THE ARAGONA CASE: A BLUEPRINT

The Frank Aragona Trust case is an important one for owners of construction companies and other businesses because of its relevance to avoiding the net investment income tax.

TO AVOID THE NET INVESTMENT INCOME TAX ON TRUSTS

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Owners of construction companies and other businesses stand to benefit — potentially significantly — from a recent decision by the U.S. Tax Court, which handed an important victory to taxpayers in the Frank Aragona Trust case.[1] While the case directly dealt with whether a trust could qualify as a real estate professional, it has much broader applications and effectively provides a blueprint for avoiding the net investment income tax on business income held in trust.

Business owners frequently transfer all or a portion of the ownership of their companies to family members through the use of trusts. This causes future growth in the value of the construction company to accrue to the benefit of younger family members and escape estate taxation. Proper drafting can cause the avoidance of death transfer taxes for several generations.

Transfers in trust are generally preferred over outright transfers in many situations. The beneficiaries may be too young to hold interests directly. More importantly, a trust can be structured, through use of "spendthrift" provisions, to provide creditor protection to the trust beneficiary. This can protect the beneficiary from a variety of claims, including those related to divorce. These trusts will frequently use an independent trustee, who is someone other than the trust grantor or a related person, to determine what distributions will be made to the trust beneficiary. This independent trustee will oftentimes be a trusted advisor (an attorney, accountant, financial advisor, etc.) or an institution (a bank or trust company).

Where the business is operated through an S corporation, a limited liability company, or other entity treated as a partnership for tax purposes, the trust is taxed annually on its share of the income of the business. Due to the compression of trust rates, the 39.6 percent maximum

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federal rate applies once the trust income reaches around $12,000. If the trust grantor is in the maximum tax bracket, this does not produce any additional tax cost. Additionally, the income can be taxed at the beneficiaries' lower tax rates through distributions of income from the trust.

Beginning in 2013, the net investment income tax (NIIT) under Internal Revenue Code section 1411 became effective.[2] This is a 3.8 percent tax applying to individuals, trusts, and estates on certain "investment income" when modified adjusted gross income exceeds stated threshold levels. For a trust, the threshold level is established at the income level at which the 39.6 percent maximum tax rate applies. This is an almost 10 percent increase in the tax burden on the current income of the trust. Furthermore, this NIIT will also apply to gains allocated to the trust on the sale of the business in the future. Advisors have spent considerable time devising strategies to avoid this tax.

IF A TRUSTEE WAS INVOLVED IN THE BUSINESS IN SOME OTHER CAPACITY (E.G., AS AN EMPLOYEE), THESE HOURS HAD TO BE IGNORED SINCE THIS WORK WAS NOT DONE IN A TRUSTEE CAPACITY.

S corporation, limited liability company, or partnership income is subject to the NIIT if the interest is considered a "passive activity" under Internal Revenue Code section 469.[3] An activity is considered to be a passive activity if an individual does not materially participate. Under the regulations, one is considered to materially participate if one of seven tests is satisfied:

1. The individual participates in the activity for more than 500 hours during the tax year;
2. The individual participates in a "significant participation activity," with participation of more than 100 hours but less than 500 hours, and the total of all hours in all significant participation activities exceeds 500 hours for the year;
3. The work done by the individual is substantially all of the work done in connection with the activity;
4. The individual participates in the activity for more than 100 hours and participates at least as much as any other person;
5. The individual materially participated in the activity for any five of the prior 10 years;
6. The activity is a personal service activity and the individual participated in the activity for any three prior years, whether or not consecutively; and
7. The individual materially participates based on all facts and circumstances. See section 1.469-5T(a).

A limited partner is considered to materially participate only if tests 1, 5, or 6 are satisfied.

The Internal Revenue Service (IRS) and the Treasury Department never issued regulations explaining how these rules apply to trusts. However, in a series of private letter rulings, the IRS maintained that the material participation of the trust is determined based on the participation of the trustee, and it ignored the activities of the grantor or the beneficiaries. Additionally, the Service held that material participation was determined only by counting the hours the trustee worked "in the capacity of trustee." Under this analysis, if a trustee was involved in the business in some other capacity (e.g., as an employee), these hours had to be ignored since this work was not done in a trustee capacity.[4]

The only other judicial authority considering this issue was *Mattie K. Carter Trust v. United States*.[5] This case involved a trust holding an interest in a ranch. The court held that material participation of the trust was determined by including the activities of employees and agents who conducted the business on behalf of the trust. The court did not limit the counted activities to only those of the trustees. However, the Service did not follow this decision in its rulings.

In the recent Tax Court case, Frank Aragona (the grantor) formed a trust with himself as trustee and his five children as beneficiaries. The five children were to share equally in the income of the trust. When Frank died in 1981, he was succeeded as trustee by his five children as non-independent trustees and his attorney as the independent trustee. Three of the children (Paul, Frank, and Annette) worked full-time as paid

employees for a limited liability company (Holiday Enterprises LLC) that was wholly owned by the trust. The limited liability company also employed other persons, including a controller, leasing agents, maintenance workers, accounts payable clerks, and accounts receivable clerks. All six trustees formally delegated their powers to Paul (the executive trustee) to facilitate the daily business operations. However, the trustees acted as a management board, met every few months, and made all major decisions regarding the trust's business. Each family trustee received $72,000 as an annual trustee fee, though one member was disabled and his portion was shown as a distribution on the trust tax return. The attorney received a trustee fee of $14,400. The trust deducted $302,400 (the total of the trustee fees net of the distribution) as an "other expense" related to Holiday Enterprises LLC.

The trust conducted some of its rental real estate activities through wholly owned entities and some through entities in which it held a majority interest. Two of the working trustees (Frank and Paul) also owned minority direct interests in the flow-through entities. The trust also conducted real estate holding and real estate development operations through flow-through entities in which Frank and Paul owned minority interests. The trust treated losses from the real estate rental activities as deductible and not subject to the passive activity loss limitation rules. The IRS determined that the real estate losses should be losses from passive activities and not deductible.

The court rejected the IRS contention that a trust could not, as a matter of law, be a real estate professional under the passive activity loss rules. More significantly, it focused on and discussed the requirements for a trust to materially participate in the activities involved.

While the court did not address the issue of whether the activities of the non-trustee employees could be considered, it found in favor of the taxpayer based on the actions of the trustees. It reasoned that the activities of the trustees, including the employee-trustees, should be considered in determining whether there was material participation by the trust.

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Under Michigan law, the trustees were required to administer the trust solely in the interest of the trust beneficiaries. The trustees were not relieved of this duty even where they conducted their activities through a different capacity.

The court said that "considering the activities of all six trustees in their roles as trustees and as employees of Holiday Enterprises LLC, the trust materially participated in its real-estate operations."[6] Three of them participated in the trust's real estate operations full-time. These operations were substantial and were practically all of the trust's operations. The minority interests held directly by Frank and Paul in certain pass-through entities did not affect this result since: a) these interests constituted only a minority interest; b) they were not relieved of their fiduciary responsibilities; and c) their interests were not at odds with those of the trust.

This case provides new guidance and a blueprint as to how to create an administrative structure for a trust to avoid the 3.8 percent NIIT on business income. It is imperative that existing trusts be reviewed and new trusts drafted with this case in mind.

Since, as in the case, an independent trustee will normally not participate in the business sufficiently to cause the trust to be considered to materially participate, a person who works in the business should be included as a non-independent trustee. In many cases, this can be the grantor of the trust, so long as no prohibited powers are kept over the trust, which can cause estate inclusion. This can be easily accomplished in a newly formed trust.

For existing trusts, the trust terms should be reviewed to determine the best available options. The trust may include language permitting the appointment of a non-independent trustee or replacing a current inactive trustee with one who is involved in the business. Other alternatives involve decanting the assets into a new trust or utilizing a trust provision permitting transfers into a new trust for the benefit of current beneficiaries. ■

NOTES

1 142 T.C. No. 9, 3/27/14. Available at: http://www.ustaxcourt.gov/InOpHistoric/frankaragonatrustdiv.morrison.TC.WPD.pdf.

2 Internal Revenue Code Section 1411. Available at: http://www.irs.gov/irb/2013-51_IRB/ar09.html.

3 Internal Revenue Code Section 469. Available at: http://www.law.cornell.edu/uscode/text/26/469.

4 Technical Advice Memorandum 200733023. Available at: http://www.irs.gov/pub/irs-wd/0733023.pdf; Private Letter Ruling 201029014. Available at: http://www.irs.gov/pub/irs-wd/1029014.pdf; Technical Advice Memorandum 201317010. Available at: http://www.irs.gov/pub/irs-wd/1317010.pdf.

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

6 *Op. cit.* note 1.