Tax Assessments

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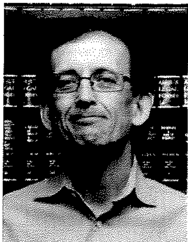
The Chair's Comments


Mike Wenig

As many of us face a busy tax season ahead, I want to mention a few things that have occurred so far during my term as chair of the Tax Section and some of the events scheduled over the next few months.

As many of you know, the IRS has cut back on its budget. As part of that, in November we had a joint meeting with the IRS and members of the Tax Committee of the North Carolina Association of Certified Public Accountants. The meeting, held at Elon Law School, gave us an opportunity to hear not only from the IRS, but also hear questions raised by our fellow tax practitioners.

In December, thanks to the efforts of Wells Hall and Jason Morton, members of the Tax Section participated in the Adopt-A-Base Program which provides instruction to tax preparers. The instruction was given over a three-day period and is part of multi-week program offered by VITA in which soldiers receive tax training to assist other soldiers with tax preparation. I thank Wells Hall and Jason Morton for taking the lead in getting the Tax Section involved in this program this year at Fort Bragg in Fayetteville. Wells and some members of his firm also assisted with a base in South Carolina. Wells, Jason, Kevin May, Kristin Rice, Jared Mobley, Deanna Coleman, and I volunteered time over the three-day period to provide the training at Fort Bragg. It was personally rewarding and a bit challenging, as there were sections of the Code that I had not looked at for a number of years and had to relearn. It is also interesting that last year these soldier volunteers prepared over 18,000 returns for other solders at Fort Bragg alone.

As for coming events, we had another joint meeting with the Tax Committee of the NCACPA and members of the North Carolina Department of Revenue, on February 4. Of course, the scheduled tax council meeting will be in Charlotte on March 18. In addition, for those

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TRUST US: YOUR TAX BILL IS GOING UP

Applying the Net Investment Income Tax to Trusts and Estates

*By Christopher E. Hannum, Linda Baugher Malone and William L. Mills IV**

The government has found yet another way to tax investment income, effective January 1, 2013. The Patient Protection and Affordable Care Act (often referred to as the "Affordable Care Act" or "Obamacare"), Pub. L. 111-152, created a new 3.8% tax, known as the Net Investment Income Tax or NIIT, to be applied against a taxpayer's unearned income. The NIIT is an additional, full-blown income tax on individuals, estates and trusts.

As the population ages, an ever-increasing portion of wealth is held in, or is structured to be held in, trust. Such trusts serve many purposes and constitute an integral part of many estate plans, often holding investment assets. However, as many families will soon discover, trusts and estates are subject to the new Net Investment Income Tax, and the impact of the NIIT on this type of family and estate planning may be significant.

Identifying Net Investment Income | "Net investment income" is defined in Internal Revenue Code § 1411(c)(1) as the excess, if any, of: (i) the sum of (a) gross income from interest, dividends annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in IRC § 1411(c)(2), (b) other gross income derived from a trade or business described in IRC § 1411(c)(2), and (c) net gain (to the extent taken into account in computing taxable income) attrib-

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utable to the disposition of property other than property that is held in a trade or business not described in IRC § 1411(c)(2), over (ii) the deduction allowed and allocable to such items of gross income or net gain. Trades and businesses described in IRC § 1411(c)(2) include any activity that is a passive activity under IRC § 469 with respect to the taxpayer and a trade or business of trading financial instruments or commodities as defined in IRC § 475(e)(2).

Notably, "net investment income" does not include Social Security income, tax-exempt income, distributions from qualified retirement plans, alimony, or any item taken into account in determining self-employment income for the tax year. *See* IRC § 1411 (c)(5)-(6). That said, these items of income should not be entirely disregarded when discussing the NIIT. As described below, the taxpayer's adjusted gross income is a factor in the calculation of the NIIT; therefore, items of non-net investment income may still impact the calculation of the NIIT by increasing the taxpayer's aggregate gross income and causing a greater share of the taxpayer's net investment income to become subject to the NIIT. *See* IRC § 1411(c).

Calculating Net Investment Income Tax

Individuals and Grantor Trusts | For individual taxpayers, the NIIT is calculated on the *lesser of*: (i) the taxpayer's net investment income for the tax year, or (ii) the *excess*, if any, of (a) the taxpayer's modified adjusted gross income (MAGI) for the tax year, over (b) the "threshold amount." IRC § 1411(a)(1). MAGI is defined as the taxpayer's adjusted gross income for the taxable year plus the amount of the taxpayer's net foreign earned income exclusion under IRC § 911(a)(1), adjusted by certain deductions and exclusions applicable to the taxpayer's net foreign earned income. IRC § 1411(d). For most taxpayers, the MAGI amount will equal the taxpayer's adjusted gross income. The threshold amount differs for each filing status: it is $250,000 for married taxpayers filing a joint return, $125,000 for married taxpayers filing separate returns, and $200,000 for single individual taxpayers. IRC § 1411(b). These threshold amounts are not subject to future inflation adjustments.

Many taxpayers engage in estate planning transactions utilizing "intentionally defective grantor trusts." When anticipating the impact of the NIIT on their personal taxes, individual taxpayers must be mindful of any grantor trusts they have previously formed. Because all items of income, deduction, and credit of a grantor trust must be reported by the grantor on his or her income tax return, an individual taxpayer will report all net investment income earned by any grantor trust established by the taxpayer, or any trust which is taxed to the taxpayer as a beneficiary under IRC § 678, on his or her personal return. *See* IRC § 671. As a result, the total of the individual taxpayer's personal net investment income and the trust's net investment income will be the amount of net investment income used in determining the impact of the NIIT on the individual. *See* Treas. Reg. § 1.1411-3(b)(v).

Non-Grantor Trusts and Estates | For non-grantor trusts and estates, the 3.8% NIIT is imposed on the *lesser of*: (i) the taxpayer's undistributed net investment income for the tax year, or (ii) the *excess*, if any, of (a) the taxpayer's adjusted gross income for the tax year, over (b) the dollar amount at which the highest tax bracket for the taxpayer begins for the tax year in question. The highest bracket for trusts and estates begins at only $11,950 of taxable income for tax year 2013 and at $12,150 for tax year 2014. *See* Rev. Proc. 2013-15; Rev. Proc. 2013-35. Unlike the static threshold amounts used to determine the net investment income of individuals, the tax bracket used to determine the net investment income of non-grantor trusts and estates will provide these taxpayers with the benefit of annual inflation adjustments. A trust's or estate's undistributed net investment income for a tax year is its net investment income, reduced by the amount of net investment income included in distributions to beneficiaries deductible by the estate or trust under IRC §§ 651, 661, and 642(c). Treas. Reg. §1.1411-3(e).

Charitable Trusts | The following types of trusts are exempt from federal income tax and therefore are specifically excluded from the application of the NIIT: (i) trusts or estates where all the unexpired interests are devoted to charitable purposes, (ii) tax exempt trusts under IRC § 501, (iii) charitable remainder trusts, (iv) statutorily exempt trusts or funds such as Archer Medical Savings Accounts, Health Savings Accounts, 529 Plans, and Coverdell Education Savings Accounts, (v) grantor trusts (as discussed above), (vi) Electing Alaska Native Settlement Trusts, (vii) Cemetery Perpetual Care Funds, and (viii) foreign trusts and estates. Treas. Reg. § 1.1411-3(b).

Notwithstanding the general exclusion of charitable remainder trusts ("CRTs") from the NIIT, the final regulations create an obligation that CRTs tract the net investment income that is distributed to non-charitable beneficiaries as a part of annuity or unitrust payments. Section 644 has long required the tracking of the class of income reportable by non-charitable beneficiaries of CRTs by providing that distributions to such beneficiaries are deemed to come first from ordinary income, then capital gains, then tax-exempt income, and finally as distributions of corpus. IRC § 644(b). However, when the proposed regulations under IRC § 1411 were issued, they created a separate method for tracking the net investment income of a CRT by assuming that distributions to non-charitable beneficiaries came first from current and accumulated net investment income. Many practitioners objected to this treatment, arguing that because CRTs are already following the IRC § 644 method, there is no reason to institute a new procedure. In response, the new method of tracking presented in the proposed regulations was abandoned and the final IRC § 1411 regulations incorporated only the general CRT rules of IRC § 644, while treating all net investment income received by a CRT before January 1, 2013 as grandfathered for purposes of the application of the NIIT. Treas. Reg. § 1.1411-3(d)(1)(iii). As a result, distributions from CRTs are deemed to come first from the income type (ordinary income, capital gains, etc.) that has the highest applicable tax rate, including the NIIT, and then from items with lower aggregate rates, successively. Treas. Reg. § 1.1411-3(d)(2).

Role of Passive Activity Within the NIIT | In many cases, particularly when dealing with trust income, identifying net investment income is as simple as determining whether the activity generating such income is a passive activity under IRC § 469. If the income-

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generating activity is passive under IRC § 469, the income derived from that activity is net investment income under IRC § 1411(c)(1)(a)(II). As a result, a trust taxpayer's ability to reduce its NIIT is largely dependent on the trust's ensuring that its income-producing activities are not passive activities under IRC § 469.

Section 469 defines a passive activity as any activity that involves the conduct of any trade or business and in which the taxpayer does not materially participate. IRC § 469(c)(1). A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis that is regular, continuous, and substantial. IRC §469(h). Detailed regulations under IRC § 469 provide further guidance as to the level of involvement required to materially participate in a trade or business activity, thereby avoiding classification of the activity as a passive activity.

For example, the regulations under IRC § 469 provide an exemption from the general rule that income derived from a rental activity is automatically passive activity income. *See* Treas. Reg. § 1.469-1T(e)(3)(ii). That exemption applies only if the actions of the taxpayer with respect to the rental real estate are significant enough to satisfy one or more of certain enumerated requirements. The exemption requires the taxpayer to have materially participated in the rental real estate activity, effectively limiting the exemption to the activities of real estate professionals. As a result, determining whether the taxpayer materially participated in the income-producing activity remains a primary concern when identifying net investment income and planning for the NIIT with respect to rental real estate.

How Does a Trust or Estate Materially Participate?

Just as the net investment income of a grantor trust is attributed to the grantor for tax purposes, the activities of the grantor are attributed to the grantor trust when determining whether the grantor trust materially participated in income-producing activities. *See* S. Rep. No. 99-313, at 735, n. 21 (1985). However, determining whether a trust has materially participated in an income-producing activity is not as clear for estates and non-grantor trusts. Although the Service reserved Treas. Reg. § 1.469-8T for future regulations relating to the application of IRC § 469 to estates, trusts, and their beneficiaries, years have passed and no such Regulations have been issued. As a result, practitioners are limited to seeking authority from the conflicting guidance of Service sources and court opinions.

Only one court opinion, *Mattie K. Carter Trust,* 256 F. Supp. 2d 536 (N.D. Tex. 2003), addresses how a trust establishes material participation under IRC § 469. In that case, the trust owned and operated a cattle ranch, employing a full-time ranch manager and other full- and part-time employees to perform all activities necessary for the day-to-day management of the ranch. The trustee's services to the ranch involved "reviewing and approving all financial and operating proposals for the [r]anch and the Trust, budget and budgeting for the [r]anch, all investment decisions for the Trust, asset acquisition and sales, supervising all employees and agents of the Trust and the Trust's service providers, reviewing all financial information, and responsibility for all banking relationships of the Trust." *Id.* at 538. After the Service reclassified the trust's losses as passive activity losses, the trust argued that the material participation of a trust for purposes of IRC § 469 should be determined by reviewing the activities of the trust through its fiduciaries, agents, and employees. The Service disagreed, arguing that material participation should be determined solely by evaluating the activities of the trustee, an argument that relied heavily on a statement in the legislative history of IRC § 469, which provides that "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 (1985). In holding for the trust, the court reasoned that because the trust is the taxpayer, and not the individual trustee, "the participation of [the trust] in the ranch operations should be scrutinized by reference to the trust itself, which necessarily entails an assessment of the activities of those who labor on the ranch, or otherwise in furtherance of the ranch business, on behalf of [the trust]." *Mattie K. Carter Trust,* 256 F. Supp. 2d at 541. The court further stated that the Service's contention that only the activities of the trustee should be evaluated did not find support within the plain meaning of the statute and was "arbitrary, subverts common sense, and attempts to create ambiguity where there is none." *Id.* The court went even further and stated that, even if it were to accept the Service's argument that only the trustee's participation should influence the determination, in this case, the trustee's activities were sufficiently regular, continuous, and substantial to constitute material participation by the trustee. *Id.* at 541-42.

Despite the holding in *Mattie K. Carter Trust*, the Service has consistently rejected that case's rationale. At issue in Technical Advice Memorandum 200733023 was a testamentary trust which owned a limited liability company engaged in an operating business. The trustees contracted with special trustees to provide significant oversight over the administrative and operational functions; however, the contract provided that the special trustees would not possess the capacity to legally bind the trust to any activity, and that the trustees would retain all decisionmaking authority over the trust's financial, tax, and business matters. Time logs indicated that the special trustees reviewed operating budgets, analyzed a tax dispute, prepared and analyzed financial documents, negotiated a sale to a newly admitted partner, and conferred with the trustees regarding these matters. In the TAM, the Service reiterated its position, in reliance on the legislative history to IRC§ 469, that the sole means for a trust to establish material participation is through the regular, continuous, and substantial involvement of its fiduciaries, then determined that this test was not met in the case under review because the special trustees lacked the authority to bind the Trust. The Service reasoned that "a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust." Because the special trustees lacked such authority, their activities were indistinguishable from those of any non-fiduciary employees of the trust. TAM 200733023 at 7. Since issuing TAM 200733023, the Service has continued to reject the holding in *Mattie K. Carter Trust* and has repeated this same position in Private Letter Ruling 201029014 and Technical Advice Memorandum 201317010.

In TAM 201317010, an individual served as special trustee of two irrevocable trusts and president of a company which was owned by the two trusts and the individual. The special trustee had the power to make all decisions relating to the sale or retention of company stock owned by the trust and the power to vote all such stock. The special trustee stated that he could not distinguish between the time spent as president of the company, a shareholder of the company, and as a spe-

cial trustee. Notwithstanding the special trustee's involvement in the day-to-day management of the company, the Service stated that the trusts failed the material participation test because the special trustee's time spent on day-to-day management activities was performed as an employee of the company and not as a fiduciary of the trusts. According to the Service, the time the individual spent as a special trustee in considering sales of company stock or voting the stock did not amount to regular, continuous, and substantial participation.

In the preamble to the final regulations under IRC§ 1411, published December 2, 2013, the Service noted that it is aware of the conflicting authority regarding how a trust or estate materially participates in a trade or business, but then side-stepped the issue by claiming that publishing regulations on that matter under IRC § 1411 would significantly delay the finalization of the Section 469 regulations. With this in mind, the Service stated that the material participation of estates and trusts is currently under study, with separate guidance to be delivered at a later, unspecified date.

Despite the Service's past failures to issue such guidance, a case pending before the Tax Court may inspire the Service to move forward with issuing temporary regulations on this subject. *Frank Aragona Trust v. Commissioner* involves the requirements for material participation by a trustee for purposes of the passive loss rules, and the case was already tried in May 2012, with reply briefs submitted in October 2012. *See Frank Aragona Trust v. Comm'r*, U.S. Tax Court Docket 015392-11. Given that this is a case of first impression for the Tax Court, the ruling in the case should be quite important.

How to Plan Around the NIIT | In light of the Service's silence in the final IRC § 1411 Regulations on material participation by trusts and estates, and its continued rejection of the holding in *Mattie K. Carter Trust*, trusts attempting to avoid the application of the Net Investment Income Tax through the active participation of the trust should ensure the following: (i) the trustees are engaged in substantial business activities of the trust (as trustees, not simply as officers or other employees); and (ii) the trustees involved in the day-to-day activities of the trade or business possess the discretionary authority to bind the trust. It may be possible to appoint special trustees to oversee the business, as was attempted in TAM 200733023 and TAM 201317010, but these trustees must at least possess non-illusory authority over the trust with respect to the business in question, and clients should be made aware of the inherent risks of this position.

Rather than deal with the complexity and uncertainty surrounding the application of the NIIT within trusts, some clients may be better served by the use of grantor trusts or trusts that require annual distributions of trust income to the beneficiaries (after giving due consideration to whether such income distributions would be appropriate for the beneficiaries in light of their financial acumen, responsibility, and creditor protection concerns), thereby shifting the reporting of trust income from the trust to the beneficiaries. Although this approach does not remove the income from the purview of the NIIT, it will shift the income from a trust which is subject to NIIT after only approximately $12,000 of income, to an individual taxpayer who enjoys more generous threshold amounts before the NIIT is applied. As a result, depending on the income of the individual taxpayer, such a shift may result in avoidance of the NIIT entirely.

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