Frank Aragona Trust v. Commissioner, 142 T. C. No. 9 (2014)

In Frank Aragona Trust v. Commissioner, the U. S. Tax Court ruled that trusts can qualify for the section 469(c)(7) exception, which allows certain real estate professionals to treat their rental real estate activities as non-passive. The court found that services performed by individual trustees on behalf of the trust can be considered personal services performed by the trust itself. This decision expands the scope of the exception beyond individuals and closely held C corporations, potentially affecting how trusts report income and losses from rental real estate activities.

Parties

The petitioner, Frank Aragona Trust, was represented by Paul Aragona, its executive trustee, against the respondent, the Commissioner of Internal Revenue. The case was heard in the United States Tax Court.

Facts

The Frank Aragona Trust, a complex residuary trust, was established in 1979 by Frank Aragona with his five children as beneficiaries. After Frank's death in 1981, six trustees, including the five children and an independent trustee, managed the trust. The trust's primary activities included owning and managing rental real estate properties and engaging in other real estate businesses. The trust paid annual fees to its trustees, which were reported as expenses on its tax returns. The trust claimed losses from its rental real estate activities as non-passive, which allowed it to offset these losses against other income, resulting in net operating losses carried back to previous years.

Procedural History

The Commissioner issued a notice of deficiency determining that the trust's rental real estate activities were passive, which would disallow the offsetting of losses against other income. The trust petitioned the Tax Court to redetermine the deficiencies. The IRS conceded on the issue of accuracy-related penalties but maintained that the trust's rental activities were passive. The trust argued that it qualified for the section 469(c)(7) exception, which would treat its rental activities as non-passive.

Issue(s)

Whether a trust can qualify for the section 469(c)(7) exception, which requires that more than half of the personal services performed by the taxpayer in trades or businesses are in real property trades or businesses in which the taxpayer materially participates, and that the taxpayer performs more than 750 hours of services in such businesses?

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Rule(s) of Law

Section 469 of the Internal Revenue Code generally disallows passive activity losses for certain taxpayers, including trusts. However, section 469(c)(7) provides an exception for rental real estate activities if the taxpayer meets specific criteria. The regulation at section 1. 469-9(b)(4) defines “personal services” as “any work performed by an individual in connection with a trade or business. “

Holding

The Tax Court held that a trust can qualify for the section 469(c)(7) exception. The court determined that services performed by individual trustees on behalf of the trust can be considered personal services performed by the trust, thus satisfying the statutory requirements for the exception.

Reasoning

The court rejected the IRS’s argument that a trust cannot perform personal services because the regulation defines personal services as work performed by an individual. The court reasoned that trustees, as individuals, can perform work on behalf of the trust in connection with a trade or business, thus fulfilling the statutory requirement. The court also noted that the legislative history did not explicitly exclude trusts from the exception, unlike other sections of the code that specifically limit applicability to “natural persons. ” The court further held that the trust materially participated in real property trades or businesses based on the activities of all six trustees, including their roles as employees of a wholly-owned entity, Holiday Enterprises, LLC. The IRS did not challenge whether the trust met the specific hour and service requirements of the exception, so the court did not address those issues.

Disposition

The Tax Court ruled in favor of the trust, holding that its rental real estate activities were not passive due to its qualification for the section 469(c)(7) exception. The case was set for further proceedings under Tax Court Rule 155 to determine the final tax liabilities.

Significance/Impact

This decision expands the application of the section 469(c)(7) exception to include trusts, potentially allowing them to treat their rental real estate activities as non-passive and offset losses against other income. This ruling may influence how trusts structure their real estate activities and report income and losses on their tax returns. The decision also highlights the need for clearer regulatory guidance on how trusts can satisfy the material participation requirements under section 469.

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