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## IRS Reasserts Its Position on Material Participation by Trusts

-by Neil E. Harl\*

On August 17, 2007, stung by the court decision in *The Mattie Carter Trust v. United States*,<sup>1</sup> the Internal Revenue Service in a technical advice memorandum<sup>2</sup> reasserted the position rejected by the 2003 decision by the United States District Court in the Northern District of Texas.<sup>3</sup> The dispute is highly important to trusts (and estates) involved in carrying on a trade or business where losses run the risk of a challenge as to deductibility as passive activity losses.<sup>4</sup>

### The statutory framework

One of the most far reaching provisions in the Tax Reform Act of 1986<sup>5</sup> involved the handling of losses and credits from passive trade or business activities.<sup>6</sup> In general, deductions from passive trade or business activities, to the extent the deductions exceed income, from all passive activities (exclusive of portfolio income) may not be deducted against other income.<sup>7</sup> An activity is considered a passive activity if it involves the conduct of a trade or business and the taxpayer does not materially participate in the activity.<sup>8</sup> A taxpayer is treated as materially participating in an activity only if the person "is involved in the operations of the activity on a basis which is regular, continuous, and substantial."<sup>9</sup>

Although the Department of the Treasury issued temporary regulations outlining tests of what constitutes material participation for individuals,<sup>10</sup> guidance has not been issued for estates and trusts.<sup>11</sup> Thus, the statute<sup>12</sup> remains the sole standard for determining whether an estate or trust satisfies the material participation requirements applicable to passive activity losses.

### The technical advice memorandum

The TAM issued on August 17, 2007<sup>13</sup> involved a testamentary trust which acquired an interest in a limited liability company. The LLC was carrying on a business.<sup>14</sup> 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 § 469(h)(1)."<sup>15</sup>

The TAM states 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."<sup>16</sup> The TAM continues with the statement that "as a general matter, the owner of a business may

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not look to the activities of the owner's employees to satisfy the material participation requirement."<sup>17</sup> Thus, the activities of agents or employees are not imputed or attributed to the taxpayer<sup>18</sup> 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."<sup>19</sup> That, states the TAM, is the "proper standard to apply to trusts for purposes of § 469."<sup>20</sup> Thus, imputation is barred under the passive loss rules as this author has stated for several years.<sup>21</sup> 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).<sup>22</sup> Moreover, while the passive loss statute made no specific reference to the matter of imputation, the temporary regulations made it clear that an individual's participation is not taken into account if a *paid* manager or agent participates in the activity and no individual performs services in connection with the management of the activity that exceed (by hours) the amount of service performed by the individual.<sup>23</sup>

#### So what about *The Mattie K. Carter Trust v. United States*?

In *The Mattie K. Carter Trust v. United States*,<sup>24</sup> a testamentary 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."<sup>25</sup> The trust also employed a full-time ranch manager along with other full and part-time employees.<sup>26</sup> In 1994 and 1995, the trust incurred sizeable operating losses. IRS disallowed the losses on the grounds the trust was a passive activity and the trustee did not meet the material participation requirements.<sup>27</sup>

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, which was based on the passage in the committee reports indicating that the material participation test was met if a fiduciary met the test.<sup>28</sup> 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 is regular, continuous, and substantial. The district court case was not appealed.

All of this means that further litigation is almost assured. As a matter of planning, taxpayers and practitioners would be well advised to follow the TAM.<sup>29</sup> The reasoning of the TAM seems firmly grounded in relevant tax law.

#### FOOTNOTES

<sup>1</sup> 256 F. Supp. 2d 536 (N.D. Tex. 2003). See generally 4 Harl, *Agricultural Law* § 30.08[1][a][iii][C] (2007); Harl, *Agricultural Law Manual* § 4.05[3][a][i] (2007). See also Harl, "Material Participation by a Trust for Passive Activity Loss Purposes," 14 *Agric. L. Dig.* 81 (2003).

<sup>2</sup> TAM 200733023, Aug. 17, 2007.

<sup>3</sup> See *The Mattie Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. 2003).

<sup>4</sup> I.R.C. § 469(h)(1).

<sup>5</sup> Pub. L. No. 99-514, § 501(a), 100 Stat. 2233 (1986), adding I.R.C. § 469.

<sup>6</sup> I.R.C. § 469.

<sup>7</sup> See, e.g., *Char-Lil Corp. v. Comm'r*, T.C. Memo. 1998-457, *aff'd*, 232 F.3d 900 (10th Cir. 2000) (interest from sales contract was portfolio income).

<sup>8</sup> I.R.C. § 469(c)(1). See *Carlstedt v. Comm'r*, T.C. Memo. 1997-331 (taxpayer deemed to be materially participating in company activities so income could not be used to offset passive losses of related partnership).

<sup>9</sup> I.R.C. § 469(h)(1). See *Chapin v. Comm'r*, T.C. Memo. 1996-56 (taxpayers' involvement in renting beach front condominium did not constitute material participation; rental agent handled all rental arrangements).

<sup>10</sup> Temp. Treas. Reg. §§ 1.469-5T(a)(1)-(7).

<sup>11</sup> See Temp. Treas. Reg. §§ 1.469-5T(g), 1.469-8.

<sup>12</sup> I.R.C. § 469(h)(1).

<sup>13</sup> TAM 200733023, Aug. 17, 2007.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986).

<sup>17</sup> TAM 200733023, Aug. 17, 2007.

<sup>18</sup> S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986).

<sup>19</sup> I.R.C. § 469(h)(1).

<sup>20</sup> TAM 200733023, Aug. 17, 2007.

<sup>21</sup> See 5 Harl, *Agricultural Law* § 41.06 (2007); Harl, "Imputing Activities from Agent to Property Owner as Principal," 10 *Agric. L. Dig.* 89 (1999).

<sup>22</sup> E.g., Ltr. Rul. 8133015, April 25, 1981 (installment payment of federal estate tax).

<sup>23</sup> Temp. Treas. Reg. § 1.469-5T(b)(2)(ii).

<sup>24</sup> 256 F. Supp. 2d 536 (N.D. Tex. 2003).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986).

<sup>29</sup> TAM 200733023, Aug. 17, 2007.