement. Treating these actors as if they were separate individual taxpayers would lead to anomalous results. For example, if each trustee serves for only half of the year and each works in the business at the same level, and if their efforts were not cumulated, the trust would be treated as if it had only one trustee working half as much.

<u>Recommendation 3.</u> <u>Work by Independent Contractors</u>.

Recommendation

We propose that work done in the business by an independent contractor engaged by the trust or estate not be attributed to the trust or estate, unless the independent contractor itself owes fiduciary duties directly to the beneficiaries and is exercising a substantial related fiduciary power that binds the trust or estate.

Discussion

A fiduciary, whether an individual or an entity, may employ independent contractors. The question is whether participation on behalf of a trust by a person engaged by a qualifying fiduciary as an agent with respect to a business interest held by the trust, either with or without a full delegation of the trustee's fiduciary powers and duties, may be counted. When the trust itself is considered the taxpayer, inclusion of such agents, *i.e.*, employees and managers, is aligned with the objective of assessing the level of participation of the taxpayer.[52] However, we believe that only the work of those persons who owe a fiduciary duty to the beneficiaries should be counted.

For example:

1. If a qualifying fiduciary hires a management company to run a building owned by the trust, ordinarily the management company would not owe fiduciary duties to the beneficiaries, so the management company's work would not count as participation by the trust and the trustee is ordinarily not responsible for all the acts of such a properly selected "expert."

2. If a qualifying fiduciary delegates investment authority to an investment advisor in order to restructure a business and the investment advisor assumes fiduciary duties running to the beneficiaries, then the investment advisor's work would count as participation. If, instead, the investment advisor does not assume duties running to the beneficiaries, then the investment advisor's work would not count.

Recommendation 4. Work by Employees of Fiduciary Entity or Individual.

Recommendation

We propose that work done by an employee of a fiduciary count as work of the trust or estate if under the governing state law and documents the work is performed in a fiduciary capacity: that is, if the fiduciary-employer is subject to the same fiduciary obligations to the beneficiaries as to the employee's work as would apply if the work were done directly by the fiduciary rather than by the employee. This same rule would apply whether the trustee or other fiduciary is an individual or an entity qualified to serve as a fiduciary under state law. The rule would include all such employees whether or not they are personally participating in the exercise of a "substantial related fiduciary power" as described in Recommendation 1.

Discussion

Our recommendation follows the same general principle of adapting the rules applicable to individuals to accommodate the distinction that the trust or estate acts exclusively through its fiduciaries and those fiduciaries act in that capacity whenever they act under a fiduciary obligation to the beneficiaries. All work done in the business by employees of the fiduciary should count as work of the trust or estate if, as would usually be true, it is performed subject to the same fiduciary obligations by the fiduciary to the beneficiaries as if done by the fiduciary directly rather than by employees.

We considered at length and rejected several alternatives:

a) Counting employee work only if the work necessarily must be done by employees, such as for a trustee organized as a business corporation: Business corporations necessarily

[52] *See Mattie Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

act through employees and therefore the work of employees of a corporate fiduciary must count as work of the trust. But if used as an exclusive test for counting work by employees this alternative would be too narrow. Trustee entities organized as LLCs or partnerships rather than corporations are not uncommon, and many business owning families still use individuals as trustees for business-owning trusts. Allowing only corporate fiduciaries to count employee work would also exalt form over substance, by focusing exclusively on the legal capacity of a particular form of business entity to serve as trustee under state law. For example, under the laws of several states a business corporation can be qualified to serve as a trustee without taking on any greater obligations or showing any greater capability to serve as trustee than an individual. Under this alternative test, a trust that had only individual trustees but was seeking to change its tax status could form such a corporation to serve as a co-trustee in order to engage employees whose work would be counted, while another trust with individual trustees could not count its fiduciary employees' work if it did not have the legal option or practical means to incorporate its fiduciary function.

b) Counting employee work only if the trustee is an entity regulated as a fiduciary under state or federal law (a "regulated family trust company") or holds itself out to the public to offer fiduciary services (a "commercial trustee"): This alternative assumes that a fiduciary entity that operates in a regulated or competitive environment is less likely to disregard fiduciary duties or, worse still, manipulate the rule by creating dual employment arrangements. Other fiduciaries, the theory goes, could or would more likely use dual employment for the sole purpose of counting employee hours (by hiring employees of the business as employees of the trustee entity in order to count their work in the business as work of the trust). We rejected this alternative because it favors, without sufficient reason, trusts served by such regulated or commercial entities. Again many business-owning families understandably rely on individual trustees; and the opportunity to use a commercial trustee or regulated family trust company depends more on governing state law, the risk profile of the business, and the size of wealth than on whether the fiduciaries are truly active in the business. The limitations imposed by this alternative would be too blunt an instrument for identifying the universe of trusts and estates where the fiduciary arrangements are bona fide.

c) Counting employee work only if the trustee, whether an entity or individual, ordinarily and customarily engages employees to fulfill fiduciary duties: This alternative is more flexible but still adopts base line criteria in order to screen out tax-motivated manipulation (e.g., using dual employees (meaning those who work for the business as employees and work for the fiduciary as an employee) who would be engaged solely in order to count hours of business work as trust work. We do not believe that the problem of tax-motivated employment is likely to occur with such frequency and magnitude as to warrant requiring a showing in every case that the use of fiduciary employees is customary. If tax-motivated dual employment or other abuses in fact become a practice used or promoted to create a desirable tax result, the existing anti-abuse rule could be applied. It is, we believe, difficult to fashion a responsive rule at this time that is not overly broad. We are sympathetic to the taxpayer when, for example, a business-owning family uses an individual trustee who performs all of the trustee work directly except for engaging the assistance of the CFO of the business as an employee of the trustee, creating a dual capacity. That arrangement is not per se abusive; it can provide important insights into and de facto controls (including controls recommended by the certified public accountants) over the business on behalf of the trust. Furthermore, given the potential additional fiduciary liability involved (such as the personal liability of an individual trustee for the misconduct or undisclosed conflicts of interest of a dual employee), these arrangements are not likely to be primarily tax-motivated. The price in terms of risk would be too high: the employee would tend to encounter conflicting duties (to the other owners, who might have different interests than the beneficiaries) and would risk losing all of the employee's compensation and being personally liable to whoever complained about the employee's actions.

Recommendation 5. Multiple Trusts.

Recommendation

We propose that, if more than one trust or estate owns an interest in a business and they have at least one qualifying fiduciary in common, all of that person's work in the business counts for each trust or estate in full, without allocating those hours among the trusts or estates.

Discussion

If a trustee serves as a fiduciary for multiple trusts that have shared ownership of a trade or business, the actions of the trustee should be counted for each trust when determining whether they materially participate in the business. As discussed above, a trust does not exist separate from its trustee, so it is consistent to treat the actions of the trustee to be made by each trust for which the trustee is a fiduciary. This is provided by the regulations in the closely-held C corporation and personal service corporation area[53] and should apply equally to a trust.

The first two examples in Reg. section 1.469-1T(k)[54] both attribute the activities of the acting individual as serving to qualify for material participation on his own behalf as well as the corporate general partner he owns. In the first example he manages the business in his individual capacity, which is attributed to his wholly owned corporate general partner so that it also

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[53] *Accord Schwalbach v. Comm'r*, 111 T.C. 215 (1998). *See* discussion *supra* note 49.

[54] Reg. § 1.469-1T(k) provides:

> Example (1). A, a calendar year individual, owns all of the stock of X, a C corporation. X is the general partner, and A is the limited partner, in P, a calendar year partnership. P has a single activity, a restaurant, which is a trade or business activity (within the meaning of §1.469-1T(e)(2)). During the taxable year, A works for an average of 30 hours per week in connection with P's restaurant activity. Under paragraphs (a)(1) and (e)(2) of this section, A is treated as materially participating in the activity for the taxable year because A participates in the restaurant activity during such year for more than 500 hours. In addition, under §1.469-1T(g)(3)(i), A's participation will cause X to be treated as materially participating in the restaurant activity.
>
> *Example (2).* The facts are the same as in example (1), except that the partnership agreement provides that P's restaurant activity is to be managed by X, and A's work in the activity is performed pursuant to an employment contract between A and X. Under paragraph (f)(1) of this section, work done by A in connection with the activity in any capacity is treated as participation in the activity by A. Accordingly, the conclusion is the same as in example (1). The conclusion would be the same if A owned no stock in X at any time, although in that case A's participation would not be taken into account in determining whether X materially participates in the restaurant activity.

materially participates. In the second example the corporate general partner is the manager of the business and the individual carries out those duties as an employee of the general partner (which he also owns). Both of these examples stand for the proposition that the activities of a single individual can be attributed to multiple parties where appropriate. In the case of a trustee who owes a continuing fiduciary duty to carry out his obligations as trustee of multiple trusts, it is consistent with this principle to attribute the trustee's activities to any trust for which the trustee is a fiduciary.

Recommendation 6. Tacking to the Participation of the Decedent or a Predecessor Fiduciary.

Recommendation

We propose that a person's work as trustee should tack to successor trustees and to successor nongrantor trusts of which that person is trustee. This tacking would apply when the passive loss rules look to participation over the course of a year or over the course of several years, even if the trust has converted over that time from a grantor trust to a nongrantor trust or from a nongrantor to a grantor trust. We propose that a decedent's estate be treated as a continuation of the decedent's activities while alive, for the purpose of counting work as participation over the time period in question.

Discussion - Conversion from Grantor to Nongrantor Trust

When a trust converts to or from grantor trust status, existing law generally does not allow one taxpayer to assume the passive losses or status of the other. However, no rules currently address how to count participation relating to the activities of fiduciaries. Given that the passive loss rules look to participation over the course of a year or over the course of several years,[55] we propose that a person's work as trustee should tack to successor trustees and to successor nongrantor trusts of which that person is trustee. Below is our proposed treatment.

The "tacking" of the trustee's activity while a trust is a grantor trust should apply when a grantor of a revocable trust (which is a grantor trust) is the trustee during his or her lifetime and the trust becomes a nongrantor trust by virtue of the grantor/trustee's death. A successor trustee will have to fill the role of the fiduciary after the grantor's death, but the activity of the grantor fiduciary should be credited to the new fiduciary for determining the nature of the trust's activity after the new fiduciary steps into that role. From that date forward, the new fiduciary's activity (credited as described in the preceding sentence) will determine the trust's active or passive nature as if the new fiduciary had been in that position in lieu of the grantor fiduciary. Similarly, when one fiduciary takes over for another, the activity of the resigned or removed fiduciary should be credited to the new fiduciary for the purposes of determining whether the trust's activity is active or passive.

As stated above, during any period that a trust is a grantor trust, only the grantor's activity is relevant for determining the active or passive nature of the income or loss because the grantor is the deemed owner of the business interest. The fiduciary's activity while the trust was a grantor trust would not be relevant for determining the nature of the trust's activity before its conversion

[55] *See, e.g.*, Reg. § 1.469-5T(a)(5) (five out of the past ten years).

to nongrantor status, because as a grantor trust the trust is disregarded for income tax purposes. Once the trust becomes a nongrantor trust it is the activity of the fiduciary that is relevant. There are numerous reasons a grantor trust may convert to nongrantor status. Regardless of the cause for the conversion to nongrantor trust status, the activity of the fiduciary of the trust while it was a grantor trust should be counted in determining whether the trust's activity qualifies as active or passive after it has become a nongrantor trust. The fiduciary is bound by fiduciary standards both while the trust is a grantor trust and once it becomes a nongrantor trust. For that reason, the fiduciary's activity while the trust is a grantor trust should be considered when determining the active or passive nature of the trust's participation after it becomes a nongrantor trust, but only for determining the characterization of the trust's income or loss after the conversion to nongrantor trust status has occurred.

Trust Example:

The trustee of a grantor trust actively participates in the management of a partnership that is owned by the trust for seven continuous years. During this time the grantor's activity in the business is the relevant measure of whether the active participation requirements are met since the grantor is the deemed owner of the stock of the corporation during that time period. In year eight the trust converts completely from grantor to nongrantor status on July 1, at which point the trustee had actively worked in the management of the business for four hundred hours. For purposes of determining the more-than-five hundred hour material participation test, the trustee's four hundred hours of work before July 1 will be aggregated with his work after July 1. Additionally, the trustee's active work for the prior seven years will count in determining whether the trust satisfies the "five of the prior ten years" material participation test. From July 1 on, the grantor's prior or current participation is irrelevant in determining the trust's participation. Furthermore, because ownership is a prerequisite for work counting as participation, the grantor's post-July 1 work will not count toward the grantor's participation for the calendar year unless the grantor owns (or is treated as owning) some other interest in the partnership during that time. However, if the grantor owns (or is treated as owning) some other interest in the partnership after July 1, the grantor's post-June 30 work would count toward the grantor's participation for the calendar year, whether the grantor's work during that time is as a trustee or as an individual.

Discussion - Treatment of an Estate

When a person dies holding a business interest, generally the executor (or personal representative or administrator) is charged with distributing assets rather than actively managing them. Whereas a trustee's duty is to manage assets actively, an executor's duty generally is to marshal and distribute assets rather than to actively manage them. Given that the executor might not learn to manage a business investment before distributing it, we propose that the decedent's estate should be treated as a continuation of the decedent's activities while alive, for the purpose of counting work as participation. This means that the activity of the decedent should be credited to the executor or other fiduciary-owner of the business interest. The activity of the fiduciary after the owner's death will then become the relevant measure of whether the activity of the estate or posthumously formed trust is active or passive, but the activity of the owner while alive will be attributed to the fiduciary when making the determination. This will be highly relevant for determining not only objective hour participation requirements for the year of the owner's death, but also for qualifying for the "five of the prior ten years" material participation test.

Recommendation 7. Exception for Real Estate Professional.

Recommendation

In determining whether a trust or estate qualifies as a real estate professional under Code section 469(c)(7), we propose that the two tests under subparagraph (B) of that section continue to apply, and that an alternative test, similar to that available to closely held C corporations (see Code section 469(c)(7)(D)(i)), be available to trusts and estates engaged in one or more real estate businesses.

Additionally and similar to Recommendation 5, we propose that, when multiple trusts or estates own interests in a real estate trade or business, the fiduciary's work in that trade or business count for each trust or estate in full, without allocating those hours among the trusts or estates, for purposes of meeting the tests under Code section 469(c)(7)(B)(i) and (ii). As an anti-abuse requirement, the trusts or estates must have the same settlor or decedent, as the case may be, or have settlors or decedents who are "members of a family," as defined substantially in Code section 1361(c)(1)(B).

Discussion

The real estate professional exception to the passive loss rules applies to trusts and estates.[56] To qualify as a real estate professional and treat real estate rental activities as nonpassive in a given tax year,[57] generally a taxpayer must meet the two tests of Code section 469(c)(7)(B): the one-half of time test under subparagraph (B)(i), and the 750-hour test under subparagraph (B)(ii).[58]

We propose that, if more than one trust or estate owns an interest in a real estate trade or business and they have at least one qualifying fiduciary in common, then all of that fiduciary's work in that trade or business count for each trust or estate in full, without allocating those hours among the trusts or estates. However, the proposed aggregation would apply only if the trusts or estates have the same settlor or decedent (as the case may be) or have settlors or decedents who are members of a family. For this purpose, the term "members of a family" has the meaning set forth in Code section 1361(c)(1)(B) (a common ancestor within six consecutive generations), except that the definition would be limited to two generations unless the taxpayer were to elect a higher number of (up to six) generations.

[56] *Frank Aragona Trust v. Comm'r*, 142 T.C. 165 (2014).

[57] Real estate trade or business rental activities are not disallowed under the passive loss rules when the taxpayer qualifies as a real estate professional (more technically referred to as a qualifying taxpayer) under Reg. § 1.469-9.

[58] The one-half of time test requires that for the tax year in question more than one-half of the taxpayer's personal services in trades or businesses be performed in real estate trades or businesses (including rental real estate activities that gives rise to deduction under Code § 212) in which the taxpayer materially participates. Reg. § 1.469-9(b)(1). The 750-hour test requires (for the same tax year) that the taxpayer materially participate in and perform more than 750 hours of service in real estate trades or businesses.

For a closely held C corporation, meeting the gross receipts test of section 469(c)(7)(D)(i) supersedes the (B)(i) and (B)(ii) tests.[59] We propose that a test comparable to the gross receipts test be an alternative available, at the taxpayer's election, to a trust or estate that receives (either directly, or through an entity or entities that it owns) over 50 percent of its gross receipts from real estate trades or businesses in which the trust or estate materially participates through its fiduciaries. A trust or estate that is concentrated so much in real estate, despite the fiduciary law and custom towards asset diversification, is clearly acting in a manner equivalent to a real estate professional and not a passive investor.

With regard to trusts, we recommend that the Treasury Regulations expressly apply the rules of Code section 643(f) to the gross receipts test proposed above. We believe this would address any concerns that the Service might have with the test being rendered meaningless by a trustee splitting a trust into, or a settlor creating, two or more trusts and strategically allocating assets among them to meet the gross receipts test for one of the trusts. Thus, if avoidance of tax was a principal purpose of creating multiple trusts, and they had substantially the same grantors and primary beneficiaries, those trusts would be treated as one trust.

Examples:

Fact Pattern for Examples 1 and 2: Assume a single tax year for all facts and circumstances presented below. Trust A, Trust B, and Trust C are irrevocable, nongrantor trusts. The respective settlors of Trust A, Trust B, and Trust C are siblings. X and Y are individuals, and Z is a corporate trustee. LLC-1 is a single member, member-managed limited liability company that wholly owns a single family dwelling rental unit and a landscaping business; LLC-2 is a single-member, manager-managed limited liability company that owns a commercial strip-mall in its entirety; and LLC-3 is a two-member, manager-managed limited liability company that owns a large residential apartment complex in its entirety. LLC-1 and LLC-2 are disregarded entities, and LLC-3 is treated as partnership, for federal income tax purposes. X is the sole trustee of Trust A, which owns a 100% membership interest in LLC-1 and holds no other assets. Trust A's gross receipts via LLC-1 were $150,000, of which $18,000 was in rental receipts and the remainder was in receipts from the landscaping business. X and Y are co-trustees of Trust B, which owns a 100% membership interest in LLC-2, and a 50% membership interest in LLC-3. Trust B also has non-real estate assets and businesses, the gross receipts from which are greater than the sum of LLC-2's gross receipts and Trust B's distributive share of gross receipts from LLC-3. X and Z are co-trustees of Trust C, which owns a 50% membership interest in LLC-3. Trust C also has non-real estate assets and businesses, the gross receipts from which are greater than Trust C's distributive share of gross receipts from LLC-3.

Example 1: For LLC-1, X personally provided 751 hours of real estate rental services and 750 hours of other personal services relative to the landscaping business operations. X's involvement in all of the services rendered was regular, continuous, and substantial within the meaning of Code section 649(h)(1). Based on the foregoing, Trust A is treated as a real estate professional for purposes of the passive loss rules, because both the one-half of time test

[59] Code § 469(c)(7)(D)(i) provides that "[i]n the case of a closely held C corporation, the requirements of subparagraph (B) shall be treated as met for any taxable year if more than 50 percent of the gross receipts of such corporation for such taxable year are derived from real property trades or businesses in which the corporation materially participates."

(751 hours / [751 + 750] hours > 50%) and the 750 hour test (751 > 750) are met. Because Trust A's gross receipts derived from real property trades or businesses were less than 50% ($18,000 / $150,000 = 12%) of Trust A's total gross receipts, only the dual test (one-half of time test and 750-hour test) under Code section 469(c)(7)(B) applies, which qualifies Trust A as a real estate professional.

Example 2:

X and Y personally provided personal services of 200 hours and 250 hours, respectively, for LLC-2. X and Y (as fiduciaries for Trust B) hired a part-time employee to provide additional real estate rental services for LLC-2, which services consisted of 201 hours. Each of X's, Y's, and the employee's involvement in the rental operations was regular, continuous, and substantial within the meaning of Code section 649(h)(1). Under Trust B's governing instrument, X and Y were liable to Trust B's beneficiaries for the work performed by the employee, as if the work had been performed by X and Y directly. X and Y also hired an independent contractor to provide real estate rental services with respect to LLC-3, which consisted of 1,200 hours, and which was regular, continuous, and substantial within the meaning of Code section 649(h)(1). Under applicable governing law and Trust B's and Trust C's governing instruments, the co-trustees duty with respect to the work of an independent contractor was limited to proper selection and supervision of the contractor; thus, X and Y were not liable as fiduciaries for the work done by the independent contractor. Furthermore, the agreement with the independent contractor did not create a fiduciary relationship running from the contractor to the beneficiaries of Trust B or Trust C. X and Y each performed and materially participated in 100 hours of real estate rental activities with regard to LLC-3, and Z through its employees provided and materially participated in 400 hours of real estate rental services for LLC-3. Assume that more than half of all personal services performed by X, Y, and Z with regard to Trust B and Trust C are real estate rental activities, and thus Trust B and Trust C meet the one-half of time test.

Even though each of Trust B and Trust C fails the gross receipts test (i.e., their respective gross receipts derived from real property trades or businesses were less than 50 percent of their respective total gross receipts), Trust B is treated as a real estate professional because, among other things, the co-trustees were liable to Trust B's beneficiaries for the work performed by the part-time employee. Thus, Trust B (through its co-trustees and their employee) performed more than 750 hours (X with 200 + 100; Y with 250; and the employee with 201 = 751) of real estate rental activities. However, Trust C fails the 750-hour test of Code section 469(c)(7)(B)(ii) because X was not liable (nor Z) as a fiduciary for the independent contractor's work and the independent contractor was not a fiduciary. As a result, X's 300 aggregated hours and Z's 400 hours are not sufficient for Trust C to meet the 750-hour test. (Note that because X's and Y's part-time employee (with regard to Trust B) worked only on LLC-2's real estate business, the employee's hours are not counted in determining whether Trust C meets the section 469(c)(7)(B) tests, even though X is a co-trustee of both Trust B and Trust C.)

Recommendation 8. ESBTs and QSSTs.

Recommendation

Although the fiduciary income tax of an ESBT is computed as if it were two separate entities, in substance it is one trust and we propose that it be treated as one trust for purposes of determining the character of its income under the passive loss rules. The determinations to which this proposal applies include whether an activity is passive and whether passive income should be recharacterized under the passive loss rules.

Furthermore, we propose that the passive or non-passive character of the sale of stock by a QSST be based on the beneficiary's participation.

Discussion

An ESBT is treated as two separate trusts for purposes of chapter 1 of the Code.[60] The portion that consists of stock in one or more S corporations is treated as one trust, and the portion that consists of all the other assets in the trust is treated as a separate trust.[61] The grantor trust rules trump this treatment.[62] The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return.[63]

We are unaware of any guidance directly addressing how the passive loss rules interact with these separate portions. Because the nongrantor S corporation portion and the nongrantor non-S corporation portion are taxed as separate trusts for all income tax purposes other than administratively, they would not – even temporarily – aggregate their income and loss in determining allowable passive losses.

However, we believe that all activities of the trustee or trustees of all portions should be combined in determining whether there is material participation, in order to conclude whether income or loss of each is passive or nonpassive. Furthermore, the rules that recharacterize passive income into nonpassive income[64] should also apply as if the two portions were a single trust. Without these rules combining both portions of an ESBT, one might be able to use the ESBT rules to separate activities and create passive income generators.

Although the ESBT rules impose a fiction of separateness as taxpayers, the trustees and terms of the S portion and non-S portion generally are the same for state law purposes. Both parts of one trust should be able to group. This approach is also consistent with our approach in Recommendation 5 of allowing a trustee's participation to count in full for each trust for which the trustee serves (and meets the other tests we proposed).

Recharacterization

A taxpayer's net rental income for the year from an item of property is treated as nonpassive if the property is rented for use in a trade or business activity in which the taxpayer materially participates[65] for the taxable year.[66] This test applies to the item of property, ignoring any

[60] Code § 641(c); Reg. § 1.641(c)-1(a).

[61] Reg. § 1.641(c)-1(a).

[62] *Id*.

[63] *Id*.

[64] Reg. § 1.469-2T(f).

[65] In *Schumann v. Commissioner*, T.C.M. 2014-138, a taxpayer who took a substantial salary from his operating business could not prove that he did not materially participate in the business (because he wanted his rent to be passive income), despite his testimony that "his income tax reporting for both years was 'tax provisioning' and that

grouping elections that might apply to that item of property.[67] Suppose an ESBT rents property to an S corporation in which it is a shareholder. Because the rental is in the non-S portion, under the ESBT rules the non-S portion of the trust as landlord is a separate taxpayer not deemed to be participating in the S corporation. That would undermine the purpose of the self-rental rule. Attributing the trustee's participation to both portions of the ESBT would prevent the perceived abuse that the self-rental rules targeted.

How an ESBT election affects the recharacterization rules also needs to be considered. For example, generally, if a taxpayer acquires an interest in a development entity after the development entity has created an item of intangible property or performed substantial services or incurred substantial costs with respect to the development or marketing of an item of intangible property, an amount of the taxpayer's gross royalty income for the taxable year from such item of property equal to the taxpayer's net royalty income for the year from such item of property is treated as nonpassive income.[68] If a trust's development entity (say, a limited liability company) starts as a partnership, later makes an S election and the trust makes an ESBT election, under the current ESBT rules the trust that developed the property would be a different taxpayer from the trust that owns the development entity, and the trust could avoid the recharacterization of passive income. Attributing the trustee's participation to both portions of the ESBT would prevent the potential abuse that this recharacterization rule was intended to address.

QSSTs Selling Stock

The beneficiary of a QSST is taxed on all of the QSST's K-1 income and losses from the S corporation.[69] However, when the QSST sells the stock, the trust itself is taxable on any gain on the sale,[70] including any gain the corporation incurs after adopting a plan of complete liquidation[71] or from a deemed asset sale resulting from a Code section 338(h)(10) election.[72]

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he did not actively provide services to either company in exchange for the wages and payments reported on his tax returns."

[66] Reg. § 1.469-2(f)(6).

[67] *See Carlos v. Comm'r*, 123 T.C. 275 (2004); *Veriha v. Comm'r*, 139 T.C. 45 (2012) (defining "item of property" for purposes of this rule); *Dirico v. Comm'r*, 139 T.C. 396 (2012); *see also Samarasinghe v. Comm'r*, T.C.M. 2012-23.

[68] Reg. § 1.469-2T(f)(7).

[69] Code § 1361(d)(1)(B). Reg. § 1.1361-1(j)(7)(i) provides:

> The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

Reg. § 1.1361-1(j)(8) further provides:

> If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made.

[70] Reg. § 1.1361-1(j)(8).

[71] Priv. Ltr. Rul. 9721020; 199905011. This includes gain from the actual sale of assets as well as gain on the Code § 336 deemed sale of assets distributed to shareholders. Of course, Code § 331 gain on the deemed sale of stock on dissolution is also taxed to the trust.

Thus, the beneficiary's participation is used in determining the passive or nonpassive character of income until the instant of sale. However, under the passive loss rules, participation is measured over time, with more than 100 or 500 hours being the thresholds. We respectfully submit that testing the trustee's participation as of the instant of the sale is inconsistent with the idea of testing over time. If the trustee's participation is tested for such a sale, both the beneficiary and trustee would need to participate in the business – just in case a sale were to occur.

Therefore, we propose that the beneficiary's participation determine whether gain on sale is passive or nonpassive. This is consistent with other relief: a disposition of S corporation stock by a QSST is treated as a disposition by the income beneficiary for purposes of applying Code sections 465 and 469 to the income beneficiary.[73]

This recommendation is also consistent with the position taken in comments we submitted on February 26, 2014, suggesting that the beneficiary's participation should be counted in determining whether a QSST's sale of S corporation stock is characterized as passive.[74]

<u>Recommendation 9.</u> <u>Recharacterization of Income in Hands of Active Beneficiary.</u>

Recommendation

When a trust or estate materially participates, significantly participates, or is a real estate professional, in a taxable year with respect to an activity, that characterization should carry through in the beneficiary's hands with respect to the taxable income of the trust or estate from the activity allocated to the beneficiary from the taxable year. We propose that, if the trust or estate does not materially participate, does not significantly participate, and is not a real estate professional in an activity such that the income therefrom is passive, but taxable income from the activity is allocated to a beneficiary, then the beneficiary's work in the activity is counted to determine whether the beneficiary materially participates, significantly participates, or is a real estate professional with respect to taxable income from the activity allocated to the beneficiary in the beneficiary's taxable year.

Discussion

The character of income is determined at the trust level, and the beneficiary is required to use that characterization on the beneficiary's own tax return. However, that rule would put the government in the following position: If a trust that does not materially participate in a business makes a distribution to the beneficiary, and that beneficiary meets all criteria for material participation under the normal rules, the regulations will recharacterize passive income to nonpassive income. More specifically, the regulations recharacterize the income to from passive

[72] Priv. Ltr. Rul. 9828006; 199920007.

[73] Reg. § 1.1361-1(j)(8).

[74] The comments addressed whether gain on sale is subject to net investment income tax. http://www.actec.org/Documents/misc/ACTEC-Recommendations-for-REG-130843-13-regarding-the-Net-Investment-Income-Tax_02_26_2014.pdf.

to nonpassive if the owner significantly participates (a lower threshold than material participation) or if certain related-party transactions occur.[75]

We believe that, as an equitable owner of a business activity, a beneficiary who works in the business (for example, a beneficiary who is president of a company and devotes his or her entire life to the business) should not be able to shelter the income that is distributed to him or her by using passive losses.[76] Section IV.E. of the comments submitted by the American Bar Association's Section of Taxation on January 20, 2015 provide detailed theories that the government might consider in adopting such a rule.[77]

In contrast, we believe that, if the trust (via its trustee) is active in the business but the beneficiary is not, the beneficiary's status as a passive participant does not justify recharacterization of nonpassive income as passive income. Rather, once income is characterized as nonpassive, it should retain that character, whether in the trust's (or estate's) hands or in the beneficiary's hands (if distributed). Again, this position serves to avoid generating passive income and the concerns that underlie the recharacterization rules.

We believe that this recommendation is fair to both the government and taxpayer and meets the reasonable expectations of both. Moreover, the rule is administrable and clear.

Examples of the Application of Our Various Recommendations

The following examples apply the principles set forth above, assuming that the fiduciary is a qualifying fiduciary:

Example 1: Facts: A is the settlor of Trust B, held solely for the benefit of A, which is a grantor trust of which A is treated as the owner pursuant to Code subpart E. C is appointed conservator of A and trustee of Trust B. As trustee, C engages in work in a business, an interest of which is held by Trust B, and owes the same fiduciary duties to A as trustee that C as conservator owes to A when C is engaged in work in the business. Result: Because C's work as trustee is subject to the fiduciary duties that C owes to A as A's conservator, C's activities as both trustee and conservator are attributed to A for purposes of material participation in the business activity.

Example 2: Facts: Trust Company is trustee of Trust A, which is a nongrantor trust. Trust A owns an interest in an entity that conducts a business activity. Trust Company assigns one of its officers, B, to work in the entity. B also owns an interest in the business. B is subject to fiduciary duties to the beneficiaries of Trust A for B's actions in B's individual capacity for the business as a result of B's employment with Trust Company. Result: Trust Company employees' work (including those of B as an officer of Trust Company) in the business, and the

[75] Reg. § 1.469-2T(f).

[76] Such income, as is the case with any other income having a particular character, may not be specially allocated to a beneficiary with allocation of other income having a different character to another beneficiary when the character of the income is not determinative of the amount or share of the income so allocated in accordance with Code §§ 652(b) and 662(b). Code § 643(f) supports this result by precluding the separate taxation of trusts that have been divided for income tax avoidance.

[77] See http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/012015comments.pdf.

work of B in B's individual capacity in the business, are all attributed to the work of Trust A (through its fiduciary) for purposes of material participation in the business.

Example 3: Facts: The facts are the same as in *Example 2*, except that B (an individual) is the sole trustee. Result: B's work in the business, as trustee and in B's individual capacity, are attributed to Trust A for purposes of material participation in the business activity.

Example 4: Facts: A is trustee of three nongrantor trusts, B, C, and D. No beneficiary of a trust is a beneficiary of the other trusts. The trusts are members of a limited liability company, LLC, that owns an interest in a business. A, individually, is a manager of the LLC. A, as trustee of Trust B, is a manager of LLC. A is subject to fiduciary duties to all the beneficiaries of the trusts for A's actions in A's individual and trustee capacities for any of A's work in the business, which work totals 600 hours in the taxable year. Result: A's work in all capacities is work attributed to each trust, such that each of Trust B, Trust C, and Trust D (as the taxpayers) is deemed to have worked 600 hours in the business.

Example 5: Facts: The facts are the same as in *Example 4*, except that (i) there are two additional trustees, E and F, of both Trust C and Trust D who also are employees of LLC, and who are subject to fiduciary duties to Trust C and Trust D for their actions as employees of LLC, and (ii) each of A, E, and F worked 200 hours in the business activity. Result: For purposes of material participation, Trust B is deemed to work 200 hours in the business (counting only A's service), and Trust C and Trust D are each deemed to have worked 600 hours in the business (counting A's, E's and F's service).

Example 6: Facts: Entity is a trust company that serves as trustee of a trust that owns stock in the trust company. Entity acts through employees, who do significant work for Entity managing the trust and other work that is intended to exercise the trustee's authority as a fiduciary or is the type of work commonly done by owners of that size and type of business. Entity owes fiduciary duties to the trust's beneficiaries with respect to Entity's employees' work for Entity. Result: The employees' work in Entity's business, work for which Entity owes fiduciary duties to the beneficiaries, constitutes participation in the business.