Estate & Succession Planning Corner

Aragona Trust: Avoiding the 3.8-Percent Net Investment Income Tax for Trusts with an Active Trustee

By Louis S. Harrison and Emily J. Kuo

For our clients' businesses in the partnership format, the interplay of income tax planning and estate planning will continue to present sophisticated challenges. This is particularly demonstrated by questions regarding the 3.8-percent tax on net investment income under Code Sec. 1411(c), and whether material participation by the trustees avoids passive income for a trust that receives trade or business income from an operating partnership.

The answer seems straightforward. After the introduction of the 3.8-percent tax last year, if an individual materially participates in a business, and receives taxable income from the business, that income is not subject to the 3.8-percent tax. If that active individual is also the trustee of a trust, income received by the trust would also seem to be similarly excluded.

Further, it would seem that the material participation of at least one co-trustee arguably counts as participation by the trust. Nonparticipation by a remaining co-trustee should not impact the passive/active determination.

But until the recent *Frank Aragona Trust* case,[1] the answer was not that easy.

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World According to the IRS

Code Sec. 1411(c) applies the 3.8-percent surtax to all passive trust income which is subject to the highest federal income tax rate of 39.6 percent, including income allocated to the trust as a partner in a partnership. However, if the material participation requirements are met, the partnership trade or business income can avoid the surtax. If an individual who is acting as trustee materially participated in the business, by all logical interpretation, that material participation should extend also to the trust through the individual's trustee role. But to date, the IRS has treated the individual as wearing two distinct hats—individually as a partner in the active business partnership, and fiduciarily, as trustee of the trust holding the partnership interest, *i.e.*, the IRS has considered whether the trustee was participating in the business specifically in his or her role as trustee.

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The final regulations under Code Sec. 1411 expressly declined to address the material participation rules as they apply to trusts and acknowledged the uncertain state of the current authority.[2] Equally unhelpful were the Treasury Regulations on material participation, which reserved a spot for future guidance under Temporary Reg. §1.469-5T(g), titled, "Material participation of trusts and estates," but provided no temporary guidance under this heading.

Logically, it is hard to imagine a trustee, solely in his or her capacity as trustee, being active in a business. But the IRS did not dig that deep into its imagination.

The IRS's position, set forth most recently in TAM 201317010,[3] is very narrow. The President of an S corporation was the trustee of a trust that owned shares in the S corporation. The trust argued that the trustee's material participation, as President, should count as the trust's own material participation.

The IRS appears to be satisfied with the activities of one co-trustee as supporting material participation by all trustees. The Aragona Trust case also supports this conclusion.

The IRS disagreed, finding that the President's day-to-day work was performed in his personal capacity as an officer of the S corporation, and not in his capacity as trustee of the trust. The IRS relied on the legislative history[4] in concluding that a trustee's material participation must be performed in his capacity as trustee, in order to count toward the trust's credit; otherwise, it counts only toward his own credit.

Since When Should We Expect the IRS to Follow Reasonable Case Law?

In a case in which the IRS has not acquiesced, *Mattie K. Carter Trust*,[5] the court allowed a trust to count the activities of the trust's employees and agents. However, the business in *Carter Trust* was a sole proprietorship, which is a type of business directly managed by its owners, in contrast to an entity (S corporation, LLC or partnership) structure, under which merely being an owner does not equate to active management.

Of most recent import is the *Aragona Trust* case.[6] There, the Tax Court expressly disagreed with the IRS's position and held that active participation by an individual can also be deemed to be active participation by that individual in his or her role as trustee of a trust stakeholder. In *Aragona*, three out of the six co-trustees worked full-time for a real estate LLC owned by the trust. Two of the three active co-trustees also owned personal interests in related businesses through which the trust's LLC operated.

The IRS argued that the real estate activities were passive and tried to assess back taxes and penalties. The Tax Court specifically held that:

(1) Material participation by a trustee counts for the trust because under state law, the trustee cannot take off his or her trustee hat, despite wearing a different hat at the same time on behalf of the business (slip op. at 23-24).
(2) The Court declined to comment on the *Carter Trust* case and the question of whether a trust can count the activities of its employees who are not trustees (slip op. at 23, n. 15).

The Court also rejected the IRS's argument that the active trustees were participating on behalf of their own individual ownership interests. The Court cited several factors, including: (1) the active trustees' personal ownership interests, when combined, were still less than 50 percent in all the related entities; (2) the active trustees' personal ownership interests, when combined, were less than the trust's ownership interest for all businesses; and (3) the goals of the personal ownership interests were aligned and compatible with those of the trust's ownership interests.

What to Do Then for Us as Practitioners

In the absence of binding regulations, any reasonable method should be acceptable in applying the passive activity rules.[7] A trust could argue that reliance on the recent *Aragona Trust* case and on the current regulations for individuals is reasonable.

The rule for individuals is that "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."[8] A partner of an active business partnership, who is active in the business operated by the partnership, who also serves as trustee of a trust which is a partner, must wear both hats at all times and cannot disregard his fiduciary duties to

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partner, she remains a partner for tax purposes (and will continue to receive a K-1 each year) even if all of her legal rights with respect to the partnership have terminated.

ENDNOTES

1 Shop Talk, *"How Small Can a Partner's Interest Be?,"* 83 J. TAX'N 126 (Aug. 1995); Shop Talk, *"No IRS Guidance Likely on How Small an LLC Member's Interest Can Be,"* 87 J. TAX'N 191 (Sept. 1997); Shop Talk, *"How Small Can a Partner's Interest Be? IRS Whispers in the Wind,"* 107 J. TAX'N 380 (Dec. 2007); Shop Talk, *"How Small Can a Partner's Interest Be? The Answer is Blowin' in the Wind,"* 108 J. TAX'N 57 (Jan. 2008); Shop Talk, *"How Small Can a Partner's Interest Be: Is 0.1% (or 0.01%) the 'New' 1%?,"* 114 J. TAX'N 186 (Mar. 2011); Shop Talk, *"How Small Can a Partner's Interest Be: More Evidence 0.1% (or Less) Is the 'New' 1%,"* 117 J. TAX'N 174 (Sept. 2012); and Shop Talk, *"Can Taxpayers With Minuscule Partnership Interests Avoid Taxes?,"* 119 J. TAX'N 198 (Oct. 2013)

2 Reg. §1.752-3(a)(3).

3 Jane could reach an even more favorable result if excess nonrecourse liabilities were allocated under Reg. §1.752-3(a)(3) based on Code Sec. 704(c) gain, but for purposes of this column, excess nonrecourse liabilities are allocated in the same ratio as profits.

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one or the other. It is most logical and practicable to count the trustee's participation—in any role—as the trust's participation.

If the reasoning is correct, then merely having one trustee active in the business should also suffice. The IRS appears to be satisfied with the activities of one co-trustee as supporting material participation by the trust.[9] The *Aragona Trust* case also supports this conclusion.

Conclusion

A trust that receives trade or business income from an operating partnership, with one co-trustee who, in another capacity (*e.g.*, as an individual partner), materially participates in the active business, should consider taking the position that its partnership income is active, on the basis of the *Aragona Trust* case. It should be understood that, at this time, the IRS has not acquiesced in the results of that case, so some risk is still involved in taking that position. Acquiescence is the reasonable next step for the IRS.

ENDNOTES

1 *Frank Aragona Trust*, 142 TC No. 9, Dec. 59,859 (Mar. 27, 2014).

2 T.D. 9644, IRB 2013-51, 676, Comment 4.F.

3 TAM 201317010, (Jan. 18, 2013).

4 S. Rep. No. 99-313.

5 *Mattie K. Carter Trust*, DC-TX, 2003-1 USTC ¶50,418, 256 F Supp2d 536.

6 *Supra* note 1.

7 *See, e.g.*, Temporary Reg. §1.469-4T(p) (allowing any reasonable method to be used during prior transition period in 1989).

8 Reg. §1.469-5(f)(1).

9 *See* TAM 200733023 (Aug. 17, 2007).

International Tax Issues

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controlled foreign corporation if the foreign corporation and the controlled foreign corporation are related parties under section 267(b). In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c).

Reg. §1.956-2(a)(3) treats a partnership as an aggregate in determining whether its investment should be treated as U.S. property under Code Sec. 956. It provides that if a CFC is a partner in a partnership that owns property that would be U.S. property if owned directly by the CFC, the CFC will be treated as holding an interest in the property equal to its interest in the partnership and such interest will be treated as U.S. property.

Therefore, if FP had loaned Amount 1 directly to U.S. Parent, the loan would have been treated as an investment in U.S. property by all of FPS's partners in proportion to their interests in FPS. Accordingly, to the extent that the partners of FPS other than CFC1 had earnings and profits, those earnings and profits would have been additional amounts included by U.S. Parent under Code Sec. 951(a)(1)(B) and 956.

The IRS, not in favor of the result that U.S. Parent achieved, applied the Reg. §1.956-1T(b)(4) anti-abuse rule. The IRS stated that if CFC Partner 1 had borrowed directly from the other CFC Partners, rather than from FPS (the partnership in which they are partners), it would be clear that the borrowing constitutes a "funding" for purposes of Reg. §1.956-1T(b)(4). The IRS then stated that the result is the same when a CFC borrows from a partnership, the partners of which are related CFCs.

It reasoned that the application of Reg. §1.956-1T(b)(4) does not depend on a "direct" funding by a CFC—that is, a loan from a CFC directly to a CFC—as opposed to a loan from a partnership the partners of which are CFCs. The IRS cited the portion of the regulation which states, "if one of the principal purposes for ... funding ... such other foreign corporation is to avoid the application of section 956 with respect to the controlled foreign corporation ... ."

The IRS also stated that applying the rule to this fact pattern comports with Reg. §1.956-2(a)(3), which treats a CFC as owning an interest in U.S. property when it is a partner in a partnership that owns U.S. property. If DE1 had loaned

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