

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

January 18, 2013

Third Party Communication: None  
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-134100-12

Associate Area Counsel ( )  
(Small Business/Self-Employed)  
CC:SB:9:

Taxpayer's Name:

Taxpayer's Address:  
Taxpayer's Identification No  
Year(s) Involved:  
Date of Conference:

LEGEND:

Trust A =

Trust B =

Date 1 =

A =

B =

C =

D =

Company X =

Company Y =

## ISSUE:

Did Trust A and Trust B materially participate in the relevant activities of Company X within the meaning of § 469(h) for purposes of applying § 56(b)(2)(D) for the tax years at issue?

## CONCLUSION:

Based on the facts submitted, Trust A and Trust B did not materially participate in the relevant activities of Company X during the tax years at issue within the meaning of § 469 for purposes of § 56(b)(2)(D) because the Trustee and Special Trustee, in their capacity as trustees of Trust A and Trust B, were not involved in the operations of Company X's relevant activities on a regular, continuous, and substantial basis during the tax years at issue.

## FACTS:

Trust A and Trust B (collectively, the Trusts) are complex trusts that were each created on Date 1. Trust A and Trust B each own an interest in Company X (an S corporation); A owns the remaining interests in Company X. Company X wholly owns Company Y, a qualified subchapter S subsidiary. Trust A and Trust B each reported positive taxable income from their interests in Company X on their respective 2007, 2008, 2009, and 2010 tax returns. Accordingly, the Trusts would not have disallowed passive losses if they were deemed to not materially participate in the relevant activities of Company X.

The trust agreements creating each of Trust A and Trust B are identical in their governing provisions. A, A's spouse, A's children, and A's grandchildren are the beneficiaries of Trust A and Trust B. B is the sole trustee of Trust A and Trust B and has served in this capacity pursuant to Article XI of the trust agreements since Date 1. C is the settlor of Trust A and D is the settlor of Trust B. Article XI of the trust agreements appoints A as a special trustee of Trust A and Trust B, and states that

[t]he Special Trustee shall control the following activities relating to Company X and Company Y common stock owned by any trust created hereunder: all decisions regarding the sale or retention of such stock and all voting of such stock.

The trust agreements do not grant any further fiduciary powers over the Trusts' assets or with respect to the operations or management of the Trusts to A as the Special Trustee. A also serves as president of Company Y and, as such, is directly involved in the day-to-day operations of Company Y's trade or business activities. A is unable to differentiate his time spent as president of Company Y, as Special Trustee of the Trusts, and as a shareholder of Company X. B, as Trustee of Trust A and Trust B, is not

involved in the operations of the relevant activities of either Company X or Company Y on a regular, continuous, and substantial basis.

Examination asserts that the Trusts did not materially participate in the relevant activities of Company X. Thus, for purposes of § 56(b)(2)(D) (which cross-references the definition of material participation in § 469(h)(1) to determine whether research and development expenses must be amortized by taxpayers over a ten-year period for purposes of the alternative minimum tax), Examination determined that the Trusts' share of the research and development expenditures incurred by Company X must be amortized by the Trusts over 10 years. Examination asserts that B's participation in the relevant activities of Company X and Company Y that counts towards meeting the material participation requirements of §§ 56(b)(2)(D) and 469(h)(1) is only that which was performed in the relevant activities in B's fiduciary capacity as Trustee of Trust A and Trust B. A's participation in the relevant activities of Company X and Company Y also count towards these requirements, but only to the extent that A participated in those activities in A's fiduciary capacity as Special Trustee of Trust A and Trust B. Examination asserts that A's time spent serving as president of Company Y does not count towards meeting this material participation requirement, because A is not the Trustee of the Trusts nor is A an employee of the Trustee. Specifically, because the trust agreements limit the powers of the Special Trustee to certain delineated acts, the Special Trustee does not possess broad or unlimited discretionary authority to bind the Trusts to any course of action without the express consent of the Trustee.

The taxpayers argue that because A is a Special Trustee of Trust A and Trust B, A's involvement in Company Y's relevant activities should be considered for purposes of determining whether the Trusts materially participate, within the meaning of § 469(h)(1) for purposes of § 56(b)(2)(D), in the relevant activities of Company X and Company Y. Therefore, the taxpayers argue that all of the personal services performed by A in those activities should count towards meeting the material participation requirements of §§ 56(b)(2)(D) and 469(h)(1) on behalf of the Trusts. The taxpayers argue that because A's roles of Special Trustee, individual shareholder, and President of Company Y are all interrelated, it is impossible to differentiate A's time into the different capacities for which A serves and A is, in fact, fulfilling A's obligations for these various capacities simultaneously. Taxpayers argue that A's total time spent involved in the operations of the relevant activities of Company X and Company Y should count towards meeting the material participation requirements of §§ 56(b)(2)(D) and 469(h)(1) on behalf of the Trusts.

#### LAW AND ANALYSIS:

Section 56(b)(2) provides, in part, that in determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation), the following treatment shall apply (in lieu of the treatment applicable for purposes of computing the regular tax)

(A) the amount allowable as a deduction under §§ 173 or 174(a) in computing the regular tax for amounts paid or incurred after December 31, 1986, shall be capitalized and –

(i) in the case of circulation expenditures described in § 173, shall be amortized ratably over the 3-year period beginning with the taxable year in which the expenditures were made, or

(ii) in the case of research and experimental expenditures described in §174(a), shall be amortized ratably over the 10-year period beginning with the taxable year in which the expenditures were made.

....

(D) If the taxpayer materially participates (within the meaning of § 469(h)) in an activity, § 56(b)(2) shall not apply to any amount allowable as deductions under § 174(a) for expenditures paid or incurred in connection with such activity.

Section 469(a)(1) provides that if aggregate losses from passive activities exceed aggregate income from passive activities for the taxable year, the excess losses may not be used to offset income from nonpassive activities, and accordingly, are not allowed for the taxable year.

Section 469(b) provides that any loss that is disallowed under § 469(a) (commonly referred to as a “suspended loss”) will be treated as a deduction allocable to such activity in the next taxable year.

Section 469(d)(1) defines “passive activity loss” as the amount, if any, by which the aggregate losses from all passive activities for such taxable year exceed the aggregate income from all passive activities for such taxable year. Suspended passive losses may accumulate and will continue to carry forward into subsequent tax years indefinitely until the taxpayer has sufficient net passive income to offset the suspended losses, or until the taxpayer disposes of the taxpayer’s entire interest in the passive activity.

Section 469(c)(1) defines a passive activity as any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate. Section 469(a) specifically enumerates trusts as one type of taxpayer to which § 469 applies.

Section 469(h)(1) defines material participation as an activity which the taxpayer participates in on a regular, continuous, and substantial basis. 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. §§ 1.469-5T(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. 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 established material participation in a trade or business activity. Nevertheless, the legislative history for § 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.

Section 7701(a)(6) defines "fiduciary" as a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person. The regulations further state that "fiduciary" refers to "persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators." Treas. Reg. § 301.7701-6.

The only court opinion addressing how a trust establishes material participation for purposes of § 469 is *Mattie K. Carter Trust v. U.S.*, 256 F.Supp.2d 536 (N.D.TX 2003). In *Mattie K. Carter*, the Court held that in determining material participation for trusts, the activities of the trust's fiduciaries, employees, and agents should be considered to determine whether the trust's participation is regular, continuous, and substantial. The Court rejected the government's position that the determination should be made solely with reference to the activities of the trustee, finding this approach arbitrary and creating unnecessary statutory ambiguity.

Determining the proper focus in § 469(h) for the relevant activities of Trust A and Trust B 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 complex 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(h) is consistent 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 employee's 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 trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An interpretation that renders

part of a statute inoperative or superfluous should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).

Notwithstanding the decision in *Mattie K. Carter*, the Service believes that the standard announced in the legislative history is the proper standard to apply to trusts for purposes of § 469(h). Thus, the sole means for Trust A and Trust B to establish material participation in the relevant activities of Company X and Company Y is if the fiduciaries, in their capacities as fiduciaries, are involved in the operations of the relevant activities of Company X and Company Y on a regular, continuous, and substantial basis.

A fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. *United States v. Anderson*, 132 F.2d 98 (9<sup>th</sup> Cir. 1942). Although the Trusts represent that A was involved in the day-to-day operations and management decisions of Company X and Company Y, A's powers as Special Trustee were restricted by Article XI of the trust agreements. As Special Trustee, A lacked the power to commit Trust A and Trust B to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue.

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.

No opinion is expressed herein as to any other issues raised in the technical advice request or that may be raised based on the facts of this case.