

ALERTS**Tax Law Alert - U.S. Tax Court Rejects IRS' Restrictive View Of Trust Material Participation**

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The U.S. Tax Court recently issued a taxpayer favorable opinion regarding how a trust materially participates in its activities. The court's holding will make it easier for trusts to currently deduct expenses against non-passive income and to exclude income from the reach of the new 3.8% net investment income tax.

In *Frank Aragona Trust v. Comm'r*, the court held that in determining whether a trust materially participates in its activities, the activities of the trustees, including their activities as employees of the businesses owned by the trust, should be considered. The court's opinion directly conflicts with recent IRS guidance that only a trustee's time spent acting in a fiduciary capacity counts toward the trust's material participation – a standard that would be very difficult for most trusts to meet. See Technical Advice Memorandum 201317010.

In *Frank Aragona Trust*, a Michigan trust owned rental real estate activities and engaged in holding and developing real estate. The trust conducted some of its activities directly, and others through its wholly-owned business, Holiday Enterprises, LLC. The trust had six trustees, three of whom worked full-time for Holiday Enterprises. The IRS argued that the participation of the trustee-employees should be disregarded. The court disagreed and concluded that the participation of the trustee-employees should be counted and further, that the participation of the trust's six trustees was sufficient to meet the material participation standard. The court based its decision, in part, on the fact that Michigan law requires trustees to "administer the trust solely in the interest of the trust beneficiaries" even when they are participating through a business wholly-owned by the trust. This decision provides helpful authority for trusts, their trustees and their advisors in navigating the complex passive activity loss and net investment income tax rules.

However, the decision in *Frank Aragona Trust* does not answer all of the outstanding questions regarding material participation of trusts. In recently finalized regulations implementing the net investment income tax, the Treasury Department and the IRS requested public comments on rules regarding material participation of trusts, which indicates that the IRS may finally undertake a formal project to provide long-awaited guidance on this issue.

For more information, contact Randal Kaltenmark at (317) 231-7741 (randal.kaltenmark@btlaw.com) or one of leaders of the firm's Private Wealth Services Practice Group: Howard Rubin at (612) 367-8714 (howard.rubin@btlaw.com), James Robinson at (404) 264-4042 (jrobinson@btlaw.com), Douglas Robson at (312) 214-4805 (douglas.robson@btlaw.com) or William Pope at (317) 231-7494

RELATED PEOPLE

William M. Pope
Of Counsel (Retired)

P 317-231-7494
william.pope@btlaw.com



Douglas S. Robson
Partner
Chicago

P 312-214-4805
F 312-759-5646
douglas.robson@btlaw.com



Howard J. Rubin
Partner
Minneapolis

P 612-367-8714
F 612-333-6798
howard.rubin@btlaw.com



Randal J. Kaltenmark
Partner
Indianapolis

P 317-231-7741
F 317-231-7433
randal.kaltenmark@btlaw.com

(william.pope@btlaw.com).

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James R. Robinson

Partner

Atlanta, Los Angeles

P 404-264-4042

F 404-264-4033

jrobinson@btlaw.com

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