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Can a trust be considered an active participant in its real estate activities?

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Can a trust be considered an active participant in its real estate activities? The IRS has always maintained that real estate activities owned by a trust were classified as passive under the passive activity rules. This limits the ability to deduct real estate losses. The United States Tax Court recently issued an opinion in the case of Frank Aragona Trust V. Commissioner (Aragona) that allows for trust's real estate activities in some cases to be classified as materially participating under the real estate professional rules of IRC Section 469(c)(7). Aragona owned real estate rental properties and also owned majority interests in other entities that conducted real estate activities. The trust was the sole owner of an LLC that managed the real estate properties. Of the six trustees of the trust, three were employed full-time by the LLC.

Income from rental activities is generally considered a passive activity unless the exception for real estate professional can be met (as well as meeting the material participation tests). This allows the income or loss to be classified as non passive. Non passive losses are deductible in the year occurred, while passive losses are suspended until the trust has passive income or the activity is sold.

In Aragona, the court ruled that three trustees who were employees of the single member LLC owned by the trust, met the two tests required to be considered a real estate professional. First, they performed more than half of their personal services in real estate activities during the year and secondly performed more than 750 hours of services in regards to the real estate activities of the trust during that year. The three trustees were full-time employees of the LLC and thus were ruled to meet the test requiring material participation. The other trustees had no connection to the LLC other than their positions with the trust. The court not only allowed the losses of the LLC to be reclassified as non passive it also allowed the losses for real estate activities in which the trust held both majority and minority interests to be reclassified.

As a result the trust was able to deduct their real estate losses currently, as opposed to the IRS's original position, which classified them as passive (resulting in suspended losses until the activities had income or were sold in future years).

Aragona was based on filings for tax years 2005 and 2006 but it has ramifications not stated in the case in regards to the new Net Investment Income Tax (NIIT). The NIIT which is effective for years beginning after December 31st, 2012, taxes passive income and other investment income above the threshold (for trusts $12,150 for 2014: $12,300 for 2015) at 3.8%. As a real estate professional, the trust's real estate activities are considered non passive and not subject to NIIT.

While the decision states that employees who are also employees of the trusts activities were considered as materially participating, the court makes no mention of whether trustees who are co-owners of majority or minority interests of the trust activities qualify for the same treatment.

Trusts should reevaluate the activities performed by their trustees to see if they may qualify for real estate professional status. Future trust agreements may want to consider naming co-trustees based on their ability to meet these requirements. In Aragona only three of the six trustees were determined to be real estate tax professionals, so the presumption is that a minority percentage of trustees qualifying should be sufficient for the trust to be determined to be a real estate professional as a whole.

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