Frank Aragona Trust Case: Trusts, Material Participation, and the Net Investment Income Tax

Frank Aragona set up a trust in 1979 with himself as grantor and trustee of his trust, and aptly named it the Frank Aragona Trust. He died in 1981 and was succeeded as trustee by his five children and an attorney who served as the independent trustee. Three of the trustees were full-time employees of Holiday Enterprises LLC, a company wholly owned by the trust. Holiday Enterprises LLC was a disregarded entity for income tax purposes. The other three trustees were not involved in the day to day operations of the trust.

By 2005 the trust, was primarily engaged in real estate development and rental real estate activities. In 2005 and 2006, the trust's rental real estate activities generated a loss. The preparer of the trust return treated the losses as nonpassive, offset ordinary or portfolio income with these losses, and generated a net operating loss which was carried back to the tax years 2003 and 2004.

There were two important questions answered by the court which we will focus on:

1. How does a trust materially participate in an activity?
2. Can a trust qualify as a real estate professional?

Material Participation

Prior to 1986 taxpayers generally treated all business income and losses as equal regardless of whether you were actively involved in the day to day operations or not. However, it became known some taxpayers were investing in business activities where they were not involved, and where the sole purpose of this investment was to generate losses to offset their regular W-2 wages or ordinary business income. Thus, Congress enacted the Tax Reform Act of 1986.

After 1986 if you were not actively engaged in the day to day operations of a business and that business generated a loss you could only use those losses against income from other business activities in which you did not participate in. The exact IRC Section 469(h)(1) reads that to be actively engaged in a business a taxpayer must participate on a "regular, continuous, and substantial" basis. However, clearly more guidance was needed and the Department of the Treasury came up with regulations.

Treasury Regulation 1.469-5T gave seven tests which drew clear lines as to how an individual would materially participate in an activity:

1. The individual participates in the activity for more than 500 hours during such year;
2. The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals for such year;
3. The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual for such year;
4. The activity is a significant participation activity for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;
5. The individual materially participated in the activity for any five taxable years during the ten taxable years that immediately precede the taxable year;
6. The activity is a personal service activity, and the individual materially participated in the activity for any three taxable years preceding the taxable year; or
7. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Finally, there was one last kicker to the 1986 passive activity loss rules, which was all rental activities will be considered passive regardless of whether an individual material participated in the rental activities or not.

However, there were many in the real estate business which did not like this provision and were able to convince Congress to carve out an exception.

The result was the real estate professional exception. This changed the rules to all rental real estate activities are passive ***unless*** you can qualify as a real estate professional.

Real Estate Professional

The two tests to qualify as a real estate professional under IRC Section 469(c)(7)(B) are:

1. more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and

2. such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

So now with that history let’s circle back to those two big questions decided in the Aragona case:

1. How does a trust materially participate in an activity?
2. Can a trust qualify as a real estate professional?

The IRS argued that for a trust to materially participate, you would look at the trustee’s participation, and that only the time spent in which the trustee was acting as a fiduciary would count. The IRS further argued the three trustees which were full-time employees of the wholly owned LLC, Holiday Enterprises, could not count their time as employees, because it was not time they were spending in their fiduciary role. The court ruled those two roles were inseparable and therefore the three trustees could include their time spent as employees.

Then, the court decided it could not apply the seven tests set forth in the treasury regulations as those were meant to apply to individual taxpayers. Instead there is a spot titled "Material Participation of Trusts and Estates" under Treasury Regulations 1.469-5T(g), but it is reserved and left blank. The court then decided that since there was a spot for guidance in this exact situation in the regulations, but no guidance given, they would return back to the “regular, continuous, and substantial” definition listed in the statute. By applying the statute, the court ruled the trust, by virtue of the trustees, did materially participate in the rental real estate activities.

As a side note, under the IRS's audit procedures, it advises auditors to apply the seven tests in the treasury regulations to the trustee to determine whether a trust materially participates, with the exception of Qualified Subchapter S Trusts, in which case the IRS advises auditors to apply the seven tests to the beneficiary.

The next issue was whether a trust could qualify as a real estate professional. The IRS contended a trust could not perform personal services and therefore could not qualify. The court looked back at the legislative history, as well as committee reports and decided the statute was not meant to be limited to natural persons and therefore a trust could qualify. Since the Aragona trust only seemed to be dealing in real estate, whether it be renting or developing, the court ruled the trust had met the standard for qualifying as a real estate professional.

However, even after qualifying as a real estate professional, the taxpayer still must go back and examine the rental activities to determine whether the taxpayer materially participates in each rental activity. Unless there is an affirmative election under Treasury Regulation 1.469-9 to group all rental real estate activities together, each activity must be looked at separately to decide if the taxpayer materially participates. The Aragona trust made the affirmative election under Reg 1.469-9, and therefore all the rental activities were looked at as a group, and the trust was deemed to materially participate in the grouped activities.

Deductibility of the Rental Real Estate Losses

Because the trust was deemed to materially participate in the rental activities and was a real estate professional, the losses from the rentals were considered ordinary in nature. This means the trust could use the losses to offset their real estate development activities and/or portfolio income. Also, the losses which exceeded the other income could generate a net operating loss, which could be carried back two years or forward twenty.

Net Investment Income Tax

Starting in 2013, there is also a net investment income tax which is applicable to most portfolio income and income from passive activities. For trusts, the 3.8% tax applies to the lesser of undistributed net investment income or adjusted gross income less the amount it takes the trust to get to the highest tax bracket.

So the applicability of the Aragona Trust case to net investment income tax, is if a trust can show it materially participates in a business activity, and it pays tax on the income at the trust level, then it can avoid the net investment income tax on income from such activity. However, most portfolio income, regardless of whether a trust materially participates would still be included in the computation for net investment income tax.

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