

Losses incurred in a trust

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The LLC is a popular tax vehicle to own real estate. The legal protection and tax flexibility afforded the partners of having this type of entity own real estate, is more appealing than the traditional limited partnership. As an added layer of protection, some investors have placed their ownership interests in a testamentary trust. This form of ownership may produce adverse tax consequences.

By definition, income and losses from real estate are passive activities. In order to deduct passive losses in a partnership, the partners must be able to demonstrate that they pass one of the seven material participation tests found in Code Sec. 469. The courts had concluded that the trustees and employees of a trust could combine their activities in meeting the material participation tests. The theory was that the employees of the trust were acting as agents for the trustees, thus their activities could inure to the trustees to meet the materiality test.

However, a released Ltr. Rul. (#200733023) concluded that employees of a trust do not have sufficient ownership and control of a partnership's interests to authorize or legally bind the trustees of the trust. As such, employee activities could not be combined with the trustee activities to determine if the material participation standard was met. This ruling causes the partnership's passive loss to be suspended. The new position is that the trustees alone have to meet the material participation standards before passive loss deductions will be allowed. This reasoning follows Temp Reg. 1.469-1T (b) (2) which states that the passive loss rules do not apply to Grantor Trusts, but instead the rules must be applied at the grantor level to determine deductibility of passive losses.

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