INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200733023**
Release Date: 8/17/2007

Index (UIL) No.: 469.00-00
CASE-MIS No.: TAM-100421-07

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Trust =

Year 1 =

Year 2 =

Year 3 =

Trustees =

Special Trustees =

P =

Business =

X =

#a =

#b =

#c =

ISSUES:

(1) How does a trust establish material participation for purposes of the passive activity loss limitation of § 469 of the Internal Revenue Code?

(2) Under the circumstances described below, did Trust materially participate in Business during Year 3 for purposes of § 469?

CONCLUSIONS:

(1) A trust materially participates in an activity for purposes of § 469 if the fiduciaries of the trust participate in the operations of the activity on a basis which is regular, continuous, and substantial.

(2) Under the circumstances below, Trust did not materially participate in Business during Year 3 because Special Trustees in this case are not fiduciaries for purposes of § 469 and Trustees' involvement in the operations of Business for Year 3 was not regular, continuous, and substantial.

FACTS:

Trust is a testamentary trust established in Year 1. The trustees of Trust are Trustees. In Year 2, Trust acquired an interest in P, a state law limited liability company (LLC) that is classified as a partnership for federal tax purposes. P engages in Business.[1] According to Trust, between Year 2 and Year 3, Trustees provided services to P that encompassed a range of administrative and operational activities relating to Business, including direct participation in operations, oversight of bond financings and borrowing activities, and approval of operating budgets.

[1]This memorandum assumes that Trust is a testamentary trust and not a business entity. See Bedell Trust v. Commissioner, 86 T.C. 1207 (1986).

The will establishing Trust provides for the appointment of a special trustee "as to part or all of the trust property." The will also states that, except as specifically limited by the appointing instrument, the special trustee "shall have all of the rights, titles, powers, duties, discretions, and immunities of the trustees. …"

For Year 3, Trustees contracted with Special Trustees to perform a number of tasks related to Business. The contract entered into between Trust and Special Trustees for Year 3 explicitly states that Special Trustees are being appointed as special trustees pursuant to the will and that their involvement in Business is intended to satisfy the material participation standard of § 469(h)(1). The contract also provides that Special Trustees "will not possess the capacity to legally bind or commit the Trust to any transaction or activity" and that "[Trust] acknowledges that it retains all decision making responsibilities related to [Trust's] financial, tax, or business matters."

Time logs submitted by Trust indicate that Special Trustees spent most of their work hours during Year 3 reviewing operating budgets, analyzing a tax dispute that arose among the partners, and preparing and analyzing other financial documents. The logs evidence repeated contacts with Trustees relating to these issues. In addition, Special Trustees appear to have spent a considerable number of hours negotiating the sale of Trust's interests in P to a newly-admitted partner. Consistent with the contractual provisions described above, Trust submits that, while Trustees relied heavily upon the recommendations of Special Trustees, ultimate decision-making authority remained vested solely with Trustees. During Year 3, Special Trustees spent approximately #a hours performing services under the contract.

Additional time logs submitted by Trust indicate that Trustees spent approximately #b hours during Year 3 on matters related to Business. Approximately #c of these hours were spent on issues related to the proposed sale of Trust's interests in P to the newly-admitted partner. The remaining hours appear to have been spent reviewing and analyzing operating budgets and other financial documents related to Business.

For its tax return filed for Year 3, Trust reported a loss from P in the amount of $X. Trust did not treat the loss as a passive loss on its tax return.

LAW AND ANALYSIS:

Issue 1: How does a trust establish material participation for purposes of the passive activity loss limitation of § 469?

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). As relevant here, § 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.[2]

[2]The legislative history is somewhat complicated by subsequent comments in the Bluebook to the 1986 Act. "No special rule is provided for determining material participation by a trust." See Staff of Joint Comm. on Tax'n, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 at 242, n. 33. However, the Bluebook is not legislative history. In addition, the discussion in the Bluebook is based on the assumption that trusts would rarely (if ever) materially participate in a trade or business activity.

Trust submits that the opinion in Mattie K. Carter Trust v. United States, 256 F.Supp.2d 536 (N.D. Tex. 2003), provides the appropriate standard for evaluating material participation for trusts. In Mattie K. Carter, the court held that in determining material participation for trusts, the activities of the employees of the trust should be included in determining whether the trust's participation is regular, continuous, and substantial. In rejecting the government's position that the determination should be made solely with reference to the activities of the trustee, the court stated:

> Such a contention is arbitrary, subverts common sense, and attempts to create ambiguity where there is none. The court recognizes that [the] IRS has not issued regulations that address a trust's participation in a business . . . and that no case law bears on the issue. However, the absence of regulations and case law does not manufacture statutory ambiguity.
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> Id. at 541.

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

Therefore, notwithstanding the decision in Mattie K. Carter, the Service believes that the standard annunciated in the legislative history is the proper standard to apply to trusts for purposes of § 469. Thus, the sole means for Trust to establish material participation in Business for Year 3 is if its fiduciaries are involved in the operations of Business on a regular, continuous, and substantial basis.

Issue 2: Did Trust materially participate in Business during Year 3 for purposes of § 469?

Trust asserts that Special Trustees are fiduciaries for purposes of § 469 and, therefore, the activities of both Trustee and Special Trustees should be taken into account in determining whether Trust materially participated in Business for Year 3.

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 provide that “fiduciary” refers to “persons who occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators." Treas. Reg. § 301.7701-6. To date, the Service has issued only limited guidance expounding upon the definition of fiduciary under § 7701(a)(6).

In Revenue Ruling 69-300, 1969-1 C.B. 167, a bank was appointed by court order to serve as the custodian of shares in a land trust. Among the powers granted to the bank was the power to vote at any stockholders’ meeting, retain legal counsel, exercise or sell conversion or subscription rights, and petition the court to make any disposition concerning the property that it considered to be in the best interests of the owner. In holding that a trust was formed, the ruling notes that “where the bank or individual is vested with broad discretionary powers of administration and management, a fiduciary relationship exists within the meaning of § 7701(a)(6) of the Code.”

In contrast, Revenue Ruling 82-177, 1982-2 C.B. 365, as modified by Revenue Ruling 92-51, 1992-2 C.B. 102, holds that a fiduciary relationship does not exist for purposes of § 7701(a)(6) where a bank merely holds money for an estate and pays interest on the account, but performs no administrative duties.

The case law is generally consistent with these rulings. United States v. Anderson, 132 F.2d 98 (6th Cir. 1942), a pre-7701(a)(6) case, involved the issue of whether an agreement between the taxpayer and a bank created a trust or an agency relationship. In that case, the bank could not invest or dispose of any corpus without the consent of the settlor and was relieved of all liability for any decline in the value of the corpus. The settlor had the power to vote any corporate stock held by the bank and could remove the bank and select a successor at any time. The court stated that while an agent undertakes to act on behalf of his principal and is subject to his control, a trustee usually has discretionary powers and acts for a term. Accordingly, because the bank did not have discretionary powers, the court held that the agreement created an agency relationship rather than a trust. See also City Nat'l Bank & Trust Co. v. United States, 109 F.2d 191 (7th Cir. 1940) (holding that no trust was formed where bank’s investment decisions could be overridden by settlor and other evidence of managerial power was lacking).

What is apparent from the line of authority in this area is that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust. Although Trust represents that Special Trustees were heavily involved in the operational and management decisions of Business, Special Trustees — like the banks in Revenue Ruling 82-177 and Anderson — were ultimately powerless to commit Trust to any course of action or control Trust property without the express consent of Trustees. The contract between Trust and Special Trustees is explicit on this point, and Trust itself has acknowledged that Trustees retained final decision-making authority with regard to all facets of Business. The services performed by Special Trustees appear to be indistinguishable from those that would be expected of other non-fiduciary business personnel. If advisors, consultants, or general employees can be classified as fiduciaries simply by attaching different labels to them, the material participation requirement of § 469 as applied to trusts would be meaningless.

Trust cites the state law case of Matter of Will of Rubin, 540 N.Y.S.2d 944 (N.Y. Sur. Ct. 1989) to argue that, under the laws of many states, a trustee's powers may be "split" among more than one co-trustee or special trustee. However, Rubin and the cases cited therein involved actual delegations of discretionary power; specifically, the case involved whether one co-executor could be delegated the exclusive power to manage realty held by the estate. In the case of Trust, no such powers were delegated to Special Trustees. Trustees' ultimate power to control Trust property was unaffected by the appointment of Special Trustees, and Special Trustees could exercise no power over Trust property without first obtaining the permission of Trustees.

Citing Revenue Ruling 61-102, 1961-1 C.B. 245, Trust argues that the Service's own rulings rely heavily upon the language of the trust instrument to determine whether someone is a fiduciary. The ruling, however, appears limited to its facts and cannot be read to create a presumption that a named trustee will be recognized as such for federal tax purposes. Consistent with the Service's position that substance, not form, governs the tax consequences of purported trust arrangements, the courts have repeatedly refused to recognize the status of appointed "trustees" who lack any indicia of discretionary power. See City Nat'l Bank & Trust Co. v. United States, 109 F.2d 191 (7th Cir. 1940); Dunham v. Commissioner, 35 T.C. 705 (1961).

In light of the limited power vested with Special Trustees under the contract, we conclude that Special Trustees were not fiduciaries of Trust during Year 3 for purposes of § 469. Moreover, even if Special Trustees were fiduciaries of Trust, a review of the time logs submitted by Trust indicates that many of the duties performed by Special Trustees had a questionable nexus to the conduct of Business. As noted above, the legislative history of § 469 indicates that Congress was insistent that the material participation standard be satisfied through participation in the operations and management of the activity. See also Treas. Reg. § 1.469-5T(f)(2)(ii) (prohibiting "individuals" from counting certain "investor" hours toward the material participation requirement unless the individual is also involved in the day-to-day management or

operations of the activity). Some of the hours reflected in the time logs of Special Trustees – particularly those spent negotiating the sale of Trust's interests in P as well as those spent resolving a tax dispute with another partner – were not spent managing or operating Business. Thus, even if Special Trustees were fiduciaries of Trust, a number of hours reflected in the time logs of Special Trustees would be disregarded for purposes of analyzing Trust's involvement in Business.

Because Special Trustees are not fiduciaries of Trust for purposes of § 469, only the activities of Trustees count toward the material participation requirement for Trust. According to the time logs submitted by Trust, Trustees spent approximately #b hours in Year 3 on activities related to Business. As noted above, however, many of these hours must be disregarded. In particular, the hours that Trustees spent negotiating the sale of Trust's interests in P (approximately #c) are not hours that should count toward Trust's involvement in Business for purposes of § 469. The limited number of hours that arguably do constitute participation in the management or operations of Business do not constitute involvement in Business that is regular, continuous, and substantial. Thus, we conclude that Trust did not materially participate in Business for Year 3.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). 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.