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Net investment income tax participation by a trust

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Many of you recently became acquainted with the new net investment income tax as you prepared your tax returns. Generally, a 3.8% tax is imposed on interest, dividends, annuities, royalties, rents, capital gains, and business income from passive activities. The tax applies to individuals having relatively high adjusted gross incomes. In addition, the tax applies to trusts on the lesser of (i) a trust's undistributed income, or (ii) the excess of the trust's adjusted gross income over $12,150.

Because the adjusted gross income threshold for trusts is extremely low, many trustees have found themselves confronted with the question of whether to distribute assets in order to avoid the tax at the trust level. This is not an easy question to answer, and it has placed many trustees in an uncomfortable position. To avoid or minimize the tax, some trustees of trusts owning real property are examining whether the trust's activities could be considered active because the tax only applies to passive income. Unfortunately, neither the Internal Revenue Code nor IRS regulations describe what factors are to be considered in determining how a trust participates in a real estate activity.

The IRS position appears to be that only the trustee's participation managing the real estate activity is considered in determining whether the trust actively participates in the activity. Furthermore, the IRS will only give credit to the trustee's participation as a fiduciary and not in another capacity. However, there is a United States District Court case concluding that the participation of not only the trustee, but also all of the employees and agents of a trust, can be considered in determining whether the trust actively participates in the activity. Obviously, this is a much broader standard which would allow more trusts to treat their real estate activities as active, thereby avoiding the new tax.

In late March, the United States Tax Court issued a ruling that falls between the IRS position and the United States District Court ruling. In Frank Aragona Trust v. Commissioner, the Tax Court concluded that the activities of a trustee can be used to measure a trust's participation in an activity, even if the trustees' activity comes from serving as an employee of an affiliated entity. Thus, both the trustee's fiduciary and nonfiduciary participation counts. However, the Court declined to address whether the activities of trust employees and agents who are not trustees should also count.

If you are the trustee or beneficiary of a trust that is receiving passive income, now would be a good time to consider whether the trust's participation is active or passive.

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