Frank Aragona Trust v. Commissioner, 142 T. C. 165 (U. S. Tax Court 2014)

The U. S. Tax Court ruled in favor of the Frank Aragona Trust, clarifying that trusts can qualify for the exception under Section 469(c)(7) of the Internal Revenue Code. This decision allows trusts to treat rental real estate activities as non-passive if they meet specific participation criteria, impacting how trusts manage their real estate investments and report losses for tax purposes.

Parties

The petitioner was the Frank Aragona Trust, with Paul Aragona as the executive trustee. The respondent was the Commissioner of Internal Revenue.

Facts

The Frank Aragona Trust, established in 1979 by Frank Aragona, owned rental real estate and engaged in other real estate activities. Upon Frank Aragona's death in 1981, the trust was managed by six trustees, including his five children and an independent trustee. The trust operated through various entities, including Holiday Enterprises, LLC, a wholly owned subsidiary that managed most of the trust's rental properties. The trust incurred losses from its rental activities in 2005 and 2006, which it reported as non-passive, enabling it to carry back net operating losses to 2003 and 2004. The IRS challenged the trust's classification of these activities as non-passive, asserting that the trust's rental real estate activities should be treated as passive under Section 469(c)(2), unless an exception applied.

Procedural History

The IRS issued a notice of deficiency to the trust for the tax years 2003, 2004, 2006, and 2007, asserting deficiencies in federal income tax and penalties. The trust filed a petition with the U. S. Tax Court contesting the IRS's determinations. The court's jurisdiction was based on Section 6214(a), allowing it to redetermine the deficiencies and penalties. After the IRS conceded the penalties for the relevant years, the court focused on whether the trust qualified for the Section 469(c)(7) exception and the proper characterization of trustee fees as expenses.

Issue(s)

Whether the Section 469(c)(7) exception, which allows certain taxpayers to treat rental real estate activities as non-passive, applies to a trust?

Rule(s) of Law

Section 469(c)(7) of the Internal Revenue Code provides an exception to the general rule that rental activities are treated as passive under Section 469(c)(2). The exception applies if more than one-half of the taxpayer's personal services in trades or businesses are performed in real property trades or businesses in which the

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taxpayer materially participates and if the taxpayer performs more than 750 hours of services in such businesses annually. The statute does not explicitly exclude trusts from this exception.

Holding

The U. S. Tax Court held that a trust can qualify for the Section 469(c)(7) exception. Services performed by the trust's individual trustees can be considered personal services performed by the trust, enabling the trust to meet the criteria for the exception. The court further held that the Frank Aragona Trust materially participated in its real property trades or businesses, thus qualifying for the exception.

Reasoning

The court's reasoning included several key points:

– The court rejected the IRS's argument that trusts cannot perform "personal services" as defined by Section 1. 469-9(b)(4) of the regulations, which specifies "any work performed by an individual in connection with a trade or business. " The court reasoned that work performed by individual trustees on behalf of the trust can be considered personal services performed by the trust itself.

– The court noted that the statute's use of the term "taxpayer" in Section 469(c)(7), as opposed to "natural person" used in other parts of the Code, suggested that Congress did not intend to exclude trusts from the exception.

– The court considered the legislative history of Section 469(c)(7) but found it did not explicitly limit the exception to individuals and closely held C corporations.

– Regarding material participation, the court determined that the activities of all six trustees, including their work as employees of Holiday Enterprises, LLC, should be considered in assessing whether the trust materially participated in its real estate operations. The trust's extensive involvement in real estate, managed primarily by three full-time trustees, supported the finding of material participation.

– The court did not need to decide the proper characterization of trustee fees as expenses of the trust's rental real estate activities, as the trust's qualification under Section 469(c)(7) meant its rental activities were not passive.

Disposition

The court decided to enter a decision under Tax Court Rule 155, reflecting that the trust's rental real estate activities were not passive due to the application of the Section 469(c)(7) exception.

Significance/Impact

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This case is significant as it clarifies the application of the Section 469(c)(7) exception to trusts, potentially affecting how trusts structure their real estate investments and report losses. The ruling provides trusts with an opportunity to treat rental real estate activities as non-passive, thereby increasing their flexibility in managing tax liabilities. It also highlights the need for clear regulations regarding the material participation of trusts in passive activities, as noted by various commentators. The decision may influence future IRS guidance and court interpretations concerning trusts and passive activity rules.

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