

**INTERNAL REVENUE SERVICE**  
**NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM**

7/24/2002

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CASE MIS No.: TAM-118390-02/CC:PSI:B2

Director  
SBSE

Taxpayers' Names:

Taxpayers' Address:

Taxpayers' Identification No:

Years Involved:  
Date of Conference:

**LEGEND:**

Husband =

Wife =

Son =

Trust =

Farm =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Year 3 =

**ISSUE:**

Whether income of a testamentary trust that is generated by farming activity and distributed by the trust to individuals who are both beneficiaries and trustees of the trust is considered net earnings from self-employment to the individuals and subject to self-employment tax under section 1402 of the Internal Revenue Code.

**CONCLUSION:**

The income of the Trust that is derived from operations of the Farm is not, in itself, considered net earnings from self employment under section 1402(a) of the Internal Revenue Code for individuals who are both beneficiaries and trustees of the trust. However, to the extent that the distributions are payments for any services that these individuals are also providing to the trust as part of any trade or business of such individuals, such amounts will generally be considered net earnings from self-employment subject to self-employment taxes. A determination should be made whether the payments received by the individuals for any services they provided to the Trust, as part of a trade or business, were reasonable and of sufficient amount .

**FACTS:**

According to the trust instrument and other information provided to us, following the death of Husband, the Trust became an irrevocable testamentary trust. The assets in the Trust included the Farm. Effective Date 1, the Wife and the Son were appointed "primary trustees," with equal trustee powers, as "co-trustees." The Wife and Son are also the beneficiaries of the Trust. Under a contract with the Trust, the Son is paid a fee for managing the operations of the Farm as part of his trade or business. The Wife is also paid a fee by the Trust for maintaining records for the operations of the Farm as part of her trade or business. According to the Trust document, all decisions concerning the operations of the Farm are made by both co-trustees.

Upon the earlier of Date 2, or the death of Wife, the Trust will terminate and distribute its assets to Son. If Son dies prior to the Trust's termination, the Trust provides for contingent beneficiaries. Additionally, if disputes arise among the trustees, the Trust provides for an arbitration trustee, defined as a third trustee who is not involved in the day to day operation of Trust, to settle the disputes.

Since the inception of the Trust, Form 1041, U.S. Income Tax Return for Estates and Trusts has been filed annually on behalf of the Trust. The Wife and Son each annually filed their separate Form 1040, U.S. Individual Income Tax Return. When Wife and Son receive their individual income distributions from the Trust, as beneficiaries of the Trust, the Trust distributions are shown on Form 1041 and each beneficiary reports the

amount of the distribution received on their respective Form 1040 return. Self-Employment Contributions Act (SECA) tax is not reported on the distributions to the beneficiaries. However, the Son includes and reports the management fees he receives for operating the Farm as being subject to SECA, and the Wife includes and reports the fees she receives for maintaining the records of the Farm as being subject to SECA.

The years that are under examination are Year 1, Year 2 and Year 3.

### **LAW AND ANALYSIS:**

Internal Revenue Code section 1402(a) generally defines net earnings from self-employment as “the gross income derived by an individual from any trade or business carried on by such individual, less deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member,” with certain exceptions that are not applicable here. Section 1.1402(a)-2(b) of the Income Tax Regulations provides that a trade or business must be carried on by the individual, either personally or through agents or employees. The regulation further provides “[a]ccordingly, income derived from a trade or business carried on by an estate or trust is not included in determining the net earnings from self-employment of the individual beneficiaries of such estate or trust.”

When the employment-tax provisions were enacted, the Congressional committee reports provided:

The trade or business must be carried on by the individual, either personally or through agents or employees, in order for the income to be included in his net earnings from self-employment. Accordingly, gross income derived by an individual from a trade or business carried on by him does not include income derived by a beneficiary from an estate or trust even though such income is derived from a trade or business carried on by the estate or trust.

S. Rep. No. 1669, 81<sup>st</sup> Cong., 2<sup>nd</sup> Sess. 155 (1950), 1950-2C.B. 354.

The requirement that income, for purposes of section 1402 of the Code, must be from the trade or business carried on by the individual is illustrated in Rev. Rul. 59-162, 1959-1 C.B. 224. The example in the revenue ruling involves distribution of an insurance renewal commission. Under the terms of a contract between the husband and his insurance company, following the death of the husband, the insurance renewal commission earned by the husband would be paid to the wife. Although the insurance renewals would be net earnings from self-employment for the husband, the ruling found

that the insurance renewals would not be considered net earnings from self-employment for the widow because they were not derived by a trade or business carried on by her. See also, Rev. Rul. 59-168, 1959-1 C.B. 625.

Section 1402 of the Code, and the regulations thereunder, provide that income derived from a trade or business maintained by trust is not included in determining net earnings from self-employment by the individual beneficiaries. Thus, where a trade or business is carried on by a trust, and not an individual, the income derived from property maintained by the trust would not be includible in determining the net earnings from self-employment of an individual beneficiary unless there is basis for disregarding the trust for purposes of the Code and finding that the net earnings are actually derived from a trade or business maintained by the individual beneficiary.

Section 301.7701-4(a) of the Procedure and Administration Regulations addresses “ordinary trusts” and provides that the term “trust” as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of either protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

Section 301.7701-4(b) of the Procedure and Administration Regulations addresses “business trusts” and provides that there are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as trusts for purposes of the Internal Revenue Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Internal Revenue Code. However, the fact that the corpus of the trust is not supplied by the beneficiaries is not sufficient reason in itself for classifying the arrangement as an ordinary trust rather than as an association or partnership. The fact that any organization is technically cast in the trust form, by conveying title to property to trustees for the benefit of persons designated as beneficiaries, will not change the real

character of the organization if the organization is more properly classified as a business entity under § 301.7701-2.

Section 301.7701-2(a) of the Procedure and Administration Regulations provides that a business entity includes any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under § 301.7701-3) that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code.

Based solely on the facts submitted and the representations made, we conclude that upon the death of Husband, the Trust became an irrevocable trust that is considered a trust under § 301.7701-4(a) and not a business trust under § 301.7701-4(b). See Estate of Bedell v. Commissioner, 86 TC 1207 (1986). Wife and Son were paid by the Trust for services that they each performed for the Trust as part of his or her trade or business. Income that Wife and Son received from the Trust as beneficiaries is separate from any payments Wife and Son should receive for the performance of services as part of a trade or business on behalf of the Trust, as an owner of the Farm.

Although we have found that the Trust qualifies as a trust under § 301.7701-4(a), there could be an issue of whether the Wife and Son received adequate payments for the services they performed for the Trust as part of a trade or business. In this regard, we suggest that a determination be made as to whether the Wife and Son received payments that were reasonable and of sufficient amount for services they provided on behalf of the Trust as part of a trade or business.

**CAVEAT:**

A copy of this technical advice memorandum is to be given to the taxpayers. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.