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IN AGENTS WE TRUST—A PROPOSAL FOR MATERIAL PARTICIPATION OF TRUSTS

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Abstract

In the business succession planning context, estate planners frequently employ the use of trusts to pass ownership of a business from one generation to another. Often, the beneficiaries of such a trust include the children of the grantor. The trust mechanism provides trustee oversight and a controlled process for transition. In many cases, the child/trust beneficiary works in the business and perhaps earns his or her sole income from participation in the business with the promise of direct ownership in the future. This transition requires thorough planning to properly pass ownership in the most tax-efficient manner.

In 2010, Congress amended the Internal Revenue Code (the "Code") as part of the Affordable Care Act ("ACA"). This amendment introduced a new tax on "net investment income" applicable to individuals, estates, and trusts. Net investment income includes income from a trade or business in which the taxpayer does not "materially participate." This raises a question regarding how a trust as a taxpaying entity materially participates under the tax code. With Section 1411 of the Code, Congress codified a requirement to look to Section 469 (passive activity losses) for guidance on determining material participation. Since the 1986 amendments to the Code, however, the Treasury has yet to pass regulations defining material participation in an estate and trust context.

In an attempt to provide guidance to trustees and estate planners, this article explores the meaning of "material participation" in the context of estates and

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trusts with respect to the Net Investment Income Tax ("NIIT"). In deriving this article's topic from Treasury comments accompanying a final rule regarding the NIIT, this discussion primarily responds to the Treasury's call for comments and guidance on "material participation" of estates and trusts and the proposed coordination with regulations under Section 469.

Current guidance on this issue remains relatively limited, consisting of two court opinions and administrative decisions. The trending position of the Commissioner of the Internal Revenue Service ("Commissioner") focuses solely upon the actions by the trustee or other person with discretionary powers and the ability to bind the trust. Such a position excludes trust beneficiaries that actively participate in the business but that lack a formal "trustee" obligation. The Commissioner's position provides a clearly identifiable person who happens to hold legal title to the trust interest. By focusing on the trustee, however, the Commissioner overlooks the equitable interest of trust beneficiaries. The involvement of beneficiaries may equal or exceed that of the trustee and may more realistically represent the underlying economic interest of the trust. With the passage of Section 1411, another tax is added to the debate involving the activities of estates and trusts, and this area merits clear guidance.

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I. INTRODUCTION

Business succession planning is fraught with challenges—both personal and financial.[1] In the estate planning process, many clients' estates consist primarily of business interests. As a response to these challenges, estate planners often use trusts for tax efficiency, protection from creditors, and transferor control. Uncertainty in federal taxation makes it difficult for estate planners and business owners to clearly evaluate the tax consequences and to plan accordingly. The Net Investment Income Tax ("NIIT") exemplifies the planning complications created by uncertainty.[2] For trusts and estates, no direct regulatory guidance exists regarding application of the NIIT. Clearly, this lack of guidance poses a problem for trusts with business interests because income derived therefrom may be subject to the new tax.

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[1] James Olan Hutcheson, *Why Succession Planning Matters*, BLOOMBERG BUSINESSWEEK (Jul. 30, 2007), http://www.businessweek.com/stories/2007-07-30/why-succession-planning-mattersbusinessweek-business-news-stock-market-and-financial-advice. As James Olan Hutcheson noted in Bloomberg Businessweek, these challenges are often enough to bring the business asunder:

> [T]he stakes are high—so high in fact, that most family businesses fail to negotiate the transition and are sold either to pay taxes or because no one in the family is willing or able to take over. Additionally, the communities of stakeholders involved in the process can be numerous and are often in conflict.

Id.

[2] I.R.C. § 1411 (2014).

In the traditional estate planning scenario, a couple seeks legal advice to plan for future ownership transition of the family business to their children. Numerous challenges and opportunities exist in this planning context, which require consideration of all forms of federal taxes—income taxes, self-employment taxes, gift taxes, estate taxes, generation skipping taxes, and now the NIIT. A business succession plan must be drafted carefully in order to maximize tax efficiency with respect to the federal income tax and the federal wealth transfer tax. In the absence of regulatory guidance, careful drafting may be unable to overcome regulatory uncertainty.

Congress enacted the NIIT in 2010 at Section 1411 of the Internal Revenue Code ("Code") to apply to individuals, estates, and trusts.[3] The NIIT taxes passive activity, meaning "any activity (A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate."[4] The NIIT statutory language expressly references Section 469, which addresses passive activity losses, for the determination of "passive activity."[5] Similarly, recent regulatory action indicated that the Treasury plans to retain this structure, whereby material participation for the NIIT relies on guidance under Section 469.[6] This centralizes the regulations on material participation, but for the same entity, a trust, this centralization binds two distinct tax issues—passive activity losses and net investment income. The question then becomes, can *material participation* mean the same for both taxes? Also, with the passive activity loss section of the Code derived from the need to *close* tax loopholes, should the same measures be applied to *impose* tax laws?

Although Congress enacted the Section 469 passive activity loss rules in 1986, the Internal Revenue Service ("IRS") has yet to promulgate regulations that define *material participation* in the context of estates and trusts.[7] As a general matter, "material participation" refers to a level of participation by a taxpayer in an activity, such as a trade or business.[8] A taxpayer that materially participates qualifies for special treatment under the Code, such as the ability to deduct losses and to apply special valuation rules for small family businesses.[9] As referenced, *supra*, the NIIT breathes new life into the discussion about material participation of trusts and estates as the NIIT applies to net investment income, including that attributable to trusts and estates.[10] Net investment income inherently results

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[3] *Id.* § 1411(a) (2014).

[4] *Id.* § 469 (2014).

[5] *Id.* § 1411(c)(2) (2014).

[6] Net Investment Income Tax, 78 Fed. Reg. 72,394, 72,402 (Dec. 2, 2013).

[7] Treas. Reg. § 1.469-8 (2013).

[8] *See, e.g.*, I.R.C. § 469(h) (2014).

[9] *See* I.R.C. § 469; Temp. Treas. Reg. § 1.469-5T (2013).

[10] *See* I.R.C. § 1411 (2014).

from passive activities. If an individual, estate, or trust *materially participates* in an activity, then income from that activity escapes the 3.8 percent NIIT.[11]

Recently promulgated regulations to Section 1411 prompted the topic of this article.[12] Within those regulations, the Treasury stated that additional guidance on material participation was omitted from the promulgated regulations to prevent undue delay given the complexity of the topic.[13] In addition, the Treasury stated that guidance on that topic is best coordinated by reference to the regulations in Section 469, as referenced by the statute.[14]

The development of guidance with respect to the NIIT reignited discussions among practitioners and scholars about the practical application of the *materially participates* language in a traditional trust context. With little guidance on the issue, advising clients involves some speculation on the application of the individual material participation rules to the estate and trust context. This uncertainty impacts estate planning for higher net worth individuals transferring business interests into a trust or estate, particularly family businesses.[15] With many trusts holding business interests that produce income each year, the meaning of material participation now controls more than the ability to deduct passive activity losses under Section 469.[16]

The current guidance on the issue of material participation by trusts and estates consists primarily of one decision from the Northern District of Texas, two Technical Advice Memorandums (hereafter "TAM"), one Private Letter Ruling (hereafter "PLR"), and one recent decision by the United States Tax Court.[17]

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[11] *Id.*

[12] *See* Net Investment Income Tax, 78 Fed. Reg. at 394, 402.

[13] *Id.*

[14] I.R.C. § 1411(c)(2)(a) (2014).

[15] See examples of guidance issued by the following lawyers: Melissa J. Willms, Davis & Willms, PLLC, *Affordable Care Act: A Trust and Estate Perspective* (2013), *available at* http://www.texastaxsection.org/LinkClick.aspx?fileticket=kRyTqTPoZs4%3D&tabid=80; *Legal Alert: The 3.8 Percent Net Investment Income Tax Regulations*, McGuireWoods (Dec. 4, 2013), *available at* http://www.mcguirewoods.com/Client-Resources/Alerts/2013/12/The-3-8-Percent-Net-Investment-Income-Tax-Final-Regulations.aspx; Casey S. August & Daniel F. Carmody, *Revisiting Passive Activities in Light of Section 1411*, Phila. Est. Plan. Council Newsl. (Spring 2013), *available at* http://www.morganlewis.com/index.cfm/publicationID/dfd2550f-7a5c-4daf-8d53-7d0fa9186711/fuseaction/publication.detail.

[16] Steve R. Akers, *American Bar Association, Material Participation by Trusts,* Frank Aragona Trust v. Comm'r, 142 T.C. No. 9 (March 27, 2014), *available at* http://www.americanbar.org/content/dam/aba/publishing/rpte_ereport/2014/2_april/te_akers.authcheckdam.pdf.

[17] Carter Trust *ex rel.* Fortson v. United States, 256 F.Supp.2d 536 (N.D. Tex. 2003); I.R.S. Tech. Adv. Mem. 2007-33-023 (Aug. 17, 2007); I.R.S. Tech. Adv. Mem. 2013-17-010 (Jan. 18, 2013); I.R.S. Priv. Ltr. Rul. 2010-29-014 (Apr. 7, 2010); Frank Aragona Trust v. Comm'r, 142 T.C. No. 9 (2014).

This article analyzes the goals of the NIIT and applies the current law on material participation to explain the NIIT's application in different planning scenarios. This article argues that focusing solely on the activities of one trustee overlooks the economic realities of a trust in exchange for administrative ease of the Code. This article then offers proposed regulatory language that would allow trustees to count the activities of agents in determining the material participation of a trust for purposes of both Sections 469 and 1411.

II. BACKGROUND

A. Enactment of the Net Investment Income Tax to Help Fund Healthcare in the United States

Congress enacted the NIIT through the Health Care and Education Reconciliation Act as part of the implementation of the Patient Protection and Affordable Care Act ("ACA").[18] The NIIT imposes a flat 3.8 percent tax on "net investment income" with the aim of funding the expansion of Medicare coverage mandated by the ACA.[19] This tax on net investment income applies to individuals on the lesser of investment income or the excess of modified adjusted gross income over the threshold amount of \$200,000 or \$250,000 depending upon filing status.[20] For estates and trusts, the NIIT is imposed on the lesser of undistributed net income or adjusted gross income over \$11,950, the dollar amount at which the highest estate and trust tax bracket begins in Section 1(e).[21] The primary rationale for the tax is that wage earners contribute to the federal coffers through the Federal Insurance Contributions Act ("FICA")[22] payroll tax and the self-employment tax, and no justifiable reason exists to exempt invest-

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[18] Health Care and Education Reconciliation Act, Pub. L. No. 111-152, 124 Stat. 1029 (2010).

[19] 156 Cong. Rec. H1891-01 (daily ed. Mar. 21, 2010). The actual need to fund the additional health insurance coverage of Americans was questioned by many members of Congress, including Walter Herger of the Ways and Means Committee: "This tax hike is aimed squarely at small businesses and is sure to result in the loss of even more jobs. Even worse, Congress is once again raiding the Medicare and Social Security Trust Funds to pay for other programs." *Id.*

[20] I.R.C. § 1411(a)(1), (b) (2014).

[21] *Id.* §§ 1(e) (2014), 1411(b) (2014).

[22] Amanda Stein, *FICA Taxation of Post-Employment Benefits: A Statutory Puzzle and Socio-political Conundrum*, 91 WASH. U. L. REV. 203, 212 (2013).

> FICA-generated revenue is credited to four separate trust funds managed by the Department of the Treasury. The Old-Age and Survivors Insurance (OASI) Trust Fund pays retirement and survivors benefits, while the Disability Insurance (DI) Trust Fund pays disability benefits. These two trust funds together are known as OASDI, which collectively pay Social Security benefits. The Hospital Insurance (HI) Trust Fund pays for inpatient hospital care, while the Supplementary Medical Insurance (SMI) Trust Fund covers Medicare Part B and Medicare Part D.

Id.

ment or unearned income from tax.[23] Congress primarily assumes, for purposes of the NIIT, that individuals subject to the NIIT have not contributed to FICA, yet should.[24]

Members of Congress voiced concerns regarding this assumption in that, assuming the need for Medicare funding is valid, the funds from the NIIT do not explicitly finance Medicare or any of the expected costs of the ACA.[25] Senator Snow of Maine noted, "[W]e have gone from zero to $210 billion in new taxes in Medicare . . . not one dollar gets reinvested in Medicare . . . we are taxing it for other purposes rather than into Medicare."[26] Other members of Congress raised concerns over the benefits of the NIIT with regard to the economic welfare of taxpayers subjected to this tax without a clear benefit to the expansion of healthcare via the ACA.[27] Funding Medicare has been a concern from the program's beginnings.[28]

Prior to the ACA and the Health Care and Education Reconciliation Act, Medicare was largely funded by taxing *wages* under FICA and the self-employment tax. For wage earners employed by an enterprise, the FICA tax is imposed on the value of the wages and both employees and the employers split the tax burden.[29] Pursuant to Section 3101(a), 6.2 percent of the wages withheld pursuant to FICA go toward the Old-Age and Survivors Insurance.[30] Currently, the maximum wage base subject to FICA withholding for the Old-Age and Survivors Insurance is

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[23] 156 CONG. REC. S1923-08 (daily ed. Mar. 24, 2010) (Senator Baucus). "Only taxes on wages contribute to the Medicare trust fund. The thought is that people with unearned income should also contribute." *Id.*

[24] 156 CONG. REC. H2195-03 (daily ed. Mar. 22, 2010). Congressman Robert Scott stated the following:

> Whatever your earned income, you pay a Medicare taxon that income, if it's earned income. If it's unearned income, stocks and bonds and trading and dividends and interest, you don't pay a Medicare tax on that. The major funding in this provides that whatever your income, you will be paying a Medicare tax. So those making more than $250,000 will pay on their unearned income just like everybody else is paying on their earned income.

Id.

[25] *See* 156 Cong. Rec. H1891-01 (daily ed. Mar. 21, 2010). Congressmen Frelinghuysen stated his concern that senior citizens, who depend on investment income for retirement expenses, will be hit by the tax and, thus, defeat the purpose of Medicare. *Id.*

[26] 156 CONG. REC. S1923-08 (daily ed. Mar. 24, 2010).

[27] *See* 156 CONG. REC. H2219-03 (daily ed. Mar. 23, 2010). Congressman Reichert of the Ways and Means Committee stated the following: "There is a 3.8 percent [flat] investment tax; other penalties if you don't provide mandated health care. This doesn't include the $588 billion in other tax hikes coming in December when the current tax rates expire." *Id.*

[28] Soc. Sec. and Medicare Bd. of Trustees, *Status of the Social Security and Medicare Programs: A Summary of the 2012 Annual Social Security and Medicare Trust Fund Reports*, 2 (2012), *available at* http://www.ssa.gov/oact/TRSUM/tr12summary.pdf.

[29] *See* I.R.C. §§ 3101(a)–(b) (2014)

[30] *Id.* § 3121(a) (2014).

$117,000.[31] Furthermore, pursuant to Section 3101(b), an additional 1.45 percent of the wages is withheld under FICA and goes toward Hospital Insurance, otherwise known as Medicare.[32] There is no maximum wage base for the Hospital Insurance withholding portion under FICA.[33]

The primary impetus for using the value of wages as the tax base was that, at the time entitlement programs were contemplated in the 1930s, ninety-five percent of Americans did not pay federal income taxes, and policy makers feared for the long-term financial viability of such programs.[34] Because payroll taxes such as FICA are limited to employees earning wages from an employer *and not* income, Congress enacted the Self-Employment Contributions Act, which imposed the self-employment tax.[35] The self-employment tax works as a backstop to FICA tax avoidance because its tax base is the "net earnings from self-employment" rather than wages.[36] One cannot circumvent the FICA payroll tax by simply owning their own company and declaring dividends, which are not wages.[37]

As referenced, *supra*, Medicare funding is largely sourced from payroll taxes due to the concerns of financial viability. A primary concern was that the federal income tax was not sufficient to pay for such social costs.[38] In light of the expansion of the federal income tax since the 1970s, the need to use wages as the most reliable proxy for the tax has been antiquated for decades.[39] Unifying taxation for entitlement spending such as Medicare has proven financially viable for some time.[40] Congress defined "wages" so "broadly, [as] to encompass 'all remuneration for employment.'"[41] As the United States Supreme Court has stated, "[t]he obligation to pay the social security tax initially is not fundamentally different from the obligation to pay income taxes; the difference—in theory at least—is that the social security tax revenues are segregated for use only in furtherance of

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[31] *Id.* § 3121(a)(1) (2014).

[32] *Id.* § 3121(b) (2014).

[33] *Id.* § 3121(a)(1) (2014).

[34] Edward D. Berkowitz, *The Historical Development of Social Security in the United States*, *in* SOCIAL SECURITY IN THE 21ST CENTURY, at 22, 24 (1996).

[35] Thomas E. Fritz, *Flowthrough Entities and the Self-Employment Tax: Is It Time for a Uniform Standard?*, 17 VA. TAX. REV. 811, 819 (1998). "Under the Self-Employment Contributions Act ("SECA"), a self-employment tax is imposed on self-employed individuals at a rate of 15.3% –a combination of a 12.4% OASDI tax and a 2.9% Medicare tax. The tax is imposed on the individual's net earnings from self-employment ("NESE")." *Id.*

[36] *See* I.R.C. §§ 1401–1403.

[37] *See id.*

[38] *See* Berkowitz, *supra* note 34, at 24.

[39] *See* Tax Policy Ctr., Urban Inst. & Brookings Inst., *Historical Amount of Revenue by Source* (Apr. 15, 2014), http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=203.

[40] *See id.*

[41] Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 709 (2011).

the statutory program."[42] Therefore, Medicare funding's reliance on wages exists as a deliberate omission by Congress.

B. *Applying the Net Investment Income Tax, a Flat Tax Imposed on Passive Income with Various Carve-Outs*

As noted, *supra*, Section 1411 imposes the NIIT on individuals, trusts, and estates.[43] Section 1411 only specifically addresses the tax base of a trust, however, it does not expressly define what constitutes *passive income*. Section 1411(c)(2)(A) states that the NIIT applies to income from "[a] trade or business [that] is described in this paragraph if such trade or business is . . . a passive activity (within the meaning of [S]ection 469) with respect to the taxpayer."[44] Section 1411 directly implicates the *material participation* or *materially participates* language from Section 469.[45] The law on material participation determines the effect on the inclusion or exclusion of certain transactions for purposes of the NIIT.[46] Section 1411 also expressly provides a charitable exclusion from the NIIT for trusts in which "all of the unexpired interests" are dedicated for one or more of the following purposes: "religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals."[47]

C. *Fragmented Guidance Surrounds Material Participation Under Section 469*

1. *The Development of Section 469*

The statutory guidance for material participation under Section 1411 stems directly from Section 469.[48] Section 469 defines a "passive activity" as "any activity

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[42] United States v. Lee, 455 U.S. 252, 260 (1982).

[43] I.R.C. § 1411(a)(2) (2014).

[44] *Id.* § 1411(c)(2)(A) (2014).

[45] *See id.*

[46] *See id.* §§ 1411(c)(2)(A) (2014), 469(c) (2014).

[47] *Id.* §§ 170(c)(2)(B) (2014), 1411(e)(2) (2014).

[48] *See id.* § 1411(c)(2) (2014). Note that "material participation" appears in other sections of the Code; *see id.* § 1402 (self-employment tax); *id.* § 2032A (estate tax special use valuation rules). Cases under §§ 1402 and 2032A do not directly apply to §§ 469 and 1411 because the standard for material participation differs for each type of tax. In § 2032A(e)(12), more direct hands-on involvement is required as material participation involves the making of a business' management decisions other than daily operating decisions. Section 1402 uses a facts and circumstances analysis, and § 469 conducts a facts and circumstances analysis to determine if participation is "(A) regular, (B) continuous, and (C) substantial." § 469(h)(1). For § 469, Congress indicated that precedents for § 2032A and § 1402 do not control as precedent. *See* S. Rep. No. 313, 99th Cong., 2d Sess. 732 (1986); W. Ralph Rodgers, Jr., *Material Participation Under the Passive Activity Loss Provisions*, 39 U. FLA. L. REV. 1083, 1085 (1987).

(A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate."[49] Congress enacted Section 469 as part of the Tax Reform Act of 1986 to eliminate abusive tax shelters.[50] Specifically, Section 469 aimed to close tax loopholes where taxpayers could have offset ordinary income with losses from an enterprise in which they had no "substantial and bona fide involvement."[51] The central direction taken by Section 469 includes the suspension of losses from "passive activities," which encompasses income from a trade or business in which a taxpayer does not materially participate.[52]

Prior to Section 469, a high-income taxpayer could obtain a limited partnership interest that produced little earnings but a great deal of deductions, such as depreciation.[53] These deductions flowed through to the taxpayer's individual income tax return and reduced the taxpayer's taxable income. These *losses*, however, were not economic in the sense of a lost investment, but were rather phantom losses to reflect changes in value. "Congress wanted to restrict the availability of tax preferences to a certain category of taxpayers. In Section 469, Congress used material participation as a tool for identifying this category of taxpayers."[54] For individuals, the Treasury promulgated regulations that govern material participation.[55] For estates and trusts, the Treasury reserved a section

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[49] I.R.C. § 469(c)(1) (2014).

[50] Rodgers, *supra* note 48.

[51] *See* S. Rep. No. 313, 99th Cong., 2d Sess. 713–14 (1986). "Section 469 therefore was enacted to restore public confidence in the Federal tax system by limiting the extent to which certain taxpayers could offset ordinary income with losses arising from activities in which they did not have 'a substantial and bona fide involvement.'" Adler v. United States, 32 Fed. Cl. 736, 738 (1995) (citing S. Rep. No. 313, 99th Cong., 2d Sess. 713–14).

[52] I.R.C. § 469; *see generally* Nina J. Crim & Ryan R. Brenneman, *Tax Sheltering of Income: Passive Losses Under the Tax Reform Act of 1986*, 4 AKRON TAX J. 101 (1987) (noting the views Congress surrounding the passage of § 469 and the impact of § 469 on business interests).

[53] Lee Knight & Ray Knight, *What Happened to Limited Partnerships: The Jewel of the 1980s has Lost its Brilliance*, J. ACCT., July 1997, *available at* http://www.journalofaccountancy.com/Issues/1997/Jul/knight.htm. (describing the heyday of limited partnerships between 1983 and 1989, in which brokerage houses heavily marketed limited partnership interests in oil and gas, real estate, and cattle farming operations with the promise of enormous tax savings via flow-through taxation).

[54] Rodgers, *supra* note 48, at 1089.

[55] *See* Temp. Treas. Reg. § 1.469-5T(a) (2013).

> [F]or purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if—
>
> (1) The individual participates in the activity for more than 500 hours during such year;
>
> (2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
>
> (3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable

of the regulations for guidance, but that section remains empty with no rule promulgated to date.

2. *Evolving Guidance Under Section 469 Regarding Material Participation in the Context of Estates and Trusts*

For material participation of trusts under Section 469, scant guidance includes two decisions, one by the United States District Court for the Northern District of Texas and the other by the United States Tax Court.[56] In addition, guidance includes some administrative decisions by the Internal Revenue Service (the "IRS"). The IRS, through its TAMs, has not addressed whether actions by individuals other than the trustee may be considered material participation. The TAMs have, however, provided thresholds for which the IRS considers sufficient participation on the part of the trustee for *material participation*. The following explanation illustrates the evolution of current guidance pertaining to material participation.

a. 2003: Carter Trust v. United States

From 1986 to 2003, estates and trusts operated without any direct guidance on the material participation of such entities.[57] The Mattie K. Carter Trust first litigated the issue in the Northern District of Texas in 2003. In *Mattie K. Carter Trust v. United States*,[58] the IRS took the position that "material participation"

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year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Id.

[56] Please note that the American Bar Association Section of Taxation has issued comments, which do not represent a formal opinion of the American Bar Association, as to how the Treasury Department could provide further guidance on material participation. The Section of Taxation's comment provides valuable background and adds to the discussion within this context.

[57] *See generally* Tax Reform Act of 1986, Pub. L. No. 99-514, 1986 100 Stat. 2085.

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

with regard to a trust depended on the activities of the trustee.[59] The case involved a testamentary trust, which held a ranch as a primary asset. The ranch's full-time ranch manager and other full- and part-time employees conducted nearly all of the ranch's activities.[60] The court disagreed with the IRS: "[M]aterial participation of [the] Trust in the ranch operations should be determined by reference to the persons who conducted the business of the ranch on [the] Trust's behalf."[61] The *Carter* court relied on the plain language of Section 469, which says that "a trust is a taxpayer and that a taxpayer is treated as materially participating in a business if its activities in pursuit of that business are regular, continuous, and substantial."[62] In drawing this distinction, the court concurred with the taxpayer, which analogized its trust operations to that of a closely held C Corporation:

> The Trust, however, is very similar to a closely held C corporation. The Trustee, like the board of directors of a C corporation, has the fiduciary obligation to the beneficiaries of the Trust for the benefit of such beneficiaries. Moreover, the Trust, like a C corporation, is a legal entity and is subject to entity-level U.S. federal income taxes. In addition, and most importantly, as a legal entity, the Trust, like a C corporation, can act only through its fiduciaries, employees and agents. Therefore, the Trust is most analogous to a closely held C corporation.[63]

This analogy was not directly invoked in later decisions, but it provides a helpful construct by which to contextualize the abstract nature of the trust.[64]

b. 2007: Technical Advice Memorandum 200733023

Despite the holding in *Carter Trust*, in 2007 the IRS disagreed in TAM 200733023, in which it assessed the activities of the trustee for the purposes of *material participation* under Section 469.[65] In this TAM, the IRS provided additional guidance and imputed the general *material participation* rules for individuals to trusts via trustees.[66] This TAM involved a testamentary trust that held a partnership interest.[67] The trustee contracted "special trustees" to meet the Section 469(h)(1) material participation test of "regular, continuous, and

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[59] *Id.* at 541.

[60] *Id.* at 538.

[61] *Id.* at 541.

[62] *Id.* at 540–41 (internal citations omitted).

[63] *Id.* at 541 n.3 (citing Am. Br. to Carter Trust Mot. at 21).

[64] See *infra* notes 97–158 and accompanying text.

[65] I.R.S. Tech. Adv. Mem. 2007-33-023 (Aug. 17, 2007).

[66] *Id.*

[67] *Id.*

substantial."[68] The contract provided that the trustee retained all decision-making powers with respect to "financial, tax, and business" matters. The IRS concluded that the "[t]rust did not materially participate . . . because [the] Special Trustees in this case [were] not fiduciaries for purposes of 469 and Trustees' involvement in the operations of Business . . . [were] not regular, continuous, and substantial."[69] In reaching its conclusion, the IRS interpreted then-existing guidance to suggest that "[w]hat is apparent from the line of authority in this area is that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust."[70] For a special trustee's activities to count toward the trust activities, such special trustee must not "lack any indicia of discretionary power," or in other words, must have the ability to bind the trust in some way.[71]

c. *2010: Private Letter Ruling 201029014 and Estate of Strangeland v. Commissioner*

Three years later, in PLR 201029014, the IRS reiterated its position in TAM 200733023. In the PLR, a taxpayer sought advice on the material participation of the trust with respect to a subsidiary of a subsidiary of the partnership held in the complex trust. The IRS noted that for individuals, the quantitative test for material participation in Temporary Treasury Regulation Sections 1.469-5T(a)(1)–(7) has largely replaced the Section 469(h)(1) "regular, continuous and substantial" qualitative test for material participation. With respect to attributing the activity of agents, the IRS reasoned, "[a]s 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."[72] Despite that reference to the legislative history, the IRS concluded that the trust *may* materially participate in the subsidiary of a subsidiary "if the trustee . . . is involved in the operations of [the subsidiary of a subsidiary]'s activities on a regular, continuous, and substantial basis."[73]

Later in 2010, the United States Tax Court avoided directly answering whether the activities of a person other than the trustee could count for determining material participation of a trust in the passive activity loss context. In *Estate of Strangeland v. C.I.R.*,[74] the Tax Court held that the taxpayer, an estate, could not take passive losses pursuant to Section 469.[75] The trust involved in the dispute had

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[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] *Id.*

[72] I.R.S. Priv. Ltr. Rul. 2010-29-014 (Apr. 7, 2010) (citing S. Rep. No. 99-313, at 735 (1986)) ("'the activities of [employees] . . . are not attributed to the taxpayer.'").

[73] *Id.*

[74] Estate of Strangeland v. Comm'r, 100 T.C.M. (CCH) 156 (2010).

[75] *Id.* at 11.

one trustee, the wife of the decedent, who performed no management activities with respect to the trust asset, meaning that she did not materially participate under Section 469.[76] However, another individual close to the decedent maintained the assets in the trust, and arguably, materially participated.[77] That court avoided the issue by stating that it did not need to "address whether or how a trust may materially participate in an activity because [it] conclude[d] that petitioners . . . failed to prove [the non-trustee's] relationship with the trust."[78]

d. 2013: Technical Advice Memorandum 201317010

Three years later in 2013, the IRS issued TAM 201317010, in which it addressed the activities of a special trustee for the purposes of "material participation" under Section 469.[79] The IRS again concluded that a trust materially participates if the "*fiduciaries of the trust* participate in the operations of the activity."[80]

In reaching its conclusion, the IRS evaluated the facts presented involving two complex trusts, both created on the same day with interests in the same S Corporation, which wholly owned an S Corporation subsidiary.[81] The trust instrument appointed a beneficiary of the trust as the special trustee who had control over "all decisions regarding the sale or retention of such stock and all voting of such stock."[82] "The trust agreements [did] not grant any further fiduciary powers over the Trusts' assets or with respect to the operations or management of the Trusts to . . . the Special Trustee."[83]

The IRS relied on the following legislative history of Section 469, "[s]pecial rules apply in the case of taxable entities that are subject to the passive loss rule. A trust or estate is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating."[84] The IRS next defined "fiduciary" under Section 7701 and the relevant case law.[85] The IRS ultimately held that the special trustee did not *materially participate* "because the Trustee

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[76] *Id.*

[77] *Id.*

[78] *Id.* at 15.

[79] I.R.S. Tech. Adv. Mem. 2013-17-010 (Jan. 18, 2013).

[80] *Id.* (emphasis added).

[81] *Id.*

[82] *Id.*

[83] *Id.*

[84] *Id.*

[85] The IRS explained its definition of "fiduciary" as follows:

> Section 7701(a)(6) defines "fiduciary" as a "guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person." The regulations further provide that "fiduciary" refers to "persons who occupy

and Special Trustee, in their capacity as trustees of [the trusts], were not involved in the operations of [S Corporations'] relevant activities on a regular, continuous, and substantial basis during the tax years at issue.[86] The Special Trustee, moreover, lacked the power to commit either trust to any course of action, control trust property beyond selling, or vote the stock of the S Corporation or its subsidiary.[87] The TAM suggests that a *special trustee* would qualify as a *fiduciary* capable of materially participating for a trust if such special trustee holds an *indicia of discretionary power* such as to bind the trust.[88]

e. 2014: Frank Aragona Trust v. Commissioner

Most recently, the United States Tax Court held that trusts *can* materially participate via the actions of multiple trustees for the purposes of Section 469.[89] *Frank Aragona Trust* involved "a complex residuary trust that own[ed] rental real-estate properties and [was] involved in other real-estate business activities such as holding real estate and developing real estate."[90] The trust had six trustees, five of whom were the children of the settlor, and one who was an independent trustee and attorney.[91] Three of the five children worked full-time for a limited liability company wholly owned by the trust, one was a dentist, and the other was disabled.[92] The court held that a trust can materially participate through the activities of its trustees acting as employees where the operations of the trust were *substantial* and those operations required the full-time attention of the trustees.[93] The court noted, "it is impossible to disaggregate the activities [the trustees] performed as employees of [the business in trust], and the activities they performed as trustees."[94] Notably, the "trustees handled practically no other businesses on behalf of the trust."[95]

Frank Aragona Trust establishes two preliminary canons regarding a trust's ability to materially participate: (1) dual status trustee/employees *can* be factored

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> positions of peculiar confidence toward others, such as trustees, executors, and administrators." To date, the Service has issued only limited guidance expounding upon the definition of fiduciary under § 7701(a)(6).

Id.

[86] I.R.S. Tech. Adv. Mem. 2013-17-010 (Jan. 18, 2013).

[87] *Id.*

[88] *Id.*

[89] *See* Frank Aragona Trust v. Comm'r, 142 T.C. No. 9 (2014).

[90] *Id.* at *3.

[91] *Id.* at *1.

[92] *Id.*

[93] *Id.* at *8–9.

[94] *Id.* at *7.

[95] *Id.* at *8.

into the calculus of whether or not the trust itself *materially participates*; and (2) in the situations involving multiple trustee/beneficiaries who reap benefits from the trust, not all the trustee/beneficiaries need to *materially participate*.[96]

Taken together, these TAMs and cases leave a number of questions unanswered. First, a trust can materially participate through the activities of its trustee(s), but to what extent can the activities of individuals the trustee has delegated be attributed to the trustee(s) for the purposes of *material participation*? Second, if an individual must be a trustee for that individual's activity to count toward material participation, does an inequity result? Theoretically, a trust that appoints an independent trustee instead of a trustee-beneficiary may owe the NIIT even if the beneficiaries meet the material participation test for individuals under Section 469. Last, is Section 469 an appropriate mechanism for applying the material participation standard to the NIIT?[97] As discussed, *supra*, this article seeks to prescribe regulations that answer these questions and assists in providing continuity in administration of the NIIT.

III. Analysis: The Dichotomy of Control vs. Economic Interests, a Case Illustration

Limited guidance exists to determine the material participation of trusts.[98] Current guidance takes somewhat conflicting positions and creates greater uncertainty for trustees, beneficiaries, and estate planners. The following discussion focuses on the difference between control and economic interests. In so doing, the discussion begins with an outline of typical trust arrangements, then compiles current material participation guidance as applied to those trust arrangements, and further explores the analogy raised in *Carter Trust* between trusts and closely held corporations.

A. Contextual Illustration of the Net Investment Income Tax with Variations of Trusts

The following contextual scenarios present tools commonly employed in estate and business succession planning, which feature different tax characteristics that could influence the focus for determining the participation level of a trust. The examples include a Qualified Terminable Interest Property ("QTIP") Trust, a Qualified Subchapter S Trust ("QSST"), and an Electing Small Business Trust ("ESBT"). For purposes of the QTIP analysis, this article presumes that the asset

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[96] *Id.*

[97] *Id*. at *7 n.12 (noting, "A number of commentators have argued that there is a need for a regulation that resolves questions regarding material participation of trusts and generally coordinates the passive-activity-loss rules of sec. 469 with the rules on taxation of trusts in subch. J.").

[98] *See supra* notes 57–97 and accompanying text.

placed into trust is a business enterprise, taxed as a C Corporation, S Corporation, or partnership.[99] The QSST and ESBT examples both involve S Corporation stock.[100]

1. Qualified Terminable Interest Property Trust ("QTIP Trust")

A decedent may claim the estate or gift tax marital deduction for property that passes from the decedent into a QTIP trust if three requirements are met. First, the trust provides the surviving spouse with "all the income from the property, payable annually or at more frequent intervals . . . ."[101] Second, "no person has a power to appoint any part of the property to any person other than the surviving spouse . . . ."[102] Third, the decedent's executor makes the QTIP election on the decedent's estate tax return.[103]

The QTIP trust offers the decedent spouse the ability to provide an income stream for the surviving spouse, while still controlling the ultimate recipients of the trust corpus.[104] Rather than transfer assets outright to use the martial deduction, the QTIP trust enables the decedent spouse to effect control over the ultimate disposition of his or her assets when used in business succession planning.

For income tax purposes, amounts that are "paid, credited, or required to be distributed" to the beneficiary are included in the gross income of the beneficiary for income tax purposes.[105] Under Section 469, the surviving spouse's ability to take losses in this scenario would depend upon the participation of the surviving spouse as an individual.[106]

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[99] *See* I.R.C. § 11 (2014) (imposing tax on corporations); *id.* § 1366 (imposing tax on S Corporations); *id.* §702 (describing distributable income of partners). The American Bar Association Tax Section has suggested that a separate body of rules on material participation be promulgated to address the distinctions between these trust entities and the tax applicable to them. *See* Letter from Armando Gomez, Chair, Section of Taxation, American Bar Association, to The Honorable John Koskinen, Commissioner, Internal Revenue Service (Jan. 29, 2015), *available at* http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/012015comments.authcheckdam.pdf. The authors believe that such alternative approaches merit consideration, but are beyond the scope of this article.

[100] QSST and ESBTs both exist to hold S Corporation stock without compromising the Subchapter S election.

[101] I.R.C. § 2056(b)(7) (2014).

[102] *Id.*

[103] *Id.*

[104] *Id.*

[105] *Id.* § 662(a)(1) (2014).

[106] *See* Temp. Treas. Reg. § 1.469-5T(a)–(d) (2013) (providing examples of material participation for individuals).

2. *Trusts for S Corporation Stock*

a. *Qualified Subchapter S Trust ("QSST")*

In general, S Corporation shareholders must be individuals.[107] In 1982, Congress created the QSST to enable owners of S Corporation stock to place such stock in a specific trust that would not violate the S Corporation rules regarding qualified stockholders.[108] This trust mechanism enables a donor to place S Corporation stock in trust and to name a single income beneficiary. In order to qualify as a QSST, the trust must satisfy the requirements set forth in Section 1361:

> (A) the terms of which require that—
>
> (i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust,
>
> (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary,
>
> (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and
>
> (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary, and
>
> (B) all of the income (within the meaning of Section 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.[109]

The QSST election must be made by the trust income beneficiary rather than by the trustee.[110] For S Corporation stock placed in a QSST, the income beneficiary is the deemed owner of the stock and is considered to be the S

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[107] I.R.C. § 661 (2014).

[108] Economic Recovery Tax Act of 1981, Pub. L. No. 97–34, 1981 95 Stat.172.

[109] *Id.* § 1361(d)(3)(A)–(B). Note that a QTIP trust, as described above, may also qualify as a QSST if it meets both requirements, which overlap by requiring only one income beneficiary.

[110] Treas. Reg. § 1.1361-1(j)(7)(i) (2008).

Corporation shareholder.[111] Items of income from the S Corporation are reported on Form K-1 and included in the income beneficiary's individual income tax return on IRS Form 1040.[112] However, when the QSST sells S Corporation stock and the income beneficiary is the deemed owner by statute but does not have the power to vest trust corpus or income in himself, then any gain recognized on sale is gross income to the trust.[113] The QSST must report income on a Form 1041, but items of income are reported on the income beneficiary's return.[114]

Planners often use QSSTs to transfer S Corporation stock to one income beneficiary. If the grantor desired to provide income to the surviving spouse and then pass the assets to the marital children, a QTIP/QSST would be advisable from an income tax perspective and from a non-tax perspective for purposes of controlling the disposition. Where the grantor does not wish to pass the S Corporation stock to the surviving spouse for income tax purposes, the grantor can use a QSST to transfer the S Corporation stock and to use the unified credit.

b. Electing Small Business Trusts ("ESBT")

Until 1996, S Corporation stockholders could not pass their stock to more than one income beneficiary without creating multiple QSSTs.[115] In 1996, Congress amended the Code to permit ESBTs, an additional type of trust that may hold S-Corporation stock and permits more than one current income beneficiary.[116] Similar to QSSTs, the requirements for ESBTs are also codified in Section 1361:

> (i) such trust does not have as a beneficiary any person other than
>
> (I) an individual,
>
> (II) an estate,
>
> (III) an organization described in paragraph (2), (3), (4), or (5) of Section 170 (c) [charities], or (IV) an organization described in Section 170 (c)(1) which

[111] *Id.* Section 678 says that where a person other than the trust grantor has the power to vest trust corpus or income in himself, such person is deemed to own those trust assets and that income earned thereon is taxed to such person. *See* I.R.C.§ 678(a) (2014); Treas. Reg. § 1.1361-1(j)(8) (2008).

[112] I.R.C. § 1361(d)(1)(B) (2014).

[113] Treas. Reg. § 1.1361-1(j)(8) (2008).

[114] *Id.* § 1.1361-1(j)(7).

[115] Small Business Job Protection Act of 1996, Pub. L. No. 104–188, § 1302, 110 Stat. 1755 (adding electing small business trusts to § 1361 of the Code).

[116] *See id.*; § 1361(e) (2014).

holds a contingent interest in such trust and is not a potential current beneficiary,

(ii) no interest in such trust was acquired by purchase, and

(iii) an election under this subsection applies to such trust.[117]

Unlike a QSST, where income from an S Corporation flows through to the income beneficiary, income from S Corporation stock held in an ESBT is taxed at the trust level at the highest marginal income tax rate.[118] The material participation rules more directly affect ESBTs because the Code treats S Corporation stock in an ESBT as a separate trust for calculating income tax, apart from other trust income, without allowing a deduction for distribution deductions.[119] For calculating the NIIT, the adjusted gross income of both trust portions is aggregated to determine the adjusted gross income of the trust.[120]

To qualify as an ESBT, the trustee, unlike in the QSST context, must make the ESBT election.[121] Because an ESBT has fewer restrictions than a QSST, a QSST may elect to become an ESBT, but an ESBT cannot elect to become a QSST.

ESBTs offer planners a less restrictive option for holding S Corporation stock. However, shareholders of an S Corporation held in an ESBT are determined by reference to potential current beneficiaries ("PCBs"). These PCBs may fluctuate over time. Given that S Corporations may only have up to 100 shareholders, planners must remain cognizant of the number of actual beneficiaries and PCBs to avoid losing the S Corporation election.[122]

Notwithstanding the concern over maintaining the S Corporation election, estate planners can form an ESBT to pass S Corporation stock to multiple beneficiaries, employing a trustee to spray or sprinkle distributions. The administrative ease of forming an ESBT may outweigh paying taxes on S Corporation income at the highest trust tax bracket.

B. Who, What, and Why

With the typical estate planning tools in mind, the following section responds to the concerns outlined by the American Bar Association in its response to the

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[117] I.R.C. § 1361(e) (2014).

[118] *Id.* §§ 641(c)(1)(A) (2014); 641(c)(2)(C).

[119] *Id.* § 641(c)(1).

[120] Treas. Reg. § 1.1411-3(c)(2) (2013) (calculating NIIT).

[121] I.R.C. § 1361(e)(3) (2014).

[122] *Id.* § 1361(b)(1)(A).

Treasury's request for comments regarding material participation. Those concerns include the following:

> 1. Whose participation is relevant to a determination of whether the estate or trust materially participates in the activity?
>
> 2. What are the relevant actions of those persons toward material participation?
>
> 3. What level of action is required to constitute material participation?[123]

1. Whose Activity and in What Capacity?

Current guidance suggests that the activities of *fiduciaries of the trust* count for material participation purposes. Per the IRS, this includes "special trustees" to the extent such trustees hold some discretionary powers over the trust.[124] This remains undecided by the Tax Court. Despite the focus in *Frank Aragona Trust* on the activities of the trustees, the court in that case did not address "whether the activities of the trust's non-trustee employees should be disregarded."[125] *Frank Aragona Trust* holds that the activities of an employee/trustee cannot be disaggregated. Thus, because the trustee cannot forego his or her fiduciary duties, work performed in the business, even as an employee, counts for material participation.[126] Of course, the Commissioner would counter by asserting first that trusts cannot materially participate, and second that even if they could, only the activities of the trustee count for material participation. Given that *Carter Trust* has not been expressly overruled, that holding may still survive as the jurisprudence evolves in this area. Arguably, *Carter Trust*'s holding recognizes the economic reality of trust arrangements with business enterprises held therein.[127]

Material participation in the trust context for purposes of Section 1411 predominantly affects whether the trust pays the NIIT on undistributed net investment income. If a trust holds a portfolio of publicly traded securities, in most cases such a trust would not be able to materially participate in these business

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[123] SECTION OF REAL PROPERTY, TRUST, AND ESTATE LAW, AM. BAR. ASSOC., COMMENTS ON INTERNAL REVENUE CODE SECTION 1411 WITH RESPECT TO AN ESTATE OR TRUST; CORRESPONDING REQUEST TO OPEN A TREASURY REGULATIONS PROJECT UNDER SECTION 469, at 2 (Mar. 6, 2014), *available at* http://www.regulations.gov/#!documentDetail;D=IRS-2013-0042-0016.

[124] I.R.S. Tech. Adv. Mem. 2007-33-023 (Aug. 17, 2007).

[125] Frank Aragona Trust v. Comm'r, 142 T.C. No. 9, *8, n.15 (2014).

[126] *Id.* at *7.

[127] *See* Carter Trust *ex rel.* Fortson v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

ventures. The contemplated scenario involves trusts with smaller, generally closely held businesses passing from one family generation to another. Given the context in which trust beneficiaries may play roles in the business, guidance from Section 2032A may provide some additional guidance. As discussed in Part IV.B.2, *infra*, those likely able to avoid the NIIT via *material participation* are akin to the beneficiaries of the proverbial "small family business and farm" that Section 2032A seeks to protect. Perhaps the best approach would be the more stringent Section 2032A requirements that look to the making of a business' management decisions other than daily operating decisions.

The concern that individuals other than trustees could materially participate may be unfounded. A trustee likely would not abuse the rule by hiring multitudes of agents because of limits imposed by trust laws governing trustees and the financial limitations of such conduct. The Uniform Trust Code, which is broader and more permissive than the common law, provides, "[a] trustee may delegate duties and powers that a prudent trustee of comparable skills could properly delegate under the circumstances."[128] Arguably, a trustee would breach his or her fiduciary duties if he or she delegated duties and powers to multiple agents solely to satisfy the material participation requirement for trusts. Even if a *prudent trustee* would engage in such conduct, trustees owe a duty of prudent administration, which would limit the amount of financial resources a trustee could spend on agents to simply meet a material participation test.[129] By considering the activities of the trustee and the trustee's agents who take part in the operation of the business, the Code would avoid imposition of the NIIT on trusts that *materially participate* for all intents and purposes.

2. What Actions Count Toward Material Participation?

Because the trust, as a taxpayer, acts through individuals, actions by individuals are attributed to the trust. Under this regime, a fiduciary of a trust could reference the regulations applicable to individuals for material participation in paragraphs (a) through (d) of Treasury Regulation Section 1.469-5T.[130] Of note, the IRS in TAM 200733023 indicated that certain activities and time spent negotiating the sale of trust assets would not count toward material participation.[131] This generally comports with the Internal Revenue Manual guidance on passive activity losses, which illustrates "investor-type activities" and notes that such activities do not

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[128] UNIF. TRUST CODE § 807(a) (2010).

[129] *See id.* § 804 ("A trustee shall administer the trust as a prudent person would, by considering the purposes, terms, distributional requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.").

[130] *See* Temp. Treas. Reg. § 1.469-5T; *see also* Internal Revenue Serv., *Passive Activity Loss, Audit Technique Guide*, 4–14, *available at* http://www.irs.gov/pub/irs-mssp/pal.pdf (last visited Apr. 26, 2014) (providing a decision tree for auditors to determine material participation for § 469).

[131] I.R.S. Tech. Adv. Mem. 2007-33-023 (Aug. 17, 2007).

count toward material participation.[132] Similarly, in *Carter Trust*, the trustee's permissible activities included many duties related to managing a cattle business:

> I was chosen to be Trustee because of my extensive business, managerial, and financial experience. My duties include reviewing and approving all financial and operating proposals for the Ranch and the Trust, budget and budgeting for the Ranch, all investment decisions for the Trust, asset acquisition and sales, supervising all employees and agents of the Trust and the Trust's service providers, reviewing all financial information, and responsibility for all banking relationships of the Trust. My duties and responsibilities as Trustee routinely require a significant percentage of my time and attention, and I maintain regular office hours during which I am consulted regarding any Trust matter that arises.[133]

In the real estate context, work performed by a trustee as an employee of the business interest held in trust counts toward material participation where that work involves routine management of the business and is performed on a regular, consistent, and substantial basis.[134]

However, unlike the 500-hour rule in Treasury Regulation Section 1.469-5T(a)(1), some of the other material participation tests for individuals do not lend themselves to aggregation.[135] That presents no major issue, however, as the other tests arise in the context of single individual activity, which could, for purposes of Section 1411, satisfy the material participation requirement for the trust.[136] As held in *Frank Aragona Trust*, not all trustees of a trust need to materially participate in order to satisfy the material participation requirements. The *Frank Aragona Trust* court, however, left an open question regarding the point at which trustee action or inaction, in the aggregate, constitutes material participation.

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[132] Internal Revenue Serv., *supra* note 130, at 4-8 to 4-11.

[133] Carter Trust *ex rel.* Fortson v. United States, 256 F.Supp.2d 536, 538 (N.D. Tex. 2003).

[134] Frank Aragona Trust v. Comm'r, 142 T.C. No. 9, *1 (2014). Please note that special regulations govern material participation in the real estate context, which is presumed to be passive activity.

[135] *See, e.g.*, Temp. Treas. Reg. § 1.469-5T(a)(2) (2013) ("The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year . . . ."); *id.* § 1.469-5T(a)(3) ("not less than any other individual").

[136] *See, e.g.*, *id.* § 1.469-5T(a)(2) ("The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year . . . .").

3. *What Degree of Action Is "Regular, Continuous, and Substantial"?*

In its TAMs, PLRs, and positions advanced in adjudicated disputes, the IRS continues to posit that a trust materially participates if the trustee "participates in the activity on a regular, continuous, and substantial basis during such year." This language, derived from Treasury Regulation Section 1.469-5T(a)(7), requires explanation. The regulation continues to provide that a person does not materially participate if such person does not spend at least 100 hours per year on the activity.[137] Furthermore, management of the activity must pass certain tests to count toward the material participation requirement:

> **(ii) Certain management activities.** An individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section unless, for such taxable year—
>
> (A) No person (other than such individual) who performs services in connection with the management of the activity receives compensation described in section 911(d)(2)(A) in consideration for such services; and
>
> (B) No individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

C. *Analogizing the Fiduciary Duty Between Trustees and Trusts and Executors and Estates to Agents and Corporations*

As a general matter, a trust is a "fiduciary relationship in which one person holds a property interest, subject to an equitable obligation to keep or use that interest for the benefit of another."[138] Under the Code, trust taxation depends upon the terms of the trust document, with the major categories including grantor trusts, non-grantor trusts, and foreign trusts.[139] Special trust rules apply to certain trusts, for example, charitable trusts, pre-need funeral trusts, and alimony trusts. For purposes of establishing a framework, some similarities exist between a trust and a closely held corporation.

The Mattie K. Carter Trust in *Carter Trust* argued that the activities of the trustee and agents thereof resembled a closely held corporation. Trusts certainly

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[137] *Id.* § 1.469-5T(b)(2)(iii).

[138] GEORGE G. BOGERT ET AL., CASES AND TEXT ON THE LAW OF TRUSTS 2 (9th ed. 2012).

[139] *See generally* 26 U.S.C. §§ 641–692 (2014) (Subchapter J).

differ from corporations in many respects, including fiduciary duties. However, clear parallels exist when viewing a trust as an entity. Trusts, like corporations, depend upon affiliates in order to operate.[140] In the case of corporations, the affiliates are agents acting as officers, all of whom have fiduciary duties to the corporation, and can delegate responsibilities to employees.[141] Similarly, trustees acting as fiduciaries to the trusts and beneficiaries may delegate their responsibilities, but in a much more limited manner.[142] Executors of estates also have fiduciary duties to the *estate* and to the beneficiaries to protect and distribute property within the estate in a similar manner as trustees with regard to trusts.[143] As *Carter Trust* illustrated, some corporate agents have similar, but lesser, fiduciary duties to corporations as compared to trustees and executors with respect to trusts and estates.[144] Nevertheless, trustees acting as employees fall outside of the scope of a pure fiduciary in assessing activities for the purposes of Section 469 because it is "impossible to disaggregate the activities [that trustees perform] as employees."[145]

In drawing the equivalence between the fiduciary duties of agents with regard to corporations and trustees and executors with regard to trusts and estates, it becomes clear that the actions of the fiduciary—either as an agent, trustee, or executor—are for the benefit of a separate entity. The common law recognizes that the actions of a fiduciary, whether an agent, trustee, or executor, are an extension of the principal when the fiduciary acts in a fiduciary capacity.[146] However, the actions of an extension do not reflect the totality of the actions of the entity: corporations may have multiple agents, trustees may engage the assistance of others for the benefit of their respective trusts in limited capacities,[147] and executors may require the assistance of professionals in administering an estate.[148] In this sense, the individual actions of fiduciaries are encapsulated as actions of the entity as a whole.

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[140] *See* RESTATEMENT (THIRD) OF TRUSTS § 70 (2007).

[141] *See* Ripley v. Storer, 139 N.Y.S.2d 786, (Sup. Ct. 1955), *aff'd*, 142 N.Y.S.2d 269 (App. Div. 1955); Kaplan v. Block, 31 S.E.2d 893 (Va. 1944).

[142] *See* UNIF. TRUST CODE § 807 (2010); *cf.* RESTATEMENT (FIRST) OF TRUSTS § 171 (1935) (explicitly forbidding trustees from delegation).

[143] *See In re* Estate of Campbell, 692 A.2d 1098, 1102 (Pa. Super. Ct. 1997); *see also* FCLT Loans, L.P. v. Estate of Bracher, 93 S.W.3d 469, 480-83 (Tex. App. 2002); *see also* MASS. GEN. LAWS ch. 191B § 13 (2013) (powers Alternative A).

[144] *See generally* Carter Trust *ex rel.* Fortson v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

[145] Frank Aragona Trust v. Comm'r, 142 T.C. No. 9, *7 (2014).

[146] *See* RESTATEMENT (THIRD) OF TRUSTS § 77 (2007); RESTATEMENT (SECOND) OF AGENCY § 383 (1958); RESTATEMENT (SECOND) OF AGENCY § 385 (1958).

[147] *See* UNIF. TRUST CODE § 807 (2000) (delegation by trustee).

[148] *See* RESTATEMENT (THIRD) OF TRUSTS § 80 (2007).

This is reflected in the Code: the corporate federal income tax, unless S Corporation status has been elected, is imposed on the corporation itself rather than officers or other agents.[149] The separateness of corporate entities from agents who largely account for the operations of the entity has been firmly established. In *Maxwell v. C.I.R.*, corporate officers in a closely held corporation who were agents of the corporation successfully sued for injuries sustained on corporate premises as agents of the corporation.[150] As corporate officers, they deducted the costs of the lawsuit.[151] The Code goes so far as to not only tax corporations on the income brought in by its agents, but also on the income of its subsidiaries in many cases.[152]

Similarly, so long as the trust is not a grantor trust, it is a separate taxable entity for income tax purposes.[153] Trusts depend upon trustees to maintain the trust and assist the trust in earning income.[154] Much like agents of corporations, trustees generally remain free from liability for actions done on behalf of the trust so long as the trustee acts in accordance with his or her fiduciary duties.[155] Actions against the trustee for acts committed outside the scope of his or her fiduciary duties likewise cannot reach assets held by the trust.[156] Agents of corporations and trustees of trusts are sufficiently similar with regard to both tax and general liability to the extent that the actions of trustees, like an agent of a corporation, act as proxies for the trust for tax purposes.

Under Section 1411, the NIIT is payable by trusts as a separate taxable entity on net investment income.[157] This net investment income includes "income which is derived in the ordinary course of a trade or business . . . [that is] (A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or (B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2))."[158]

The interplay between state trust law and tax law arises when examining the entity paying the tax for purposes of distinguishing *active* versus *passive* activity.

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[149] *See* I.R.C. § 11 (2014).

[150] Maxwell v. Comm'r, 95 T.C. 107 (1990).

[151] *See id.*

[152] *See* I.R.C. § 1561(a) (2014).

[153] *See id.* § 641(a) (2014). "Grantor trust" refers to the concept that the trust grantor retains sufficient interests in the trust that he or she remains the owner of the trust for income tax purposes. *See id.* §§ 671–678.

[154] *See* RESTATEMENT (THIRD) OF TRUSTS §§ 70, 75 (2007).

[155] *See* RESTATEMENT (SECOND) OF TRUSTS § 261 cmt. (a) (1959).

[156] *See id.* § 266.

[157] *See* I.R.C. § 1411(a)(2) (2014).

[158] I.R.C. § 1411(c)(1)(A)(i), (2)(A)–(B) (2014).

Under Section 469, "'passive activity' means any activity—(A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate." Regulatory guidance on *material participation* has been hotly debated. Regulations under Section 469 provide guidance for assessing the material participation of individuals, however, the regulations remain silent as to the material participation of trusts. In determining the material participation of trusts, tax attorneys must speculate as to the proper focus of the activity in order to decide if the trust materially participates.[159]

IV. PROPOSED REGULATORY LANGUAGE

A. *Proposal*

In order to add clarity and reduce the difficulties posed by the trustee-only test, the Treasury could adopt a rule using the following language ("Proposed Language") for Treasury Regulation Section 1.469-5T(g) that could govern material participation of estates and trusts:[160]

> **Proposed Treasury Regulation § 1.469-5T(g)**
>
> (1) Except as provided in paragraphs (e) and (h)(2) of this section, a trust shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if the trust satisfies the requirements for individuals set forth in paragraphs (a) through (d), through its trustee or trustees and any agents thereof.
>
> (2) For purposes of this paragraph, agents of the trustee include income beneficiaries of the trust, the transferor as defined in section 2652(a), and individuals contracted by the trustee in an arms length transaction, who perform services related to the trust activity.

This regulatory language recognizes that in order for a trust to materially participate for tax purposes, an individual's activity must be attributed to the trust. The Proposed Language blends the position of the United States Tax Court in Michigan with that of the Northern District of Texas. *Frank Aragona Trust* holds that in the context of Section 469 "[s]ervices performed by individual trustees on behalf of the trust may be considered personal services performed

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[159] *See* Temp. Treas. Reg. § 1.469-5T(g) (2013) (reserved for regulations regarding material participation of trusts and estates).

[160] Please note that material partial participation under § 1411 refers to the regulations under § 469. *See also* Net Investment Income Tax, 78 Fed. Reg. 72,934, 72,402 (Dec. 2, 2013).

by the trust."[161] The Proposed Language uses the trustee as the anchor, but aligns more closely with *Carter Trust*, where the court established that material participation with respect to a trust "should be determined by reference to the persons who conducted the business" on the trust's behalf, including the trustee.[162] The flexibility provided in the Proposed Language incorporates different trust types and determines material participation "by reference to the persons who conducted the business" on behalf of the trust.[163]

By deviating from *Frank Aragona Trust*, the Proposed Language addresses the potential loophole created by the NIIT, which considers the situation where only trusts with large business interests avoid the NIIT by having sufficient resources to compensate a trustee to "materially participate within the business."[164] To the extent trusts distribute all net investment income, zero NIIT is due at the trust level.[165]

B. *Possible Concerns Regarding the Proposed Language*

As noted above, for Section 1411, material participation provides an escape mechanism from the NIIT for trusts that have undistributed net income greater than the trust's adjusted net income over the "threshold amount" of $200,000.[166] Eliminating situations in which a trust holds significant business interests[167] that generate adjusted net income in excess of the threshold amount, *arguendo*, the material participation rules in the Section 1411 impact primarily trusts holding family businesses in whatever form of entity.

1. *Aggregating Activities—Self Employment Tax Alternative*

By taking the position that the only activities that count toward material participation are those of the trustee, the Tax Court imposes a backstop. Under the Proposed Language, a trust with one trustee could theoretically designate each income beneficiary as an agent, aggregate the total hours of *active participation*, and satisfy the material participation requirement. In trusts with multiple income beneficiaries, this scenario would require few hours on each individual to satisfy the 500 hour requirement in Temporary Treasury Regulation Section 1.469-5T(a)(1).

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[161] Frank Aragona Trust v. Comm'r, 142 T.C. No. 9, *1 (2014).

[162] Carter Trust *ex rel.* Fortson v. United States, 256 F. Supp. 2d 536, 541 (N.D. Tex. 2003).

[163] *Id.* at 541 ¶ 6.

[164] *See* I.R.C. §§ 1411(a)(2), (b) (2014).

[165] *Id.* § 1411(a)(2).

[166] *See id.* §§ 1411(a)(2), (b).

[167] For purposes of the discussion in this section, business interests include all forms of flow-through taxation.

However, viewing the NIIT as an alternative to the self-employment tax, one must look beyond trust taxation to determine the equity of this scenario under the Proposed Language. Under this scenario, the underlying business income flows through to the trust's tax return, free of the NIIT, although subject to income tax at trust tax rates in Section 1(e). Income beneficiaries receive distributions free of any further income tax obligation because the trust paid the tax. This business income escaped the self-employment tax at the individual income beneficiary's level and at the trust level via the NIIT. Assuming this taxpayer had received his or her share of the business outright rather than in trust, income produced by the business would be reported on the individual's Form 1040, and would be subject to either self-employment tax or the NIIT. Under this Proposed Language and scenario, income beneficiaries could shelter income in a trust to avoid the NIIT and the self-employment tax. However, for all but the highest marginal bracket taxpayers, this strategy comes at a high cost. The compressed income tax rates for trusts would cost more in tax than if the trust distributed the income to the beneficiaries.

Of course, non-tax reasons exist for placing such an interest in trust—namely, the assurance provided to grantors that a trustee oversees trust activities and can ensure the proper management of trust assets, the business. Furthermore, the business may not make distributions, and therefore the trust's income tax covers *phantom income* not easily distributed.

Taking the same scenario in which all trust income is distributed to the income beneficiaries, a similar inequity would result between two income beneficiaries in different marginal tax brackets. The income beneficiary with adjusted gross income above the threshold amount would owe the NIIT, while the income beneficiary below the threshold would not.[168] By design of the statute, Congress engaged in line-drawing. However, because the NIIT is separate from the income tax, the question becomes whether a trust should escape the NIIT by aggregating small activities of many income beneficiaries. Such instances would occur when, but for that aggregated activity, NIIT would be due, either at the trust level or at the income beneficiary's level in the case of distributed net income.

2. *Concerns About Insufficient Legislative Support for the Proposed Language*

Outside the ambit of Section 469, Section 2032A provides more descriptive language for evaluating material participation in the estate and trust context. Section 2032A provides for special use valuation of a decedent's assets, which enables executors of certain estates to value qualified real property at less than their "highest and best" use.[169] Under this exception for certain estates, "material

[168] I.R.C. § 1411(a)(2), (b) (2014).

[169] *Id.* § 2032A (2014).

participation in the business by the decedent owner or a family member" is found in one or more of four scenarios:

> Where property is owned by a trust, the arrangement will generally be found in one or more of four situations. First, the arrangement may result from appointment as a trustee. Second, the arrangement may result from an employer-employee relationship in which the participant is employed by a qualified closely held business owned by the trust in a position requiring his or her material participation in its activities. Third, the participants may enter into a contract with the trustees to manage, or take part in managing, the real property for the trust. Fourth, where the trust agreement expressly grants the management rights to the beneficial owner, that grant is sufficient to constitute the arrangement required under this section.[170]

In the Section 2032A context, which provides a favorable estate tax savings through valuation, material participation focuses more so on the activities of the decedent or family member of the decedent, rather than on the activities of the trustee.[171] Arguably, this results from the differences between Sections 469 and 1411, and 2032A. Sections 469 and 1411 involve the tax on income, which for businesses in trust would be payable by the trustee if the trust has undistributed income.[172] Section 2032A focuses on the family members of the decedent as the presumptive beneficiaries of the business. For Section 2032A, the executor, if an unrelated person to the decedent, stands to benefit little from the valuation of land included in the decedent's estate. Assuming the focus of Section 2032A is truly on the beneficiaries that stand to benefit from this Code Section, reason suggests that Section 1411, and Section 469 for that matter, should focus on the income beneficiaries of a trust rather than the trustee. For the hypothetical small business placed in trust, should the Code focus on the actions the trustee in the business when an able-bodied child beneficiary of the trust is also present? Trustees obviously owe fiduciary duties to the beneficiaries of a trust, but material participation in a business to avoid the NIIT certainly is not a default fiduciary duty owed. If Section 1411 followed more closely to Section 2032A for the trust context, trust beneficiaries would bear the onus and the opportunity to materially participate to avoid the NIIT.

3. Inequitable Treatment of Minor Beneficiaries v. Adult Beneficiaries

Next, we should consider the inequity that results when a business interest is placed in trust for the benefit of minors compared to an interest placed in trust

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170 Treas. Reg. § 20.2032A-3 (2013).

171 *Id.*

172 *See* I.R.C. §§ 469, 1411 (2014).

for the benefit of able-bodied adults. A trust for minors more likely accumulates income, thus increasing the likelihood that such a trust would owe the NIIT.[173] Under the Proposed Language, where the beneficiaries are over the age of majority, they may choose to participate in the business and avoid the NIIT. This inequity extends beyond the direct scope of defining the material participation of a trust, but it bears consideration as a consequence of the Proposed Language, or other proposed guidance on this topic.

Non-tax reasons exist for accumulating income in the trust, such as the case of minors. One may posit that minors cannot materially participate in a business in trust, and thus have little choice but to have their trust income subject to the NIIT, unless the trustee materially participates. However, such a result would also occur if the income were distributed. Under the Proposed Language, however, a trustee could delegate responsibilities such that an agent of the trustee alone or in conjunction with the trustee could *materially participate* in the business and alleviate the NIIT for the minor. Such a planning option would remain unavailable if income were distributed. Even if the income was deemed net investment income and subject to the NIIT, the tax applies to "passive income."[174] For all intents and purposes, trust income for the benefit of a minor is passive income and no inequity results where the income is subject to a tax in the case of a non-participating minor versus an actively participating adult beneficiary.[175]

4. *Inequitable Treatment of Similarly Situated Taxpayers*

The IRS would argue that the activities of an income beneficiary do not count toward the determination of material participation by likening the income beneficiaries to employees of a business owner and asserting that a business owner does not materially participate in an enterprise solely by the actions of his or her employees.[176] The Tax Court would distinguish the trustee who is an employee of the business from an income beneficiary who is also an income beneficiary of the business.[177] For trustees, "it is impossible to disaggregate the activities they performed as employees of [the business], and the activities they performed as trustees."[178] Although the Tax Court did not address whether a trust could

[173] This presumes that the minor would not be able to spend the proceeds from the trust's earnings and the earnings would thus accumulate, because the minor would not be entitled to the funds until he or she reaches majority.

[174] *See* I.R.C. § 1411(c) (2014).

[175] By way of analogy, compare the alleged inequity that results in this case with the imposition of the "kiddie tax" under § 1(g) that taxes a minor's net investment income in excess of $1,900 at the minor's parents' marginal tax rate, which presumably exceeds the minor's marginal tax rate.

[176] I.R.S. Priv. Ltr. Rul. 2010-29-014 (Apr. 7, 2010).

[177] *See supra* notes 124–129 and accompanying text.

[178] Frank Aragona Trust v. Comm'r, 142 T.C. No. 9, *7 (2014).

materially participate via trust beneficiaries, the prevailing view by the IRS is no.[179] Taking the law as it stands, a business interest left in trust would cost significantly more for NIIT purposes than had the interest been gifted outright.

To illustrate, compare the business owner that leaves shares in an S Corporation in an ESBT for his two children versus the business owner that left each child a fifty percent interest in the business. To maximize each child's threshold for the maximum marginal rate for single filers, let's assume the trust assets generate income equal to $406,750 x 2, or $813,500.[180] Let's further assume that each child works in the business a minimum of 500 hours per year.[181]

An ESBT earning $813,500 would pay income tax on that trust income for a total tax of $322,146, or $161,073 per child.[182] If each child held the interest outright, the total tax paid by each child would be $118,118. The ESBT already pays income tax that exceeds the amounts paid by a single filer by $38,222.05. Assuming each child *materially participates*, neither child would owe the NIIT if owning the S shares outright. However, under current precedent, if the shares were held by the ESBT and the children were not trustees, then the trust would pay $30,459 for the 3.8 percent NIIT on $813,500 of adjusted gross income.[183] Eliminating all non-tax considerations, the ESBT in this scenario costs an extra $116,367.[184] Between an ESBT and another trust that distributes trust income, no tax difference exists because the tax amount in either situation would equal that calculated on the individual's personal income tax return.

Under current law, an interest held in an ESBT inequitably treats income beneficiaries that materially participate.[185] Under the Proposed Language, the

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[179] *See id.* at *5.

[180] *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

[181] *See* Temp. Treas. Reg. § 1.469-5T(a)(1) (2013).

[182] ESBTs are taxed at the highest marginal tax rate for trusts set forth in § 1(e) of the code, which is currently 39.6%. *See* I.R.C. § 641(c)(2)(A) (2014).

[183] *See* I.R.C. § 1411(a)(2) (2014).

[184] This calculation omits consideration for any transactions costs or deductions that would reduce gross income and generate and "adjusted gross income" less than "gross income." This extra cost compares the aggregate income taxes paid by two single filers materially participating in a business interest held personally versus two single filers materially participating in a business held in an ESBT. The individual single filers pay tax according to the progressive rates in § 1. The ESBT pays tax according to the rates in § 1(e), meaning the trust pays tax on all taxable income at the highest marginal rate, 39.6%. In addition, the ESBT would pay the NIIT under § 1411(a)(2) on the excess of any "adjusted gross income" over "the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year." § 1411(a)(2). Therefore, the 3.8% NIIT is applied to a tax base equal to adjusted gross income less $11,950 in 2014.

[185] As a counter, the transferor of the business could reorganize the business so as to avoid use of the ESBT. The transferor could switch to a state-law LLC taxed as a partnership to avoid the ESBT expense. However, the reorganization could subject the corporation to taxes upon changing tax status. *See* I.R.C. § 1362 (2014).

ESBT would pay a greater amount in income tax, but the trust would avoid the NIIT. In cases where income beneficiaries' work in the business contributes to the earnings of the trust, regulatory guidance should recognize the contribution of the income beneficiaries to avoid a tax on net investment income. The economic reality in such instances suggests that income derived from a beneficiary's activity is not passive, but is active because the beneficiary's actions constitute the test for material participation on an individual level.

5. Purposes of the NIIT as Related to FICA

Given the purpose of the NIIT as a complement to wage taxes, the material participation test may misalign with that purpose. If the NIIT is based on material participation, it presumes that individuals who have an interest in a trust subject to the NIIT are not otherwise employed. Requiring material participation as a proxy for determining the NIIT poses a problem, not simply for the potential *loophole*, but also because under its current construction, Section 1411 facilitates the possibility of inequitably taxing trust earnings, whether or not the beneficiary is employed by a business in the trust.[186]

Medicare funding has been sourced from "wages" since the inception of Medicare in the 1960s.[187] "Wages" as a legally operative term has been stretched to its broadest logical bounds, yet still remains the legal predicate for the taxation and subsequent funding of Medicare.[188] "Wages," however, are legally distinct from "income" and other bases of taxation.[189] For QSSTs and QTIP trusts that distribute all trust income to beneficiaries, the NIIT applies at the individual level, with material participation determined on behalf of the individual or individuals reporting the income.[190]

If a taxpayer works and earns wages, his or her contributions to Medicare constitute 1.45 percent of those wages.[191] As discussed above, this flat tax does not have any limit on the wage base.[192] If the same taxpayer has an interest in a trust such as a QSST or QTIP that is subject to the NIIT and the trust does not *materially participate*, then the income from that trust will be taxed at 3.8 percent.[193] If the taxpayer has income from the trust and wages, he or she

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[186] *See supra* notes 160–165 and accompanying text.

[187] *See* Stein, *supra* note 22 and accompanying text.

[188] *See* Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 709 (2011).

[189] *Cf.* I.R.C. § 61(a) (2014).

[190] *See id.* § 1411 (a)(1) (2014) (NIIT for individuals), *id.* § 1361(d) (2014) (QSST); *id.* § 2056(b)(7)(B) (2014) (QTIP).

[191] *See id.* § 3121(b) (2014).

[192] *See id.* § 3121(a)(1) (2014).

[193] *See id.* § 1411 (2014).

will contribute to Medicare at an effective rate between 1.45 percent and 3.8 percent.[194] As the proportion of trust income to wages increases, the effective rate increases. This article is not necessarily arguing for a lower rate, but rather noting an inconsistent rate applied based on the source of the income. The variance in the effective rate is not horizontally equitable because a taxpayer who *only* earns wages of the same dollar amount will be forced to contribute to Medicare at 1.45 percent. The material participation test for the NIIT creates a contingency whereby taxpayers can choose to participate in order to avoid the NIIT.[195] This example merely demonstrates one instance where the mechanics of the NIIT may produce inequity that regulations could remedy.

If an ESBT avoids the NIIT, then the trust pays income tax on earnings at the trust's tax rates, with the income beneficiaries receiving tax-free distributions. If the income beneficiaries of the ESBT materially participated, then under the Proposed Language, no self-employment taxes would be collected at either the trust level or individual level; furthermore, no NIIT would be collected at either level. Assuming the income beneficiary receives no wages, the trust distributions to the ESBT income beneficiaries would pass free of employment taxes, self-employment taxes, and net investment income taxes. This *escape mechanism* to avoid FICA contributions comes, however, at a cost of the compressed income tax rates for trusts. The ESBT income is taxed at the highest level of tax at 39.6 percent.[196] A single filer would need to earn at least $406,750 to reach the marginal rate of 39.6 percent.[197] The additional 3.8 percent NIIT would not deter a person from choosing another trust form and remaining passive, thus paying the NIIT. In the ESBT scenario, where the trust receives no distribution deduction and pays tax at the highest marginal rate of 39.6 percent, an additional 3.8 percent tax would likely entice the trustee or trust beneficiaries to actively participate.

V. Conclusion

Until the enactment of the NIIT, little regulatory activity occurred with respect to the material participation of estates and trusts. With the new NIIT, however, many trust arrangements that hold business interests face the tax, but for the exception of active participation. Under current guidance, a trust may materially participate to the satisfaction of the IRS if the trust counts only the actions of the

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[194] Because no double taxation exists, the effective rate of tax in this scenario is calculated by adding the total taxes paid, proportional share of NIIT and 1.45% of Medicare from employment taxes, and dividing that total by the sum of the total proportion of trust income plus total wages. The maximum effective rate would be 3.8%.

[195] Please note that this discussion is with respect to § 1411. Passive activity loss rules are contained within § 469.

[196] *See* I.R.C. § 641(c)(2)(A) (2014).

[197] *See* Rev. Proc. 2013-35, 2013-47 I.R.B. 537.

trustee or co-trustees who can act with discretion and bind the trust. For purposes of attributing actions to the trustee, the IRS disapproves of looking beyond the actions of the trustees and aligns its position with an analogy to an employer's inability to count the actions of its employees for material participation.

The authors' Proposed Language seeks to offer a regulatory solution in an attempt to illuminate this area for practitioners and trustees. By bridging the holdings in the cases in this area and the handful of PLRs and TAMs, the authors sought to develop a regulation that addresses the concerns of commenters and the legally supported positions taken in the existing case law. As a result, the authors propose that the Code attribute the activities of trustees and agents thereof to trusts for purposes of determining the material participation of a trust. In conformity with the design of Section 1411, this regulation would appear in the Section 469 regulations and would also govern the deductibility of losses from passive activities.

Although looking to the trustee offers a bright-line rule, considering the activities of the trustees and agents thereof more accurately reflects the economic reality of material participation in the context of trusts with income beneficiaries involved in the business held in the trust. The relationship between trustees and beneficiaries is not directly analogous to a business owner and his or her employees, and the attribution rule suggested herein would reflect that difference and not be applied to the actions of a sole employer. In the normative sense, a trust, as a taxpaying entity, materially participates when an income beneficiary materially participates in the business. For now, the Code uses *material participation* as the test for applying the NIIT to individuals and trusts. Treasury regulations should recognize the distinct relationship between a trustee and the trust and should consider the real-world operations of a trust for purposes of aligning the regulations with the available guidance from Congress. If the overarching concern beneath the IRS's position is the funding of Medicare coffers, then perhaps a test other than material participation should apply for estates and trusts. That, however, remains a task for Congress, not the judiciary or the agency.