Dear [Name],

This responds to the letter dated [Date], submitted on behalf of Trust [Name], requesting guidance under § 469 of the Internal Revenue Code.

Facts

According to the information submitted, Trust [Name] is a complex trust. A is the beneficiary and a trustee of Trust [Name]. Trust [Name] holds various assets including a partnership interest in B. B wholly owns C, which wholly owns D. Trust [Name] requests a ruling under § 469 as to whether Trust [Name] can materially participate in the activities of D.

Law and Analysis

Section 469(a)(1) disallows the passive activity loss for any taxable year to any individual, estate or trust, any closely held C corporation, and any personal service corporation. The passive activity loss for a given year is the amount, if any, by which the passive activity deductions for the taxable year exceed the passive activity gross income for the taxable year. Temp. Treas. Reg. § 1.469-2T(b)(1). Section 469(c)(1)
defines the term “passive activity” to include any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate.

Section 469(h)(1) provides that a taxpayer materially participates in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial. The legislative history to § 469 contains significant discussion of the concept of material participation. Embodied throughout the discussion is a general notion that in order for a taxpayer to materially participate, the taxpayer must be involved in the day-to-day operations of the trade or business: “Even an intermittent role in management, while relevant, does not establish material participation in the absence of regular, continuous, and substantial involvement in operations.” S. Rep. No. 99-313, 99th Cong., 2d Sess. 734 (May 26, 1986), Vol. 3 1986-3 C.B. 734.

For individuals, the qualitative test of § 469(h)(1) has largely been replaced by the more quantitative regulatory tests of Temp. Treas. Reg. §§ 1.469-5T(a)(1)-(7) of the Income Tax Regulations. The Treasury Department has not yet issued regulations addressing the material participation requirement for trusts and estates. See Treas. Reg. §§ 1.469-5(T)(g), 1.469-8. Until regulations are promulgated, § 469(h)(1) remains the sole standard for determining whether a trust or estate satisfies the material participation requirement of § 469. Cf. Hillman v. IRS, 263 F.3d 338 (4th Cir. 2001) (while the government’s authority to issue regulations exempting certain self-charged fees from the ambit of § 469 was clearly contemplated by Congress, the failure to do so did not obviate the basic statutory rule that the fees in question were passive activity deductions). The statutory standard for material participation can be applied in the absence of regulations. See Housing Pioneers v. Commissioner, 58 F.3d 401 (9th Cir. 1995) (applying statutory requirement of regular, continuous, and substantial involvement to a tax-exempt entity in a case where an unrelated statute explicitly borrows the language of § 469.)

As noted above, other than the “regular, continuous, and substantial” language of § 469(h)(1), there is an absence of explicit statutory or regulatory guidance regarding how a trust establishes material participation. Nonetheless, the legislative history of § 469 provides important insight into how Congress intended for the material participation standard to apply to trusts: “Special rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity...if an executor or fiduciary, in his capacity as such, is so participating.” S. Rep. No. 99-313, at 735.

Determining the proper focus in § 469 for the activities of Trust is a question of federal tax law and must include an examination of the treatment of trusts under Subchapter J. The taxation of trusts under Subchapter J is a hybrid regime involving an entity-level tax as well as the pass-through of income to the beneficiaries. While a trust is sometimes required to pay tax on its own income under § 641, it may also generally deduct under § 661 income that is passed through to its beneficiaries under § 662.
Although the beneficiaries of a trust do not generally participate in the activities of the trust, the designated trustee acts on behalf of, and in the interests of, the beneficiaries.

The focus on a trustee's activities for purposes of § 469 accords with the general policy rationale underlying the passive loss regime. As 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. See S. Rep. No. 99-313, at 735 (1986) ("the activities of [employees]…are not attributed to the taxpayer."). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of other business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee. Thus, the sole means for a trust to establish material participation is if its fiduciary is involved in the operations of the activity on a regular, continuous, and substantial basis.

Conclusion

Based solely on the facts submitted and the representations made, Trust may materially participate in D's activities if the trustee, in this case A, is involved in the operations of D's activities on a regular, continuous, and substantial basis. No opinion is expressed concerning whether A in fact materially participates in D's activities or whether D's activities constitute an appropriate economic unit under § 1.469-4(c).

Except as specifically set forth above, no opinion is expressed or implied as to the federal tax consequences of the facts described above under any other provision of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter will be sent to Trust's authorized representative.
Sincerely,

/s/

David R. Haglund
Branch Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures:
Copy of this letter
Copy for '6110 purposes