

PUBLICATION

IRS Limits Losses Sustained by Trusts

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Since 1986, Section 469 of the Internal Revenue Code has imposed limitations on the ability of most taxpayers to offset losses from activities in which they do not materially participate against wages and other non-passive income. The taxpayers to which this limitation applies are individuals, estates and trusts, closely held C corporations and personal service corporations. If the passive loss rules prevent the loss from being used currently, the loss may be carried forward to the year when the activity generating the loss is disposed of, at which time it may be utilized.

TAM 201317070

A recent Technical Advice Memorandum (TAM 201317070, released April 2013) addressed the situation where two trusts owned interests in an S corporation that had passive losses for the years in question. The issue under consideration in TAM 201317070 was whether the trusts materially participated in the activities that generated the losses.

The Treasury Regulations construing Section 469 in the case of individuals provide mechanical, non-subjective tests for determining whether the degree of participation by the individual rises to the level of "material," thus entitling the taxpayer to offset the loss currently against non-passive income. However, the regulations contain little guidance with respect to the application of the passive loss rules to entities such as trusts or estates.

In TAM 201317070, the two trusts, which were identical, appointed an individual as "Special Trustee" of the two trusts. The same individual was president of the subchapter S corporation that conducted the activity that generated the passive losses and was also the owner of another corporation that also owned some of the stock of the subchapter S corporation. It was stipulated that the individual could not differentiate his time spent between acting as the Special Trustee of the trusts and acting as president of the subchapter S corporation.

The trust instruments stated that the individual appointed as Special Trustee would control the activities relating to the ownership of the stock of the corporation that generated the loss, including all decisions regarding the sale or retention of the stock of the subchapter S corporation, including the voting of such stock. The trusts contended that the total time spent by the Special Trustee, in his capacity as the president of the corporation and as the Special Trustee, should be counted towards meeting the material participation requirements of the passive loss limitations.

The IRS examining agent asserted that the trusts did not materially participate in the relevant activities of the subchapter S corporation. In support of such assertion, the agent contended that the trust agreements limit the powers of the Special Trustee to certain delineated acts; and thus, the Special Trustee did not possess broad or unlimited discretionary authority to bind the trusts to any course of action without the consent of the trusts' trustee.

The Internal Revenue Service ruled in the TAM that proper focus is whether the fiduciary, in his capacity as such, is materially participating. In holding that the trusts failed the material participation test, the Service stated that the individual designated as the Special Trustee did not have sufficient discretionary authority for

his activities as a fiduciary to be "regular, continuous and substantial" within the context of the passive loss rules.

District Court Decision

This TAM Ruling is contrary to the only court case to consider this issue. In the case of *The Mattie K. Carter Trust, by Benjamin J. Fortson, Jr., Trustee, v. U.S.*, the District Court for the Northern District of Texas, in holding for the taxpayer in a suit for refund, stated that "material participation" of a trust in a trade or business within the meaning of the passive loss rules is to be determined by reference to all of the persons who conducted the business in question as opposed to solely the trustee's activities in such capacity.

Summary

In view of the only judicial precedent being the *Mattie K. Carter* decision, which the Service did not appeal, it is questionable whether the Service can successfully defend its TAM position. On a related point, the Service has not made its position known when the fiduciary trustee is an institution.

Should you have questions or otherwise wish to discuss TAM 201317070, please contact any one of the attorneys in the Firm's Tax Practice Group.