CPA Practice Advisor

Investment Income Tax

Sep. 24, 2014

The American Institute of CPAs has submitted comments to the Internal Revenue Service (IRS) and Department of the Treasury relating to the issue of material participation by a trust or estate in a trade or business for purposes of section 469 of the Internal Revenue Code.

The AICPA explained that section 469, which was enacted in 1986, limits the amount of losses from passive activities that can be recognized each year to the amount of income from passive activities during the year. Section 1411, the net investment income tax, imposes a tax on unearned income from investments of certain individuals, estates and trusts whose income is above statutory threshold amounts. However, trusts or estates that had no losses from a trade or business had not previously been required to determine whether the income from a trade or business was active or passive. Section 1411 requires those trusts and estates to make that determination.

In its Sept. 22 letter, the AICPA said that "after 28 years without guidance and two court decisions on which taxpayers are able to rely, the expanded scope of the section 1411 net investment income tax (NIIT) has created a broader need for all trusts and estates that have an interest in a trade or business to determine under section 469 whether the trust or estate materially participates in the trade or business."

If Treasury and the IRS choose to address this issue through regulations, the AICPA suggested that the guidance should:

- Incorporate the conclusions reached in the two court decisions;
- Thoroughly address the complicated issues involved;

- Provide comprehensive, administrable, and clear guidance;

- Provide that the material participation tests for individuals set forth in Temp. Reg. § 1.469-5T(a) apply to trusts and estates;
- Include a special rule to treat, for a certain period of time, an estate or former grantor trust as materially participating in any trade or business in which the decedent or deemed owner materially participated at the time of his or her death;
- Provide that the character of the income is determined at the level of the trust or estate, and the character of any distributed income remains the same in the hands of the beneficiary;
- Include a special rule to provide that the participation of the beneficiary of a qualified subchapter S trust is used to determine whether the trust's gain from the sale of the S corporation stock is treated as active or passive;
- Include a special rule to provide that the S portion and the non-S portion of an electing small business trust are treated as a single trust for purposes of applying the section 469 rules; and
- Provide that a trust or estate may qualify as a real estate professional under section 469(c)(7) and tests for how a trust or estate may qualify as a real estate professional.

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