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TAX AND WEALTH ADVISOR ALERT: THE FIRST CLUE TO THE IRS' POSITION AND THE TAX COURT'S THOUGHTS ON MATERIAL PARTICIPATION OF A TRUST FOR THE 3.8% NET INVESTMENT INCOME TAX—ARAGONA TRUST V. COMM'R., 142 T.C. 9 (2014)

Beginning in the 2014 tax year, when a taxpayer's Adjusted Gross Income ("AGI") exceeds a threshold amount, the taxpayer will be subject to a 3.8% tax on his or her net investment income. Net investment income includes income from a business in which the taxpayer does not "materially participate." The section of the Internal Revenue Code (the "Code") dealing with the tax on net investment income (specifically Code section 1411) borrows its critical material participation definition from Section 469 of the Code which deals with the rules on deductibility of losses from passive activities. Under Code section 469, while the rules for measuring the material participation of a human being are straightforward, when the taxpayer who owns an entity is a non-grantor trust, the guidance is conspicuously absent. In fact, Section 1.469-5T(g) of the Treasury Regulations entitled "Material Participation of Trusts and Estates," has no information; it is simply blank. In the regulations to Section 1411, the IRS admits it provides no guidance on material participation by trusts, but states that it hopes to provide future guidance through Regulations promulgated under Code section 469.

So, in essence, when a business is owned by a non-grantor trust, the taxpayer is left without guidance on whether the business' income is subject to the net investment income tax. However, a recent case does provide insight into the IRS' and Tax Court's position on the matter. In *Frank Aragona Trust v. Comm'r.*, the IRS posits that, under Code section 469, a trust cannot materially participate. If the IRS succeeded in that argument, all income from an active business owned by a non-grantor trust would be subject to the 3.8% tax. The IRS also argued, in the alternative, that if the Tax Court held that a trust can materially participate, it is the services that the trustee provides *as the trustee and not the services the trustee provides as an employee of the business* that can be counted towards the material participation standard.

The Tax Court disagreed with the IRS on both counts. It held that a trust can materially

participate, and the services of the trustee, whether as an employee of the business or as trustee count towards meeting the material participation standard. This ruling should provide some comfort for taxpayers who utilize non-grantor trusts for estate planning and asset protection purposes to hold businesses, as the Tax Court gives a framework for meeting the material participation standard. At the same time, it should serve as a cautionary tale that holding business assets in that way might lead to IRS scrutiny and challenge.