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Trusts Qualifying as Real Estate Professionals

By: Ezra Dyckman and Libin Zhang

Prior to the enactment in 1986 of the passive activity loss rules, many lawyers, doctors, and other high-income individuals would invest in tax shelters that generated tax losses, which could be used to offset their other income. The passive activity loss rules now prevent taxpayers, including trusts, from deducting their losses from certain "passive" activities against that taxpayer's active income (such as wages) or portfolio income (such as interest and dividends). For an individual to have active income or losses from a rental real estate business, the individual must generally be a "real estate professional" who works full time in the real estate business. For trusts, the passive activity loss rules have historically been confused and contradictory. In the recent case of *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (2014), the Tax Court concluded that a trust could qualify as a "real estate professional" due to the activities of three trustees. The trust was therefore allowed to use its losses from the real estate activities against income from its investments and other activities.

Material Participation

The Internal Revenue Code contains detailed passive activity loss rules for individuals. A trade or business activity is considered non-passive for a taxable year only if the individual materially participates in the activity, such as by spending more than 500 hours on the activity during the year. However, nearly all rental real estate activities are considered per se passive activities, regardless of the taxpayer's level of involvement, unless the taxpayer can prove that he is a "real estate professional." A "real estate professional" must generally (i) spend more than 750 hours during the year in real property trades or businesses in which he materially participates, and (ii) those hours must constitute more than half of his time spent performing all personal services that year. Real property trades or businesses include real property construction, condominium development, property brokerage, apartment leasing, and hotel management. An individual taxpayer must spend all of the 750 hours personally, and cannot count the hours spent by his spouse toward the total hours. Once a taxpayer is a real estate professional, if he or his spouse materially participates in a real estate rental activity, it will generate non-passive income and losses.

An individual generally materially participates in an activity by if the individual and his spouse spend more than 500 hours during the year on that activity. Treasury Regulation 1.469-5T(g) contains a single word on how non-grantor trusts can materially participate in an activity: "Reserved."[1] The only guidance is in the 1986 legislative history of the passive activity loss rules, which provides that a trust materially participates in an activity if the trustee, in his capacity as trustee, so participates. Furthermore, neither the legislative history nor any other authority discuss whether a trust can be a real estate professional. If the real estate professional rules apply only to individuals and not to trusts, trusts would always have only passive income and losses from rental real estate activities.

Medicare Tax

The tax stakes were raised further in 2014 when the 3.8% Medicare tax on unearned income under section 1411 became effective. The tax generally applies only to passive income and investment income. A taxpayer with net income from rental real estate would be subject to the 3.8% Medicare tax, unless the income is non-passive income due to the taxpayer being a real estate professional who materially participates in the rental real estate activity. The 3.8% Medicare tax provides a further incentive for taxpayers to materially participate in their activities and to qualify as real estate professionals, if possible.

Non-Trustee Employee

In a 2003 case, *Mattie K. Carter Trust v. United States*, 256 F.Supp. 2d 536 (D. Texas 2003), a Texas district court concluded that a trust can materially participate in a cattle ranch business, based on the activities of all of the persons who conducted the ranch's business on the trust's behalf, including the trustee and several non-trustee employees,

***Ezra Dyckman** is a partner in, and **Libin Zhang** an associate of, the law firm of Roberts & Holland LLP.*

such as a full-time manager. The court rejected the IRS's contention that only the activities of the trustees should be considered in determining the trust's level of material participation.

The IRS has never accepted the results in the Carter Trust case. In Private Letter Ruling (PLR) 201029014, the IRS reaffirmed its position that only the activities of the trustees count in determining the trust's level of material participation and whether the trust has any non-passive income or losses. The PLR noted that if the trust's non-trustee employees were counted toward material participation, a trust would almost never have any passive income, which would therefore defeat the purpose of the passive activity loss rules applying to trusts. The trustees also have to be real trustees who exercise actual fiduciary responsibilities, and not sham trustees designated for the express tax purpose of satisfying the material participation requirement.[2]

The Carter Trust case and other authorities only analyzed the issues of material participation for trusts, without any discussion of the real estate professional rules, because the underlying trades and businesses were not rental real estate activities. Until earlier this year, no authority has analyzed the effects of the real estate professional rules on trusts, as to whether a trust can materially participate in a rental real estate activity.

Frank Aragona Trust

The Frank Aragona Trust was a non-grantor trust that owns all of the interests in Holiday Enterprises LLC. Five adult children of the decreased grantor were the beneficiaries of the trust. The trust was a "complex trust" that was not required to distribute all of its income to its beneficiaries, so the trust incurred some income tax liability each year. The five children were also the trustees of the trust, along with an independent trustee. Three of the adult children who were trustees also worked full-time for Holiday Enterprises LLC, which employed the three trustees and approximately 20 non-trustee employees in various real property trades or businesses. The fourth child-trustee was a dentist, and the fifth child-trustee was disabled. Each of the trustees was paid an annual fee for attending the trust's board meetings.

The trust sought to be classified as a "real estate professional," in order for the trust to generate non-passive losses from its rental real estate activities that may be used to offset the trust's investment income and other income. The trust determined that it was a "real estate professional" based on the activities of its trustees who were also employees of Holiday Enterprises LLC and worked full time in the trust's rental real estate activities. The relevant taxable years (2003-2006) predated the enactment of the 3.8% Medicare tax, but if the trust were to generate any non-passive activity income in a later year from the rental real estate activities, real-estate-professional status would also exempt the trust's rental income from the 3.8% Medicare tax.

The Tax Court held that the activities of the trustees could be attributed to the trust for purposes of the real estate professional test, and the trustees had spent more than the required 750 hours on the trust's real property trades or businesses in order for the trust to be considered a real estate professional. The court rejected the IRS's argument that the real estate professional rules can apply only to individuals and not to trusts, because there was no such explicit prohibition in the statute or legislative history.

Other passive loss provisions were limited to "natural persons," but not the real estate professional rules. The IRS also argued that the hours spent by the three employee-trustees in the real property trades or businesses did not count because they were not spent in the individuals' capacity as trustees, but rather in their capacity as employees of the trust's wholly owned subsidiary Holiday Enterprises LLC or in their capacity as owners of minority interests in some of the properties. The court concluded that the trustees' work as employees of Holiday Enterprises LLC were in furtherance of their duty to administer the trust solely in the interest of the trust beneficiaries. They were subject to trust fiduciary duties during their work as employees. Therefore, the trustees' time spent working as employees could be counted toward the 750 hour threshold.

The Tax Court summarily concluded that the trustees spent sufficient hours on the trust's real estate activities for the trust to be materially participating in those activities and to be a real estate professional with respect to those activities. The opinion was sparse on the exact time spent by each trustee, and it is unclear whether the 750 hours requirement of the real estate professional trustee has to be met by a single trustee or can be met by all three working trustees combined.

Furthermore, neither the court nor the IRS addressed the second prong of the real estate professional test, as whether the trust's time spent in real property trades and businesses constitute more than half of the trust's time spent performing all personal services that year. The second prong might require an analysis of all of the time spent by all of the trustees on all personal services, so that another trustee's services as a dentist would be added to the denominator of the test. Alternatively, the second prong might require only that those trustees who work in the real property business have spent more than half of their own time on the business.

The Frank Aragona Trust case follows the IRS position that only the trustee's activities should be considered in applying the passive activity loss rules to the trust, with the Carter Trust case viewed as an anomaly that would allow almost all trusts to materially participate in their business activities. But the IRS lost in all other respects. A trust can be a real estate professional if the activities of its trustees enable the trust to meet the 750-hour requirement. When a trustee is also an employee of the trust's trades or businesses, the hours spent as an employee may be counted toward the trust's material participation.

What helped the taxpayer in the case was the fact that the trustees were not designated as trustees solely for income tax purposes to benefit from the material participation rules. All of the adult children of the trust grantor were designated as trustees, and three adult children spent

significant time managing the trust, exercising their fiduciary duties, and continuing to work in the trust's businesses.

Since the Frank Aragona Trust is a complex trust that was not required to distribute all of its taxable income, the trust was subject to income tax liabilities on its accumulated income. It is reasonable that the income and losses allocable to the three trustee-beneficiaries who worked in the real property business would be non-passive, since such income and losses would be non-passive if earned by the three beneficiaries directly. However, the income and losses allocable to the fourth dentist trustee-beneficiary and the fifth disabled trustee-beneficiary were also treated as non-passive, even though the income would be passive income subject to the 3.8% Medicare tax if earned by the two beneficiaries directly. It is possible that as long as one trustee worked at least 750 hours in the real property businesses, all of the trust's real property income and losses would be non-passive regardless of the number or activities of any of the other trustees or beneficiaries. Since the case only deals with the tax liability of the trust, it is unclear whether the non-passive character of the income and losses are carried over to the beneficiaries when the trust makes distributions.

Conclusion

The Frank Aragona Trust case is the firs t authority that has held that a trust can be a real estate professional and can therefore generate non-passive income and losses from its rental real properties. Its holding is limited to the taxation of non-grantor complex trusts, but such trusts may benefit substantially with some proper structuring and designation of trustees. The trustees should be real trustees who can and do exercise fiduciary responsibilities for the benefit of the trust's beneficiaries. With effective planning, the trust's non-passive losses can offset all of the trust's other income, and the trust's non-passive income would not be subject to the 3.8% Medicare tax.

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[1] Grantor trusts are treated as the same taxpayer as the grantor, and material participation is therefore tested by reference to the grantor's activities.

[2] IRS Technical Advice Memorandum 200733023; IRS Technical Advice Memorandum 201317010.