STUDENT WRITING COMPETITION WINNER

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Navigating the Code's 'Taxpayer' Labyrinth for Trusts and Estates

by Paul Hawkins

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In this report, Hawkins explores the unsolved and interconnected issues for trusts and estates under sections 469, 1411, and 199A.

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> The only difference between death and taxes is that death doesn't get worse every time Congress meets.[1]

I. Introduction

The tax code is filled to the brim with tension. Notable among its many features is the allowance for preferential tax rates on income that constitutes net capital gain and qualified dividends under section 1(h). However, section 1411 was enacted in 2010 to impose a net investment income tax on income from passive activities as defined under section 469.[2]

The NII tax applies to specified individuals and to trusts and estates. Unfortunately, it's still unclear how the section 469 definition of passive activity — which is based in part on the taxpayer's lack of "material participation" — applies in the context of trusts and estates. Because trusts and estates are treated as hybrid entities under the rules of subchapter J, the taxpayer might be the trust or estate, a beneficiary, or both.

Despite the lack of clarity on that issue, Congress recently enacted section 199A[3] and, at the last minute, made it expressly applicable to trusts and estates.[4] Section 199A provides a 20 percent deduction for qualified business income (QBI) from a qualified trade or business. The addition of section 199A to the code not only creates additional layers of statutory complexity, but it also follows in the footsteps of section 469 by focusing on the taxpayer — ignoring the hybrid nature of trusts and estates. Thus, taxpayers and practitioners need guidance on the unresolved issues of sections 1411 and 469, as well as on the new layers of statutory complexity provided by section 199A.

This report navigates the statutory labyrinth by reviewing section 1411 and examining section 469 and its definition of passive activity. It finds that analyzing how the material participation requirement should be applied to trusts and estates helps inform a workable approach to section 199A. It also identifies planning opportunities that exist until regulations are issued under the new provision.

II. The Net Investment Income Tax

Section 1411 imposes a 3.8 percent tax on the lesser of (1) individuals' NII for the tax year, or (2) the excess (if any) of their modified adjusted gross income for the tax year over the threshold amount.[5] The term "modified adjusted gross income" usually simply means AGI.[6] The

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[1] Will Rogers, actor and humorist.

[2] Enacted by the Health Care and Education Reconciliation Act of 2010, P.L. 111-152.

[3] Enacted by the Tax Cuts and Jobs Act, P.L. 115-97.

[4] Tony Nitti, "Tax Geek Tuesday: Making Sense of the New '20% Qualified Business Income Deduction,'" *Forbes*, Dec. 26, 2017.

[5] Section 1411(a)(1).

[6] Section 1411(d).

threshold amount is $250,000 if the taxpayer is married and filing a joint return or is a surviving spouse, $125,000 if married and filing a separate return, and $200,000 in most other cases.[7] As a result, for joint filers with an AGI of $400,000, the tax of 3.8 percent will be imposed on $150,000 ($400,000 - $250,000) unless the couple's NII amount is less. Consequently, for high-income taxpayers hoping to avoid the 3.8 percent tax, the critical inquiry is the meaning of the term "net investment income."

For trusts and estates, section 1411 imposes a 3.8 percent tax on the lesser of (1) the estate's or trust's undistributed NII for the tax year, or (2) the excess (if any) of the AGI for that tax year (as defined in section 67(e) and as adjusted under reg. section 1.1411-10(e)(2), if applicable) for the tax year over the dollar amount at which the highest tax bracket in section 1(e) begins for the tax year.[8] The dollar amount at which the highest tax bracket in section 1(e) begins in 2018 is $12,500.[9] That compressed rate structure places trusts and estates at a disadvantage. The fiduciary of an estate or trust is required to pay the 3.8 percent tax on the AGI of the estate or trust minus the section 1(e) amount unless the undistributed NII for the tax year is less. Consequently, a fiduciary potentially avoids the 3.8 percent tax only if he distributes all NII, earns zero NII, or has virtually no AGI.

Admittedly, some estates or trusts aren't subject to the NII tax under section 1411.[10] If all the unexpired interests in a trust or decedent's estate are devoted to at least one of the purposes described in section 170(c)(2)(B), the trust or estate is exempt.[11] Foreign estates and foreign trusts are also exempt.[12] And the following are either exempt from the NII tax or subject to special rules: trusts exempt from tax under section 501; charitable remainder trusts described in section 664; any other trust, fund, or account that is statutorily exempt from taxes imposed in subtitle A; a trust or portion thereof that is treated as a grantor trust under subpart E of subchapter J; and electing small business trusts.[13] For a grantor trust or portion thereof, each item of income or deduction that is included in computing taxable income of a grantor or another person under section 671 is treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating that person's NII.[14]

Still, it's clearly important to define NII. The term means the excess (if any) of (1) the sum of (A) gross income from interest, dividends, annuities, royalties, and rents, except to the extent that income is attributable to a trade or business that is not a passive activity; (B) other gross income derived from a trade or business that is not a passive activity; and (C) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is not a passive activity minus (2) the deductions allowed by subtitle A that are properly allocable to that gross income or net gain.[15]

The determination of whether a trade or business constitutes a passive activity is made under section 469 and its regulations.[16] If the taxpayer is actively engaged in a trade or business, however, the taxpayer will have no NII, and the 3.8 percent tax imposed by section 1411 is potentially avoidable (assuming there is no other activity or portfolio of investments).[17] If there is NII for a trust or estate, the fiduciary should at least consider distributing that income to avoid the compressed rate structure applicable to trusts and estates.

[7]Section 1411(b).

[8]Section 1411(a)(2). An estate's or trust's undistributed NII is its NII reduced by distributions of NII to beneficiaries and by deductions under section 642(c) as outlined in the regulations. Reg. section 1.1411-3(e).

[9]Section 1(j)(2)(E).

[10]Reg. section 1.1411-3(b)(1).

[11]Reg. section 1.1411-3(b)(1)(i).

[12]Reg. section 1.1411-3(b)(1)(viii) and (ix).

[13]Reg. section 1.1411-3(b)(1)(ii), (iii), (iv), and (v); reg. section 1.1411-3(c).

[14]Reg. section 1.1411-3(b)(1)(v).

[15]Section 1411(c)(1) and (2). The tax also applies to businesses trading in financial instruments or commodities. Further, NII doesn't include items taken into account in determining self-employment income subject to tax under section 1401(b). *See* reg. section 1.1411-9.

[16]Section 1411(c)(2)(A). *See also* reg. section 1.1411-5(b).

[17]Certainly, section 1411 appears to target the "idle rich." To assert that the tax is of the type to successfully address income inequality, however, is seriously questionable. *See* Matthew Smith et al., "Capitalists in the Twenty-First Century" (Nov. 15, 2017). Perhaps, the tax is needed to target disguised wages.

III. Section 469

A. Defining Passive Activity

Under section 469, the term "passive activity" means any activity that involves the conduct of a trade or business and in which the taxpayer does not materially participate.[18] This includes rental activities.[19] The term "trade or business" can include activities outside the ambit of a trade or business proper.[20] Otherwise, it carries the same meaning as in section 162.[21] Thus, to recognize what constitutes passive activity, one must understand the definitions of activity and material participation.

An individual is considered to materially participate in an activity if at least one of the following seven tests is satisfied:

1. the individual participates in the activity for more than 500 hours during the tax year;
2. the individual's participation in the activity for the tax year constitutes substantially all of the participation in that activity by all individuals for that year (including by individuals who aren't owners of interests in the activity);
3. the individual participates in the activity for more than 100 hours during the tax year, and that participation is not less than the participation of any other individual for that year (including of individuals who aren't owners of interests in the activity);
4. the activity is a significant participation activity (within the meaning of reg. section 1.469-5T(c)) for the tax year, and the individual's aggregate participation in all significant participation activities during that year exceeds 500 hours;
5. the individual materially participated in the activity for any five tax years (whether or not consecutive) within the 10 tax years that immediately precede the tax year;
6. the activity is a personal service activity (within the meaning of reg. section 1.469-5T(d)), and the individual materially participated in the activity for any three tax years (whether or not consecutive) preceding the tax year; or
7. based on all the facts and circumstances (taking into account the rules in reg. section 1.469-5T(b)), the individual participates in the activity on a regular, continuous, and substantial basis during the tax year.[22]

Notably, an individual will not be treated as materially participating in any activity of a limited partnership to the extent of his limited interest in the partnership unless he satisfies tests 1, 5, or 6.[23] The courts generally don't treat an interest in a limited liability company as an interest in a limited partnership by a limited partner for these purposes.[24]

In November 2011 the IRS published proposed regulations on the definition of an interest in a limited partnership as a limited partner for purposes of determining material participation under section 469.[25] The proposed regulations provide that an interest in an entity will be treated as an interest in a limited partnership under section 469(h)(2) if:

- the entity in which the interest is held is classified as a partnership for federal income tax purposes under reg. section 301.7701-3; and
- the holder of that interest doesn't have rights to manage the entity at all times during its tax year under the law of the jurisdiction in which the entity was organized and under the governing agreement.

As a result, a member of an LLC may or may not have an interest in a limited partnership as a limited partner, depending on the member's rights to manage.

Individuals engaged in rental activities must clear a couple more hurdles to satisfy the material participation requirement. For starters, rental

[18] Section 469(c)(1).

[19] Section 469(c)(2); *see also* reg. section 1.469-1T(e)(3).

[20] Section 469(c)(6).

[21] Reg. section 1.469-4(b).

[22] Reg. section 1.469-5T(a).

[23] Reg. section 1.469-5T(e).

[24] *See Gregg v. United States*, 186 F. Supp.2d 1123 (D. Or. 2000); *Garnett v. Commissioner*, 132 T.C. 368 (2009); *Thompson v. United States*, 87 Fed. Cl. 728, 730 (2009), *acq.*, AOD-2010-02; and *Newell v. Commissioner*, T.C. Memo. 2010-23.

[25] REG-109369-10.

activities are deemed passive even if the taxpayer materially participates.[26] However, this rule doesn't apply when the taxpayer is engaged in a real property trade or business.[27] In other words, for a taxpayer engaged in a real property trade or business, the general rules for determining material participation apply instead of the per se passive rule. Thus, if a taxpayer is engaged in a real property trade or business, he can satisfy the material participation standard and avoid the consequences of passive activity treatment.

The term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.[28] For a taxpayer to be treated as engaged in a real property trade or business, however, the following two conditions must be satisfied:

1. more than half of the personal services performed in trades or businesses by the taxpayer during that tax year must be performed in real property trades or businesses in which he materially participates; and
2. during the tax year the taxpayer must perform more than 750 hours of services in real property trades or businesses in which he materially participates.[29]

Thus, if a taxpayer qualifies as a real estate professional, his rental activities will not be subject to the per se passive rule but instead will be subject to the general rules for determining material participation. Importantly, although a taxpayer may elect to treat all interests in rental real estate as one activity, and thereby more easily pass the material participation requirement, each of his interests in rental real estate is otherwise treated as a separate activity, and the material participation requirement must be satisfied for each activity.[30]

With this fresh understanding of the material participation requirement for individuals, one can now consider more fully the meaning of the term "activity." As an initial matter, an activity will simply be any trade or business or rental activity. However, reg. section 1.469-4 allows for grouping a taxpayer's trade or business activities and rental activities in applying the passive activity loss and credit limitation rules.[31] Multiple trade or business activities or rental activities (as defined in reg. section 1.469-4(b)) may be treated as a single activity if they constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469.[32] Whether activities constitute an appropriate economic unit depends on all the relevant facts and circumstances.[33]

A taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. Several factors are given greater weight when analyzing the grouping of specific activities. These include:

- similarities and differences in types of trades or businesses;
- the extent of common control;
- the extent of common ownership;
- geographical location; and
- interdependencies between the activities (for example, the extent to which the activities purchase or sell goods between themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).[34]

The regulations provide a helpful example illustrating the flexibility inherent within that determination:

> Taxpayer C has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a

[26] Section 469(c)(4).

[27] Section 469(c)(7).

[28] Section 469(c)(7)(C).

[29] Section 469(c)(7)(B).

[30] Section 469(c)(7)(A).

[31] Reg. section 1.469-4(a).

[32] Reg. section 1.469-4(c)(1).

[33] Reg. section 1.469-4(c)(2).

[34] *Id*.

> bakery and a movie theater in Philadelphia. In this case, after taking into account all the relevant facts and circumstances, there may be more than one reasonable method for grouping C's activities. For instance, depending on the relevant facts and circumstances, the following groupings may or may not be permissible: a single activity; a movie theater activity and a bakery activity; a Baltimore activity and a Philadelphia activity; or four separate activities.[35]

Only a material change in circumstances will permit a change in grouping during subsequent tax years.[36] Further, the IRS may regroup a taxpayer's activities "if any of the activities resulting from the taxpayer's grouping is not an appropriate economic unit and a principal purpose of the taxpayer's grouping (or failure to regroup under [reg. section 1.469-4(e)]) is to circumvent the underlying purposes of section 469."[37]

Despite the apparent flexibility of reg. section 1.469-4, there are significant restrictions with which taxpayers must comply. A rental activity may not be grouped with a trade or business activity unless the activities constitute an appropriate economic unit and (1) the rental activity is insubstantial relative to the trade or business activity; (2) the trade or business activity is insubstantial relative to the rental activity; or (3) each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case only the portion of the rental activity that involves the rental of property for use in the trade or business activity may be grouped with the trade or business activity.[38]

Whether an activity is insubstantial relative to another is a facts and circumstances inquiry, and there is no safe harbor or bright-line test.[39] Nonetheless, it is at least possible for rental activities to be grouped with other trades or businesses to apply the passive loss and credit limitations of section 469.

B. The *Stanley* Debate

Reg. section 1.469-9 provides guidance to taxpayers engaged in specific real property trades or businesses on how to apply the real property trade or business exception of section 469(c)(7) to their rental real estate activities. A taxpayer may make an election under reg. section 1.469-9(g) to treat all interests in rental real estate as a single activity. However, the regulations state that each separate rental real estate activity — or the single combined real estate activity, if the taxpayer makes an election — "will be an activity of the taxpayer for all purposes of section 469, including the former passive activity rules under section 469(f) and the disposition rules under section 469(g)."[40]

Strangely, however, any rental real estate that the taxpayer grouped with a trade or business activity under reg. section 1.469-4(d)(1)(i)(A) or (C) is not an interest in rental real estate for purposes of reg. section 1.469-9.[41] As a result, it appears that a taxpayer must separate a grouping under reg. section 1.469-4(d)(1)(i)(A) or (C) from the grouping rules under reg. section 1.469-9(g). Further, treating an activity as an activity for all purposes of section 469 doesn't necessarily mean the activity can't later be grouped with other trades or businesses as a matter of literal interpretation. This distinction is significant in the context of *Stanley*.[42]

The taxpayer in *Stanley* held a minority interest in more than 100 entities that owned or operated rental properties. He was the CEO of the company that managed those properties. However, through a family limited partnership, the taxpayer also held interests in nearly 100 additional entities that were other trades or businesses. He aggregated all the rental activities and then grouped the aggregated rental activity

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[35] Reg. section 1.469-4(c)(3), Example 1.

[36] *Id.*

[37] Reg. section 1.469-4(f).

[38] Reg. section 1.469-4(d)(1)(i).

[39] *See* preamble to T.D. 8565.

[40] Reg. section 1.469-9(e)(1).

[41] Reg. section 1.469-9(b)(3). It is not obvious why a rental activity grouped under the limitation of reg. section 1.469-4(d)(1)(i)(B) is still included in the meaning of rental activity for purposes of reg. section 1.469-9. Perhaps the nature of the grouping and the type of rental activity at play didn't concern the drafters.

[42] *Stanley v. United States*, No. 5:14-cv-05236 (W.D. Ark. 2015), *nonacq.*, AOD-2017-07.

with the other trade or business activities in which he was passive but that were insignificant relative to the rental activities. The taxpayer asserted that the material participation requirement was satisfied for the grouped activity because it was satisfied for the aggregated "rental activity."

The government argued that the taxpayer couldn't group his aggregated rental activity with any other non-rental activity because the grouping was categorically prohibited by reg. section 1.469-9(e)(3)(i), which provides:

> For purposes of this section, a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity under section 1.469-5T.

The district court rejected the government's argument based on a close reading of the code and regulations. It found that reg. section 1.469-9(e)(3)(i) "bars grouping only for purposes of determining material participation and does not categorically bar a real estate professional from grouping rental and non-rental activities for other purposes, including for purposes of determining passive activity loss and credit." Thus, the decision distinguishes between grouping for purposes of determining material participation and grouping for other purposes, including application of the passive activity loss and credit limitations of section 469. That distinction is odd considering that a person tries to satisfy the material participation requirement to apply the passive loss and credit limitations.

The district court gave several reasons for its interpretation of reg. section 1.469-9:

> First, subsection 1.469-9(e)(3)(i) is self-limiting, as it begins with the words, "for purposes of this section." "This section" refers to 1.469-9, entitled "Rules for certain rental real estate activities" with the stated purpose of "provid[ing] guidance to taxpayers engaged in certain real property trades or businesses on applying section 469(c)(7) to their rental real estate activities." 26 C.F.R. section 1.469-9(a).

The district court continued:

> Subsection 1.469-9(e)(3)(i) does not otherwise purport to prohibit real estate professionals from taking advantage of the rules set out in [reg.] section 1.469-4, allowing taxpayers to group certain activities and, specifically, allowing grouping of rental activities with other trade or business activities in certain circumstances, section 1.469-4(d)(1), "for purposes of applying the passive activity loss and credit limitation rules of section 469," section 1.469-4(a).

This is significant considering that reg. section 1.469-4 is explicitly referenced in other subsections of reg. section 1.469-9.

The district court's reasoning on this first point is misleading, even though it's ultimately correct. Reg. section 1.469-9 expressly states that if a taxpayer groups rental activities with other trade or business activities under the limitations in reg. section 1.469-4(d)(1)(i)(A) or (C), those rental activities do not constitute rental activities under reg. section 1.469-9.[43] Thus, the only grouping potentially allowed by reg. section 1.469-9 is the grouping method permitted under the reg. section 1.469-4(d)(1)(i)(B) limitation. This makes some sense because reg. section 1.469-4(d)(1)(i)(A) or (C) contemplates situations in which the rental activity is insignificant or linked to a larger trade or business.

Nonetheless, reg. section 1.469-4(d)(1)(i)(B) contemplates a situation in which the trade or business is insignificant relative to the rental activity. That is the limitation that applied to the taxpayer in *Stanley*. Reg. section 1.469-4(h) directs real estate professionals to reg. section 1.469-9 under the heading, "Rules for grouping rental real estate activities for taxpayers qualifying under section 469(c)(7)." If a taxpayer makes an election

[43] Reg. section 1.469-9(b)(3).

under reg. section 1.469-9(g) to aggregate all his rental activities, however, there is no language that precludes him from then grouping the aggregated rental activity with other trades or businesses subject to the reg. section 1.469-4(d)(1)(i)(B) limitation. The language of reg. section 1.469-9(e)(3)(i) focuses on material participation and says nothing that prevents the taxpayer from applying the rules of reg. section 1.469-4. Although aggregated rental activity will be an activity for all purposes of section 469 under reg. section 1.469-9(e)(1), the section does not say that "activity" cannot then be grouped with other trades or businesses.

The second reason provided by the district court involved a close reading of the summary conclusion in 1.469-9(e)(3)(i):

> Subsection 1.469-9(e)(3)(i) ends with the summary conclusion that, because a real estate professional may not group a rental real estate activity with any other activity of the taxpayer for purposes of section 1.469-9, "only the participation of the taxpayer with respect to the rental real estate may be used to determine if the taxpayer materially participates in the rental real estate activity under section 1.469-5T." The conclusion does not say that a real estate professional cannot, thus, group rental activities with any other activity for purposes of applying the passive activity loss and credit limitation rules of section 469. Rather, read in context, the subsection appears to apply to grouping for purposes of determining material participation or, perhaps, to aggregating rental activities pursuant to subsection 1.469-9(g) (which would be done, in part, to meet material participation requirements).

The court was correct in its assertion because the language of the regulation is specifically tailored to discussing the material participation requirement and goes no further.

The final reason provided by the district court for its decision was that reg. section 1.469-4(c)(1) "explicitly allows for grouping of rental and non-rental activities in certain circumstances." That seems almost redundant. Nonetheless, the net result of the court's interpretation is that rental activities may be grouped together for material participation purposes, but not with other trades or businesses. However, rental activities may be grouped with other trades or businesses for other purposes, such as for the passive loss and credit limitations.

Undoubtedly, the district court is interpreting some ambiguous language. I would certainly ask whether the taxpayer in *Stanley* grouped the aggregated rental activity with other trades or businesses to apply the passive loss limitations or because he knew he otherwise didn't satisfy the material participation requirement for those other trades or businesses. The IRS recognized that point but failed to convincingly argue it before the district court.

It appears the regulations contain a serious drafting error because it's possible for a passive activity to be converted into an activity that is not passive through the election available under reg. section 1.469-9(g) and the grouping rules under reg. section 1.469-4(d)(1)(B). Until that issue is addressed through further guidance, aggressive taxpayers could justifiably follow a literal interpretation of the code and regulations, like the *Stanley* taxpayer.

The IRS, in its action on decision declaring non-acquiescence in the *Stanley* decision,[44] stated that the court "never reconciled the language in section 1.469-9(e)(3)(i) with the regulatory language in section 1.469-9(e)(1) or the statutory language in section 469(c)(7)(A)(ii) from which the regulatory language is derived, both of which make clear that those rules apply for all purposes of section 469." Indeed, if one looks at the language of section 469(c)(7), it clearly states, "This section shall be applied as if each interest of the taxpayer in rental real estate were a separate activity." The IRS correctly recognizes that the words "this section" refer to section 469 generally and not just section 469(c)(7). However, the words "this section" in reg. section 1.469-9(e)(3)(i) clearly refer only to reg. section 1.469-9. That provision appears particularly tailored to the material participation requirement.

[44] AOD-2017-07.

Further, although an aggregated rental activity is an activity for all purposes of section 469 under reg. section 1.469-9(e)(1), the regulation doesn't say that that "activity" cannot then be grouped with other trades or businesses. Although the IRS may have intended aggregated rental activity to be ineligible for grouping under reg. section 1.469-4(d)(1), that prohibition doesn't clearly follow from the language of the regulations or the statute — no matter how strongly the IRS believes otherwise.

Still, one must take a step back to appreciate the IRS's perspective. The goal of the material participation requirement is to distinguish trades or businesses or rental activities in which a taxpayer is active from those in which the taxpayer is passive for purposes of applying the passive loss and credit limitations. It makes no sense to say a taxpayer is grouping activities for purposes of applying the passive loss and credit limitations but without regard to the material participation test, or for material participation purposes but without regard to the passive loss and credit limitations. A taxpayer must determine the one to apply the other. However, with the poorly drafted section 469 regulations and a taxpayer-friendly judge, that is exactly the kind of argument a taxpayer can get away with, as in *Stanley*.

Ultimately, the taxpayer must satisfy the material participation requirement for each activity, and if multiple activities are to be grouped together into one activity for purposes of applying the passive loss and credit limitations under reg. section 1.469-4, each activity should be of the same type (active or passive) before that grouping occurs. Otherwise, conversion is possible. However, there is no such restriction (or at least a clearly recognizable one) in the regulations.

Thus, although the taxpayer in *Stanley* may have flunked the reg. section 1.469-4(f) test because his primary goal in grouping the activities was to circumvent the underlying purposes of section 469, the IRS failed to make a compelling argument why reg. section 1.469-9(e)(3)(i) should have prevented him from doing it. The regulations are complex and inherently ambiguous, thus giving sophisticated taxpayers the opportunity to play each provision against the other. The link between reg. section 1.469-9(e)(3)(i) and reg. section 1.469-4 and the material participation requirement is not well articulated. That is a problem Treasury and the IRS must fix.

C. The Material Participation Debate

The regulations under section 469 reserve on the question of how trusts and estates can satisfy the material participation requirement.[45] Yet it's clear that estates and trusts can materially participate for purposes of sections 469 and 1411 and that they can qualify for the real property trade or business exception.[46]

Richard L. Dees has pointed to the legislative history of the Tax Reform Act of 1986, which added section 469, as "the most definitive authority on whether a trust can materially participate for purposes of section 469."[47] He notes that the Senate report accompanying TRA 1986 treats an estate or trust as materially participating in an activity "if an executor or fiduciary, in his capacity as such, is so participating."[48] The fiduciary is not merely the named trustee but whoever has decision-making authority over the trust.[49] Unfortunately, although the Senate report identifies the executor or fiduciary as the person or persons of primary importance, section 469 requires looking to the activities of the taxpayer. The taxpayer must be involved in an activity on a basis that is regular, continuous, and substantial to satisfy the material participation standard.[50] Thus, we are stuck trying to fit the square peg of section 469 into the round hole of subchapter J.[51]

The question remains of whose efforts count when it comes to satisfying the material participation requirement. In *Carter Trust*,[52] the IRS argued that the material participation of a trust in a trade or business, within the meaning of

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[45] Reg. section 1.469-5T(g).

[46] *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014).

[47] Dees, "20 Questions (and 20 Answers!) on the New 3.8 Percent Tax," *Tax Notes*, Aug. 12, 2013, p. 683.

[48] S. Rep. No. 99-313, at 735 and n.287 (1986).

[49] TAM 200733023.

[50] Section 469(h)(1). This is the only standard that applies to trusts and estates, unlike the seven tests applicable to individuals.

[51] M. Carr Ferguson, James J. Freeland, and Mark L. Ascher, *Federal Income Taxation of Estates, Trusts & Beneficiaries*, section 8.01 (3d ed. 2011).

[52] *Mattie K. Carter Trust v. United States*, 256 F. Supp.2d 536, 539 (N.D. Tex. 2003).

section 469(h)(1), "should be determined by evaluating only the activities of the trustee in his capacity as such." The trust argued that "because the trust (not the trustee) is the taxpayer, 'material participation' . . . should be determined by assessing the activities of [the trust], through its fiduciaries, employees, and agents." The district court held in favor of the trust. Dees explains the court's holding as follows:

> The court in *Carter Trust* treated the trust as an entity and therefore concluded that the activities of the trust's employees and agents were just as important as those of the trustee. The IRS's view is more traditional: The trustee is the legal owner of the trust assets and owes fiduciary duties to the trust beneficiaries. The trust is a fiduciary relationship, not a legal entity; therefore, only the trustee's actions were relevant as if the individual trustee was an individual owner of the trust assets.[53]

The IRS did not appeal or declare non-acquiesce in the decision, and the questions surrounding this subject still abound.[54] Ultimately, until regulations are issued on this point, section 469(h)(1) remains the sole standard for determining whether a trust or estate satisfies the material participation requirement of section 469.[55] Presumably, to qualify as a real estate professional, a fiduciary or executor must still meet the two additional requirements noted earlier in this report. Yet, this issue is still unsettled. At the very least, we know a fiduciary or executor must satisfy the "regular, continuous, and substantial" standard.

The American Bar Association Section of Taxation and the New York State Bar Association Tax Section have submitted comments on the direction they believe future regulations under section 469(h)(1) should take.[56] The following summary shows each group's position on several questions:

> QUESTION 1: Whose participation is relevant to whether a trust or estate materially participates in the trade or business or rental activity owned by a trust or estate?
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> > ABA tax section: The participation of each person owing fiduciary duties to the beneficiaries of the trust or estate with decision-making authority and the power to act on behalf of the trust or estate is relevant. When the taxpayer is not the trust but the beneficiary, the ABA is split on whether the activities of the beneficiary should count in determining material participation.
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> > NYSBA tax section: The activities of the trustee or trustees should be the sole consideration. The trustees whose activities are being relied on to show material participation should have fiduciary responsibility to the trade or business in which the trust has an interest. This prerequisite generally will be satisfied if the trustee is required to act as a fiduciary in making decisions regarding the trade or business. However, if there are limitations on the ability of a specific trustee to act, such as when a trustee's authority is limited to making distributions from the trust, the activities of that particular trustee (who has limited authority) should not be considered in determining whether the trust materially participates.
>
> QUESTION 2: Should the activities of the fiduciary counting toward the material participation requirement be limited to those performed in the capacity of a fiduciary, or can other activities the

[53] Dees, *supra* note 47, at n.99.

[54] *See*, *e.g.*, TAM 200733023 (only the efforts of the fiduciary of a trust count for material participation purposes); LTR 201029014 (the beneficiary and trustee of a complex trust that owns a partnership interest in B can materially participate in the activities of a multitier subsidiary of B); and TAM 201317010 (a trust couldn't take advantage of the special trustee's participation in an individual capacity to establish participation on behalf of the trust).

[55] TAM 200733023.

[56] ABA tax section, "Comments on Material Participation by a Trust or Estate Under Section 469" (Jan. 20, 2015); and NYSBA tax section, "Material Participation of Trusts and Estates Under Sections 469 and 1411 of the Code," Rep. No. 1326 (Aug. 17, 2015).

fiduciary performs (for example, as an employee, manager, etc.) also be included?

ABA tax section: The trust or estate may consider the actions of its fiduciary undertaken in any capacity in the trade or business or rental activity if undertaken while owing fiduciary duties to the beneficiaries of the trust or estate.

NYSBA tax section: Activities performed by a person serving as trustee (with fiduciary responsibility to the trade or business) — whether performed as trustee, employee, or otherwise — should be considered in applying the material participation test.

QUESTION 3: What test(s) should trusts and estates satisfy to meet the material participation requirement?

ABA tax section: A fiduciary's participation in a trade or business or rental activity owned by a trust or estate should constitute material participation by the trust or estate when the fiduciary satisfies either of two alternative tests: (1) an objective, hours-based parity test, or (2) a subjective facts and circumstances test. The parity test should apply to each fiduciary the seven individual hours tests prescribed by the regulations for determining whether an individual materially participated in a trade or business or rental activity. The facts and circumstances test should aggregate the participation of all the fiduciaries of the trust or estate and all their employees and agents.

NYSBA tax section: The activities of a trustee that count toward material participation generally should be determined in the same manner as an individual who is an owner of the trade or business. Thus, mere management authority or oversight like that of a shareholder, without involvement in operations, should not be included in determining whether a trustee materially participates. However, if the person serving as trustee has the appropriate authority with respect to the operation of the business, and actually undertakes such activity (whether alone or with other trustees), all time spent by that person in the business should be counted toward material participation. Trustees should be able to rely upon the safe harbors set forth in reg. section 1.469-5T(a), with appropriate modifications, to meet the material participation standard. In determining whether a material participation standard has been satisfied, the activities of multiple trustees with requisite authority should be aggregated, but with appropriate adjustments to the existing rules relating to safe harbor tests available to individuals. Work performed by the agents or employees of a trustee should not count toward material participation by the trust.

QUESTION 4: Do the tests specific to the real property trade or business exception apply to trusts and estates?

ABA tax section: The real estate professional exception should apply to trusts and estates, counting fiduciary hours in the same manner as under the facts and circumstances test.

NYSBA tax section: For purposes of the real estate professional exception, a trust may be treated as engaging in personal services and therefore qualify under the exception if there is at least one trustee who qualifies as a real estate professional.

QUESTION 5: How should a corporate trustee be treated in applying the material participation requirement?

ABA tax section: If a fiduciary who has authority to participate in the trade or business or rental activity on behalf of the trust or estate is a corporate trustee or trust company, including a private

> trust company, the actions of the employees and agents of the corporate trustee or trust company should be considered in determining whether the trust or estate materially participates in the trade or business or rental activity under the facts and circumstances test.
>
> NYSBA tax section: Material participation may not be achieved through the activities of corporate trustees, such as banks and trust companies, with a limited exception for private trust companies.

In reviewing the positions taken by the ABA and NYSBA tax sections, some interesting observations emerge. On Question 1, concerning whose participation is relevant, both groups agree that the activities of the fiduciary or fiduciaries or those with substantial decision-making authority or power over trust assets should be considered first. That's consistent with the Senate report to TRA 1986 and appropriate if the trust is the taxpayer.

However, if the beneficiary is the taxpayer, the ABA tax section appears split on whether the beneficiary's actions should count, whereas the NYSBA tax section seems to maintain that regardless of the statutory language, only the fiduciaries' activities should be considered. Recall that section 1411 requires determining the character of items of income in the hands of the trust before distribution to a beneficiary, and that the character of that income remains the same in the hands of the beneficiary as it is in the hands of the trust.[57] For that reason, I believe that the statute should control and that the beneficiary's actions should be considered in making the character determination if the beneficiary is the taxpayer on that income.

What would happen if the statutory language were ignored and the beneficiary's actions were never considered? In the context of section 469, the term "taxpayer" would be interpreted as nothing more than the fiduciary or fiduciaries of a trust or estate. However, as discussed later, section 199A also requires looking to the taxpayer in computing the 20 percent deduction. I believe, therefore, that one would be hard-pressed to argue that the beneficiary's status should be ignored. For the sake of consistency with section 199A, the actions of the beneficiary should count for section 469 purposes.

On Question 2, concerning which of the fiduciary's duties should count, the ABA and NYSBA tax sections both recognize that it doesn't matter what hat a fiduciary wears when performing services (for example, employee, manager, etc.) as long as the services are undertaken while owing fiduciary duties to the beneficiaries or the estate.

The groups differ on Question 3, however. Both the ABA and NYSBA tax sections appropriately recommend applying the same tests that are applicable to individuals. However, the ABA tax section would also incorporate the *Carter Trust* holding and permit looking to the activities of employees or agents to satisfy the material participation requirement.

That view is appropriate only when a trust directly owns or manages a trade or business. If a trust is acting only in the capacity of a shareholder, it's hard to understand how it can satisfy the regular, continuous, and substantial activity standard.[58] Further, it seems untenable to permit the actions of employees or agents of a trust to count when the actions of the principal do not. Thus, I argue, as does the ABA tax section, that depending on the facts and circumstances, the efforts of employees and agents should count.

On Question 4, concerning the applicability of tests specific to the real property trade or business exception, both the ABA and NYSBA tax sections recognize that the exception should apply to trusts and estates in the same manner as to individuals.

Under Question 5, the two groups have very different views on whether a corporate trustee should be allowed to satisfy the material participation requirement. Because a corporate trustee can act only through officers, directors,

[57] Reg. section 1.1411-3(e)(3)(ii).

[58] "The work that shareholders . . . do generally is considered 'investor' work that does not count under the passive loss rules." Steven B. Gorin and Richard E. Barnes, "Trustee Material Participation in Businesses: A Surprising Way to Overcome TAM 201317010 and Avoid the NII Tax," 29 *Prob. & Prop.* 58 (2015) (citing reg. section 1.469-5T(f)(2)(ii)).

employees, and agents, I believe a corporate trustee should be allowed to satisfy the material participation requirement only to the extent that those persons are actively engaged in the management or operation of the trade or business and not simply acting in the capacity of a shareholder-investor. This may require a corporation or passthrough entity to specifically engage a corporate trustee to provide management services to it.[59]

The NYSBA tax section recommends not giving corporate trustees the ability to satisfy the material participation requirement, but it recognizes that "the requisite linchpin for trustee material participation" could exist since, "as a matter of state law, a corporate trustee's fiduciary duties extend to its directors and officers." The group's position is unjustifiably harsh and burdensome; there are plausible workarounds to address the concerns at issue.

IV. Applying Section 199A

Section 199A is new, and it is dense. Further, like section 469, it focuses on the taxpayer and fails to address the unique hybrid nature of subchapter J. It allows any taxpayer that is not a corporation a deduction equal to 20 percent of the taxpayer's taxable income for the tax year minus any net capital gain — unless the taxpayer's combined QBI is less, in which case the deduction is limited to that amount (assuming no qualified cooperative dividends). The 20 percent deduction cannot exceed the taxpayer's taxable income (reduced by net capital gain) for the tax year.[60]

QBI is the net amount of qualified items of income, gain, deduction, and loss for any qualified trade or business of the taxpayer.[61] The term does not include qualified real estate investment trust dividends or qualified publicly traded partnership income.[62]

Under section 199A(b), combined QBI is the sum of:

(1) the lesser of

(A) 20 percent of the taxpayer's QBI; or

(B) the greater of (i) 50 percent of the Form W-2 wages regarding the business, or (ii) 25 percent of the Form W-2 wages paid regarding the business plus 2.5 percent of the unadjusted basis immediately after the acquisition of all qualified property; plus

(2) 20 percent of the aggregate amount of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income for the tax year.[63]

The provisions above are an acknowledgment that some qualified trades or businesses have a significant employee base while others have fewer employees but significant amounts of qualified property. The term "qualified property" means tangible property subject to depreciation under section 167.[64] Thus, the term doesn't apply to land but does apply to the improvements or physical development added to land, like buildings and fixtures.[65] But even if there is a large employee base or lots of qualified property, the "lesser of" rule limits the deduction to 20 percent of QBI.

The term "qualified trade or business" means any trade or business other than a specified service trade or business or the trade or business of performing services as an employee.[66] In other words, if the trade or business is related to health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business whose principal asset is the reputation or skill of one or more of its employees, the trade or business doesn't qualify for the deduction.[67] However, a taxpayer engaged in one of those trades or businesses may still qualify for the

[59] *Id.*

[60] Section 199A(a).

[61] Section 199A(c)(1).

[62] *Id.*

[63] To simplify matters further, this report assumes the trust or estate holds no qualified REIT dividends and does not earn any qualified publicly traded partnership income.

[64] Section 199A(b)(6).

[65] Reg. section 1.167(a)-2.

[66] Section 199A(d)(1).

[67] Section 1202(e)(3)(A). Engineering firms and architecture firms qualify for the deduction, however.

deduction if her taxable income is less than $415,000 (for joint filers) or $207,500 (for single filers).[68]

A taxpayer computes her taxable income without regard to the deduction and then determines the amount of the deduction to apply. For example, if an individual's taxable income put her in a 37 percent marginal tax rate bracket and she qualifies for the 20 percent deduction, her effective top income tax rate would be 29.6 percent (37 percent - (37 percent * 20 percent)).

Clearly, this deduction is valuable. But how is it computed for a trust or estate? If the trust is treated as the taxpayer, one must apparently identify its taxable income (after the section 651 or section 661 distribution deduction under the rules of subchapter J) and compare that amount with its combined QBI.

But if the beneficiary is the taxpayer under the rules of subchapter J, to determine the amount of the section 199A deduction one must compare the beneficiary's taxable income with his allocable share of the combined QBI amount from the trust or estate plus any other combined QBI amount he earns. Notably, the factors considered in computing the deduction (such as Form W-2 wages) are allocated among the estate or trust and its beneficiaries at the entity level and can't be recomputed by the beneficiary.[69] The allocation is based on the allocation of distributable net income, taking into account the separate share rule but excluding the deduction under section 199A(a).[70] If there is no distributable net income, the factors are allocated entirely to the estate or trust.[71]

The hybrid nature of subchapter J creates flexibility and planning opportunities under section 199A. As Steven B. Gorin points out, by managing taxable income through the income distribution deduction, trusts may be able to get below the desired threshold to qualify for a better deduction.[72] For example, $1 million in Schedule K-1 income from a partnership could be pushed out to a beneficiary so that the trust qualifies for the deduction when the beneficiary and trust may both have initially been disqualified from taking the deduction because they already had too much income.[73] Alternatively, if a trust and beneficiary both have zero taxable income except for $315,000 in Schedule K-1 income the trust receives, and if the trust distributes $157,500 to the beneficiary, both the trust and the beneficiary could qualify for the full deduction even though the trust initially wouldn't have qualified for the full deduction (because its income was above the threshold limit for individuals).[74]

Also, notably absent from section 199A is any reference to section 469. In other words, eligibility for the deduction doesn't depend on how active a taxpayer is in a qualified trade or business.[75] However, under section 1411 a taxpayer may be subject to the 3.8 percent NII tax unless the taxpayer is actively engaged in the trade or business. In light of the compressed rate structure applicable to trusts and estates, there are some clear strategies for minimizing the tax burden. A trust or estate should try to satisfy the material participation requirement, keeping in mind how the grouping rules under section 469 operate. Then the trust or estate should distribute all NII to the beneficiaries, if possible, keeping in mind applicable income thresholds that might maximize the section 199A deduction for both the trust and the beneficiaries.

Indeed, it is strange that a taxpayer may be subject to the 3.8 percent NII tax at the same time the taxpayer qualifies for a 20 percent deduction. However, this could be a sign that the NII tax is on its way out. In the meantime, individuals

[68] Section 199A(d)(3) and (e)(2). If a taxpayer qualifies, however, she is subject to a potential limitation wherein she must apply the "applicable percentage" rules under section 199A(d)(3)(A)(ii) and (B).

[69] "Arrangements to Save Income Taxes," at 8, para. 10.01; David Westfall and George Mair, *Estate Planning Law & Taxation*, Thompson Reuters Tax and Accounting Series (Feb. 2018); section 199A(f)(1)(B) (referring to similar allocation rules under former section 199(d)(1)(B)(i)); reg. section 1.199-5(e)(1).

[70] *Id.*; reg. section 1.199-5(e)(2)(i).

[71] *Id.*

[72] Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications," at II.E.1.f.ii (Jan. 11, 2018).

[73] *Id.*

[74] *Id.* Another interesting planning opportunity might include taking advantage of any difference in the tax years of an estate and beneficiaries under section 662(c) and controlling *when* those beneficiaries might include income on their tax returns to increase the advantages of deferral in conjunction with the 20 percent deduction.

[75] Also, section 199A focuses on trades or businesses and does not appear to focus on "activities" with all the grouping rules that exist under section 469. However, the term "trade or business" is undefined, and further guidance is needed on that matter.

involved with trusts and estates should carefully consider the labyrinth that is sections 1411, 469, and 199A, and the current planning opportunities.

V. Conclusion

As certain as death and taxes are, taxes have an uncanny ability to create uncertainty. For several years now, trusts and estates have wrestled with their tax treatment under sections 1411 and 469. Now they must come to terms with section 199A. This says nothing of the dozens of other considerations that must be made in the administration of a trust or estate. Hopefully, this report has provided a snapshot of some of the moving parts and has offered a helpful approach to some of the unresolved issues. For practitioners and taxpayers alike, there are planning opportunities that can pay off in big ways while regulations are pending. ■