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Passive Activity Loss Rules for Trusts Carrying on a Business

-by Neil E. Harl*

The striking increase in the use of trusts in recent years in owning farmland[1] has focused attention on passive activity rules applicable to trusts particularly when the trust is used in farm and ranch estate (and business) planning if a business is carried on by the trust.[2] A 2003 United States District Court case[3] has cast a bright light on the fact that the Department of the Treasury has yet to issue regulations governing trusts in a setting where passive activity losses have been incurred.

The Mattie K. Carter Trust v. United States

In 2003, a United States District Court in Texas, in *The Mattie K. Carter Trust v. United States,*[4] approved material participation for a testamentary trust through a trustee, employees and agents, notwithstanding a passage to the contrary in the Committee report. The trust was established to hold and manage a 15,000 acre ranching operation and oil and gas interests in Texas. The trustee of the trust, as the court noted, "dedicated a substantial amount of time to ranch activities." The trust also employed a full-time ranch manager along with other full and part-time employees. In 1994 and 1995, the trust incurred sizeable operating losses and the trustee alone did not meet the material participation requirements.

The trust paid the tax and filed a claim for refund which was denied. The United States District Court for the Northern District of Texas dismissed the argument by IRS that only the trustee's involvement mattered for purposes of establishing material participation. That argument was based on the passage in the Committee report that the material participation test was met only if the fiduciary met the test. The court held that, in determining material participation for trusts and estates, the activities of employees of the trust should be included in determining whether the trust's participation was "regular, continuous and substantial."[5] The district court decision was not appealed.

Response by IRS

A Technical Advice Memorandum[6] involved a testamentary trust which acquired an interest in a limited liability company. The LLC was carrying on a business. The trustees handled administrative and some operational activities but appointed "special trustees" to perform a number of tasks related to the business. The TAM recites that the involvement of the special trustees was "intended to satisfy the material participation standard of I.R.C. § 469(h)(1)."[7] The TAM further stated that "an estate or trust is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating."[8] The

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TAM continues with the statement that "as a general matter, the owner of a business may not look to the activities of the owner's employees to satisfy the material participation requirement."[9] Thus, the activities of agents or employees are not imputed or attributed to the taxpayer and the focus is solely on the activities of the trustee or trustees which must be at a level which is "regular continuous and substantial."[10] Thus imputation is barred under the passive loss rules as has been stated by this author for several years.[11] The meaning of material participation is not routed through the general rule authorities which allow imputation of activities of an agent or employee to the principal (usually the property owner).

The Internal Revenue Service position was reaffirmed most recently in a 2010 private letter ruling.[12] In that ruling, the Service indicated that a trust can meet the passive loss material participation requirement[13] *only through the trustee*. Further litigation appears indeed likely. The reasoning of the TAM and the 2010 letter ruling seems to be well grounded in tax law.

The statutory guidance

There are several issues involved in the controversy – (1) is the Internal Revenue Service on firm ground in asserting that material participation for passive activity loss purposes involving trusts is limited to the fiduciary or fiduciaries of the trust and (2) did the Congress intend to block imputation of activities by agents and employees in the case of trusts (which was done in 1974 involving agents – farm managers – involved in leasing arrangements)?

The Tax Reform Act of 1986,[14] enacted I.R.C. § 469 limiting deductibility for passive activity losses. The legislation provided definitions and governing provisions for individuals, limited partnerships, corporations and personal service corporations but did not mention trusts and made only passing mention of estates[15] where reference was made to a two-year rule after death during which time the decedent's activities prevail in determining whether the active participation test was met. However, the Committee Report of the Committee on Finance of the United States Senate,[16] referred to trusts in the Committee Report. The report states –

> An 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.[17]

The Committee report, on the same page, states as to imputation –

> The fact that a taxpayer utilizes employees or contract services to perform daily functions in running the business does not prevent such taxpayer from qualifying as materially participating. However, the activities of such agents are not attributed to the taxpayer, and the taxpayer must still personally perform sufficient services to establish material participation.

The statute itself refers to material participation by the taxpayer but does not specifically bar imputation of the services of an agent or employee to a principal or employer, as the case may be.[18] The temporary regulations, however, state that the presence of a paid manager or agent destroys the principal's own record of involvement if no individual performs services in connection with the management of the activity that exceed (by hours) the amount of service performed by the individual.[19]

It is important to note that the temporary regulations did not address the issue of material participation by trusts and estates.[20] The temporary regulations note that the section on trusts, estates and their beneficiaries[21] was reserved. To date, regulations have still not been proposed to provide guidance on the issues involved.

In conclusion

The IRS has clear support in the legislative history of the 1986 enactment as to limiting the material participation determination to the fiduciary or fiduciaries of a trust. Moreover, the position taken elsewhere in the temporary regulations on imputation provides some support for the IRS position as well. The position of the IRS would be immeasureably strengthened, however, if the segment of the regulations obviously planned for trusts and estates and their beneficiaries were to be issued.

ENDNOTES

[1] See Duffy and Smith, "Farmland Ownership and Tenure in Iowa, 2007," Pm. 1983, Iowa State University Extension Service, Table 3.2, p. 8 (2008) (increase of trust ownership of Iowa farmland from one percent in 1982 to 10 percent in 2007).

[2] See generally 8 Harl, *Agricultural Law* Ch. 62 (2011); Harl, *Agricultural Law Manual* Ch. 8 (2011).

[3] The Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003) (ranching operation had full-time ranch manager but was allowed to include activities by employees of the trust in determining whether material participation test had been met).

[4] 256 F. Supp. 2d 536 (N.D. Tex. 2003).

[5] See I.R.C. § 469(h)(1).

[6] TAM 200733023, Aug. 17, 2007.

[7] *Id*.

[8] *Id*.

[9] See Harl, "IRS Reasserts Its Position on Material Participation by Trusts," 18 *Agric. L. Dig*. 137 (2007).

[10] I.R.C. § 469(h)(1).

[11] See 5 Harl, *Agricultural Law* § 41.06 (2011); Harl, "Imputing Activities from Agent to Property Owner as Principal," 10 *Agric. L. Dig*. 89 (1999).

[12] Ltr. Rul. 201029014, April 7, 2010.

[13] I.R.C. § 469(h).

[14] Pub. L. No. 99-514, § 501.

[15] I.R.C. § 469(i)(4).

[16] Rep't 99-313, dated May 29, 1986.

[17] *Id*. At 735.

[18] I.R.C. § 469(c)(1)(B).

[19] Temp. Treas. Reg. § 1.469-5T(b)(2)(ii).

[20] See T.D. 8417, Passive Activity Losses: Passive Activity Credits: Technical Amendments to Regulations, May 12, 1992.

[21] Temp. Treas. Reg. § 1.469-8.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

FEDERAL TAX

SALE OF CHAPTER 12 ESTATE PROPERTY. The Chapter 12 debtor's plan provided for payment of federal taxes by surrendering to the IRS eight parcels of land. The plan also provided that all federal and state tax claims which arose from the transfer of the property to the IRS were treated as general unsecured claims not entitled to priority under Section 507. The eight parcels were sold, resulting in substantial taxable capital gains tax. The debtor argued that, under Section 1222(a)(2)(A), the capital gains tax was a claim of the Chapter 12 estate. The IRS argued that Section 1222(a)(2)(A) did not apply to post-petition sales of the debtor's property. The Bankruptcy Court and the District Court reviewed the three cases which had ruled on the issue, *In re Knudsen, 356 B.R. 480 (Bankr. N.D. Iowa 2006), aff'd, 389 B.R. 643, 680-81 (N.D. Iowa 2008), aff'd, 581 F.3d 696 (8th Cir. 2009)* (ruled for debtor)*; In re Hall, 376 B.R. 741 (Bankr. D. Ariz. 2007), rev'd, 393 B.R. 857, 862 (D. Ariz. 2008)* (ruled for debtor on appeal)*;* and *In re Schilke, 379 B.R. 899 (Bankr. D. Neb. 2007), aff'd, 2008 U.S. Dist. LEXIS 68176 (D. Neb. 2008), aff'd, 581 F.3d 696 (8th Cir. 2009)* (ruled for debtor), and followed them in holding that capital gains taxes resulting from post-petition sales of a Chapter 12 debtor's property were administrative expenses entitled to application of Section 1222(a)(2)(A). On appeal the appellate court reversed, holding that, because no taxable estate was created in Chapter 12, the taxes from the sale of the debtor's property were not a claim against the estate. ***In re* Dawes, 2011-1 U.S. Tax Cas. (CCH) ¶ 50,454 (10th Cir. 2011), *rev'g*, 2009-1 U.S. Tax Cas. (CCH) ¶ 50,280 (D. Kan. 2009), *aff'g*, 2008 Bankr. LEXIS 362 (Bankr. D. Kan. 2008)**.

FEDERAL FARM PROGRAMS

NO ITEMS.

FEDERAL ESTATE AND GIFT TAXATION

CHARITABLE DEDUCTION. The decedent had created a trust which became irrevocable on the decedent's death. The trust provided for payment of the medical expenses of a certain person during life, with the remainder to be paid to a foundation at that person's death. The estate petitioned a court to reform the trust to meet the requirements of a charitable remainder annuity trust. The new trust would annually distribute a percentage of the original trust, dividing the annuity between the person and the foundation, with the remainder passing to the foundation. The distribution formula was determined by an expert's appraisal of the value of the person's estimated medical costs. The IRS ruled that the reformation was qualified so that the estate would be allowed a charitable deduction for the remainder interest to the foundation, if the trust otherwise qualified as a charitable reminder annuity trust. **Ltr. Rul. 201125007, Feb. 16, 2011**.

DISCLAIMERS. The decedent owned an interest in a trust established by the decedent's predeceased spouse. The trust was funded with an IRA and two retirement accounts from which automatic quarterly payments were received, based on the required minimum distributions (RMD) received by the predeceased spouse. After the decedent's death one quarterly RMD payment was received before the executrix filed a disclaimer of a portion of the decedent's interests in the trust. The RMD payment was transferred to a new bank account established for the decedent's estate but was not withdrawn. The IRS ruled that the disclaimer was qualified and that the disclaimer was effective for all but the RMD already received. **Ltr. Rul. 201125009, March 10, 2011**.

GENERATION-SKIPPING TRANSFERS. The taxpayers, husband and wife, created an irrevocable trust for their three children and made several transfers to the trust. The remainder holders were the descendants of the children. The taxpayers filed gift tax returns and treated each transfer as a joint gift. Sometime after the returns were filed, the taxpayers learned that I.R.C. § 2632(c) automatically allocated the taxpayers' GST exemption to the transfers. The taxpayers sought an extension of time to file the election out of the allocation of the GST exemption. The IRS granted the extension. **Ltr. Rul. 201124003, March 10, 2011**.

The taxpayers, husband and wife, created an irrevocable trust for their three children and grandchildren and transferred stock