Passive Activities Estate and Trust Considerations

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1. Why are passive activities important for Trust and Estate?

Passive activities play an important role in many Trust and Estates. Our clients frequently hold business and Real Estate interests which may be encompassed within the passive activity regulations. In an Estate context, the decedent may have owned passive activities which need to be addressed earlier at the planning stage.

At the Estate and Trust level, special rules apply to the treatment of **passive losses** which are unique to the income taxation of Trust and Estates.

The recent 3.8% Medicare surtax imposed by Internal Revenue Code Section 1411 presents new considerations for passive income which must be addressed. As we will discuss, substantial planning opportunities for tax savings as well as tax traps and pitfalls must be considered.

2. What is a passive activity?

A passive activity is any activity involving a trade or business in which the taxpayer does not materially participate.

Material participation is defined as regular continuous and substantial activity rendered on behalf of the trade or business. **Real Estate** and rental activities are generally, per-se, passive.

In determining Material Participation the IRS has described **seven (7) tests**.

The most well-known of which, is that the individual participates in the
activity for more than 500 hours. Activities of a spouse may be counted and there is a special 100 hour test which is also available.

There are many important considerations for which hours count and how to count the hours. These issues are beyond the scope of our discussion today.

3. What happens to an individual’s passive losses when the individual dies?

It is important for planners to address special situations with respect to passive activity losses which are suspended. As is commonly known, passive activity losses are only able to be utilized to offset passive activity income.

The unused losses are suspended and would be allowable as a deduction in a later year provided there was appropriate passive activity income in such year.

When a person dies their suspended passive losses are eliminated to the extent of any asset basis step up that occurs as a result of the special estate valuation rules at death.

For example, if a person had an interest in a real estate rental property which had a very low basis, say $10,000 and a fair market of $150,000, the basis step up under IRC section 1014 of $140,000 eliminates an equal amount of the individuals suspended passive activity losses.

These PALs disappear and are not able to be utilized for any purpose whatsoever.

Any remaining suspended losses can be used on the decedent’s final return.

4. Are there any planning options available in such a situation?
Yes, the decedent might sell such passive activity interest prior to death and utilize all suspended passive losses. This must be considered and compared to the loss of those benefits if there is no sale. It’s important to note that an installment sale should not be utilized because the installment sale would be considered income in respect of a decedent after the decedent’s death.

5. What would happen in the planning stage if the interest were gifted to children?

IRC Section 469 (j)(6) allows the donee’s basis to be increased by the amount of the suspended losses attributed to the gift property.

Proper records of fair market value must be maintained.

For loss purposes, there is a special limitation that any loss on a later sale is limited to the fair market value on the date of gift (which of course, would not include the value of the suspended loss).

6. Is a Trust limited in its utilization of passive losses?

Yes, a Trust cannot use passive activity losses to offset income other than passive activity income.

Moreover, the Trust is not able to distribute the passive activity loss to the beneficiaries.

Trust taxation utilizes the principal of Distributable Net Income which acts as a conduit to avoid double taxation. The income that is distributed from a Trust to the beneficiaries passes through this conduit and the beneficiaries become taxable on their share of the income distributed.

This provides an allowable distribution deduction to the Trust.

Items of NII are included in DNI. The distribution deduction includes NII.

Passive activity losses in excess of passive activity income are not allowed
to reduce other income sources that would be included within DNI and therefore will not get passed to the beneficiary.

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<th>7. What happened to those passive activity losses?</th>
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<td>The passive activity losses get <strong>suspended</strong> and carried forward at the Trust level to be utilized against later passive activity income.</td>
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<th>8. What happens at the conclusion of an Estate or Trust with respect to those losses?</th>
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<td>Considerations similar to those we discussed earlier for an individual are present. Section 469(j)(12) provides that when the passive activity is distributed out of a terminating Trust or Estate any suspended passive losses are added to <strong>increase the basis of the interest</strong>.</td>
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<td>This increase <strong>does not increase the basis of any particular assets</strong> but merely the basis of the interest itself. For example, if an LLC is holding rental properties, only the basis of the LLC is increased and the regulations make it clear that you’re not allowed to take any additional losses or deductions with respect to that basis increase such as depreciation deductions.</td>
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<td>A Trustee or Executor might consider that a sale of the property would be more beneficial than a distribution to utilize those suspended losses.</td>
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<td>Losses are not passed to the beneficiary until the final years of the Estate or Trust.</td>
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<th>9. What about passive income?</th>
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<td>The new <strong>Medicare Surtax</strong> imposes a 3.8% tax on Passive Activity Income and on any capital gain upon sale. This mandates a close review of both the passive activity exceptions which have been incorporated into the regulations as well as the special income tax considerations regarding Trusts and Estates.</td>
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Items of Net Investment Income such as interest, rents, royalties, passive activity income, and capital gains are frequently recognized in Trusts and Estates.

If not in DNI, capital gains are generally taxed to the Trust at the highest rate due to the condensed tax brackets.

Proper utilization of the beneficiaries’ lower income tax brackets and utilization of their individual thresholds will help avoid the tax on net investment income and may reduce the effective tax bracket.

10. Will a Trust or Estate incur a higher Medicare Surtax?

It has been frequently stated that the new Estate planning is a re-visitation of income tax planning. This is especially true with the new surtax on net investment income. One of the factors which makes this surtax more pronounced are the lower threshold amounts for an Estate or Trust. The maximum bracket, which also acts as the threshold amount for an Estate or Trust, is only $12,150 in 2014.

This means that only a small amount of capital gain or undistributed income will result in the Estate or Trust not only being subject to the Medicare surtax but also to the maximum brackets: 20% on Long Term Capital Gains, 39.6% on ordinary income, and the 3.8% Surtax. So I think it is fair to say that the Medicare surtax will be an important factor in almost every Estate and Trust.

11. Many Trusts and Estates hold business interests or rental activities. If there are losses, those losses might be restricted by the passive activity rules. Can an Estate or Trust take advantage of any of the special rules, such as the material participation, in order to avoid these negative income tax consequences?

That question pierces right to the heart of the current evolution and we should take a minute or so to present the appropriate framework. The short answer is that an Estate or Trust can materially participate.
There is little legislative guidance; only two cases which discuss the material participation standard with respect to Estates and Trusts.

The court cases conflict with IRS guidance.

The first case was in 2003 called the **Matty K. Carter Trust**. This case involved a diversified ranch oil and gas business which was conducted within a Trust. The IRS took the position that you only look at the activities of the Executor or the Fiduciary in such capacity and cited the Senate Committee Report as support. The Court disagreed and considered employees hired and overseen by the Trustee. Subsequent to that decision the IRS issued two TAMs and a private letter ruling both of which very narrowly construed the ability of a Trust or an Estate to materially participate.

In **TAM 2007333023**, the IRS stated that only the activities of a Trustee with power to bind the Trust count toward material participation. Such Trustee must be involved in the business or rental operations on a regular continuous and substantial basis. Ancillary or special trustees are not counted.

**TAM 201317010** was even more restrictive. One of the trustees was a corporate officer and the IRS held that you couldn’t count the Trustee’s participation as an officer and owner because he could not differentiate the time spent.

12. **Can you discuss the recent Aragona decision?**

Just recently at the end of March 2014 the Frank Aragona Trust decision made it very clear that a **Trust may materially participate**.

The Aragona Trust had some very strong factors on its side and these good facts I think made for a somewhat **fuzzy decision**.

There were six (6) Trustees, five (5) of whom were children of the decedent and three (3) of the Trustees were involved on a full time basis. However, three (3) of the Trustees were either not involved or were marginally involved. The Court did not discuss how it went about counting
or looking at hours or participation but merely said in this instance there was material participation even though the Trustees had delegated their powers to one particular child who was the leader and the executive trustee.

13. What else did the Aragona Trust discuss with respect to the rental activities?

The Decision was very helpful with respect to rental activities held within a Trust or Estate. The Trust aggregated all rental activities and was thereby able to qualify as a real estate professional. Such qualification, in this instance, enabled the Trust to utilize its rental losses as non-passive losses.

14. What if the Trust had rental income instead of rental losses?

The ability to qualify as a real estate professional is a recognized exception under the final regulations dealing with the Medicare surtax.

Also the acceptance of the concept of aggregation with respect to the Trust helps facilitate the material participation standard because all of the rental activities are treated as one activity and therefore all of the time and efforts spent are combined, thereby making it easier to meet the material participation test. The Final Regulations provide a Regrouping Election.

Although rental activities are generally considered per-se passive, the ability to aggregate will enable the Executor or Trustee to more easily qualify under the exception for Real Estate professionals and might also make it easier to qualify for the section 162 trade or Business Exception.

Avoiding the Passive Activity classification is essential in avoiding NII at the Income Level and on the eventual capital gain upon sale. The Final Regulations created a special Safe Harbor for Real Estate Professionals.
15. **What were the factors that the court discussed in the Aragona decision that assisted in determining that the activity was not passive?**

The fundamental factors that provided the ground work for the Courts decision were really two-fold.

First, the Court stressed that the Trustees *duty of loyalty* and to act in the best interest of the beneficiaries of the Trust override all of their other functions. For example the trustees were also employees of a management entity and two (2) of the children had minority interests in some of the real estate. The IRS, in conformity with their TAM 201317010, stated that the Trustees *could not differentiate* their time in a clear manner; therefore, the time should not be counted. The Court did not agree with the IRS and held that the duty of loyalty *supersedes* any of the other “hats” that these Trustees may have been wearing. However, the Court did not present clear guidance regarding how Trustee participation is counted.

The Trustees could not isolate their *Fiduciary responsibility* by serving in other capacities.

I also believe that in this case the Court’s decision was easier because of the *substantial rental* and development operations that the Trust was engaged in. Unfortunately, the Court did *not provide* us with any *bright-line test* as to how the standards should be applied in future cases.

The IRS is likely to take a very contradictory approach when they issue *later regulations* and everyone should watch for these.

16. **Is this decision only important with respect to the classification of rental or business income and losses? Or does it have a broader impact?**

It is important to note that the Medicare surtax regulations and the instructions and guidance provided on *Form 8960* make it clear that if you qualify under one of the exceptions to the passive activity rules, *any gain recognized on the subsequent sale of the rental property or business interest would not be considered net invest income* and would not be subject to the Medicare surtax. This might be an extremely important
benefit; complying with these standards is extremely important in a long term view.

17. Are there any special considerations in the computation of the Estate or Trust adjusted gross Income?

The AGI of the Estate or Trust is generally computed in the same manner as an individual.

However, under IRC Section 67(e) a deduction is allowed for administrative expenses which would not have been incurred if the property were not held in such Trust or Estate. The importance of this exception is that AGI is reduced thereby resulting in a lower income tax and Surtax, if any.

The discussion relates back to the 2008 Supreme Court decision in *Knight v. Commissioner* and the IRS has just enacted final regulations which described these expenses. Expenses such as the preparation of Estate and Generation Skipping Tax Returns, Fiduciary income tax returns and even the decedent’s final income tax return would all be allowable expenses as are appraisal fees used to determine the date of death valuation or used for the purpose of making distributions. Fiduciary commissions, bond premiums and probate costs are also allowed as deductions in computing the AGI of the Estate.

Whereas, in an individual capacity, such expenses would be treated as itemized deductions subject to differing limitations and computed after AGI of an individual.

Other administrative expenses will reduce taxable income subject to the 2% of AGI but they will not reduce AGI. Therefore, they will not act to reduce the tax on net investment income unless they are properly allocable. Treasury Regulation §1.652(b)(3) allocates expenses first to the specific class of income to which they are directly attributable. Expenses directly attributable to a passive activity class will be directly allocated to that class; thereafter, expenses are proportionally allocated to tax exempt income, and lastly to any item of income in the discretion of the Executor or Trustee.
I think it remains to be seen how far this discretion will apply with respect to the allocation against items of Net Investment Income.

18. **What other considerations should Executors and Trustees evaluate in the area of passive activities?**

We’ve already discussed the grouping election which is essential in defining the activity and in the determination of material participation.

Other considerations include the Self Rental Rule and Self Charged Interest Rule and the determination of whether the activity rises to the level of a §162 Trade or Business.

The Preamble to the Final Regulations issued in 2013 confirm that one rental property may rise to the level of a §162 Trade or Business and discuss relevant criteria.