**8570. What considerations are relevant in determining if a trade or business is non-passive with respect to a trust for purposes of treating the income derived therefrom as excluded from net investment income?**

As discussed in Q 8567, whether a trade or business activity from which the taxpayer derives income from is passive depends on the taxpayer’s level of participation in the activity in question. In the case of a trust that owns interests in a pass-through entity, such as an S corporation or partnership, it is the trustee’s participation in the business activities that is relevant in determining whether the investment is active or passive with respect to the trust.

In a 2013 technical advice memorandum, the IRS expressed a restrictive view of what participation in a business activity by a trustee is attributable to the trust. In that memorandum, the IRS declared that a trustee’s participation in a business in which the trust owned interests was *not* material even though the trustee was also the president of the company through which the business activity was conducted.[[1]](#footnote-1) The IRS reached this conclusion based on its view that the trustee’s participation in the company as an *employee* was separate from his role as trustee; and, thus, it was not attributable to the trust. Further, although the IRS did count the trustee’s time spent serving as *trustee* in dealing with the company’s business, it determined that the trustee’s activities were nonetheless not “regular, continuous and substantial” within the meaning of IRC Section 469 (governing passive activities generally).[[2]](#footnote-2)

Although the technical advice memorandum did not address the issue of whether the trust income was net investment income, it reflects the IRS view that the participation of a trustee as an employee or officer of an entity is not attributed to his or her role as the trustee. Based on such a restrictive view of the role of the trustee, it may be virtually impossible for any trust to materially participate in a business activity.

However, in a recent decision, the Tax Court rejected the IRS’ restrictive position.[[3]](#footnote-3) In that case, a trust owned rental real estate properties and engaged in other real estate activities. Three of the five trustees worked full-time in the trust’s wholly owned rental real estate LLC. The issue was whether the personal services of the trustees as employees of the LLC would be attributable to the trust.

Pursuant to IRC Section 469(c)(2), all rental activities are passive. In order to rebut that characterization, IRC Section 469(c)(7)(B) requires the taxpayer to meet the following two tests: (1) more than one-half of the personal services performed in the trades or businesses by the taxpayer during the taxable year is performed in real property trades or businesses in which the taxpayer materially participates; and, (2) the taxpayer performs more than 750 hours of services during the year in real property trades or businesses in which the taxpayer materially participates.

Consistent with the technical advice memorandum, the IRS argued that the personal services performed by the trustees as employees of the LLC were not attributable to the trust. The Tax Court, however, rejected the IRS’ view as being too narrow and held that the participation of the trustees as employees were attributable to the trust. So, because the activities of those trustees/employees met the two IRC Section 469(b)(7)(B) tests, the trust was deemed to have materially participated in the rental real estate activities, and, for that reason, they were non-passive activities.

**Planning Point**: Although the Tax Court case also did not involve net investment income, based on the holding, the non-passive rental income would have most likely been excluded from net investment income. Additionally, the Tax Court case is significant because it was a regular opinion reviewed by the entire Tax Court bench rather than a Tax Court Memorandum decision that carries less authoritative weight. In any event, IRS has not yet indicated whether it will follow the decision or continue to apply the restrictive view of the technical advice memorandum. Because a low applicable threshold subjects many trusts to the net investment income tax (see Q 8569), trustees should pay attention to how the IRS will deal with this issue as it relates to treating rental real estate activities of a trust as passive or non-passive.

1. . TAM 201317010. [↑](#footnote-ref-1)
2. . IRC Sec. 469(h)(1). [↑](#footnote-ref-2)
3. *Frank Aragona Trust et. al. v. Comm.*, 142 T.C. No. 9 (March 27, 2014). [↑](#footnote-ref-3)