Cannon Insights
A Monthly Publication by Cannon Financial Institute

Planning Ideas—S Corporations in Trust and the New 3.8 Percent Tax

Here's a relatively common planning scenario. Dad owns and operates an S corporation, which allows pass-through of income and loss to shareholders. Dad wishes to continue to control the corporation while sharing some of the income generated by the corporation with his family. Rather than diluting his ownership interest by issuing more stock, Dad transfers his S corporation stock to a non-grantor trust, naming family members as beneficiaries. Following the transfer, income and loss flow to the trustee, who has discretion over distributions.

A key issue is whether or not the trustee participates materially in the operation of the S corporation. If so, several benefits are available including the deductibility of operating losses. If not, among other things, the deduction is lost and the passive income derived from the corporation is considered "net investment income" for purposes of the additional 3.8 percent tax on net investment income.

Material Participation

The reason for the rule requiring material participation is to prevent taxpayers from deducting "paper" losses on passive investments from compensation and self-employment income.

The regulations say taxpayers achieve "material participation" in non-real estate activities for a tax year if they:

- Participate at least 500 hours; or
- Participate at least 100 hours and at least 500 hours in that and other 100 hour activities; or
- Participate at least 100 hours and more than anybody else, or are the only participant; or
- Materially participated in five of the past ten years) or in any three years for a service activity).

There is also a "facts and circumstances" test, for determining material participation. Basically, it's what you would expect. If an individual performs services as an employee or officer, the individual is considered to have materially participated in business operations.

A special rule applies to real estate. If the taxpayer is not a real estate professional, losses are normally passive no matter what, unless the taxpayer provides "extraordinary" personal services.

If the taxpayer is a real estate professional, he or she can apply the normal material participation rules to determine whether they have a passive activity. To qualify as real estate professionals, taxpayers must spend at least half of their working hours – not less than 750 hours annually – in "real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade."

Technical Advice Memorandum (TAM) 201317010

A recent TAM considered whether trust shareholders materially participated in the business activities of an S corporation and its subsidiaries.

The trusts in question were complex trusts that had a Trustee and a Special Trustee. Unlike simple trusts, which are required to distribute all of their income, complex trusts may accumulate income. Income of a complex trust that is not distributed is subject to income taxation at the trust level. Income tax rates for trusts are steeply graduated. Rates for 2013 are set forth below.

INCOME TAX RATES ON ESTATES AND TRUSTS FOR 2013

Tax Rate	Limit
15% on Taxable Income to:	$2,450
25% on next Taxable Income to:	5,700
28% on next Taxable Income to:	8,750
33% on next Taxable Income to:	11,950
39.6% on next Taxable Income above:	11,950

Trusts and estates are also subject to capital gains' tax rates of 20 percent. Also, trusts and estates are subject to the new 3.8 percent surtax on investment income.

Under the facts presented in the TAM, the Special Trustee was a beneficiary of the trusts, a shareholder of the S corporation, and president of one of the S corporation's subsidiaries. The Special Trustee was permitted under the trust agreement to make all decisions regarding the sale or retention of the stock and all voting of the stock.

The trusts argued that *all* of the Special Trustee's time spent in the activities of the S corporation (as fiduciary, shareholder, and employee) should be considered in determining whether or not the trust materially participated in the corporation. Normally, there would be no question that a company president is a material participant in business activities.

However, the IRS National Office disagreed and concluded that only time spent by Special Trustee *in his fiduciary capacity* (for example, voting the trusts' S corporation stock) counted toward the trusts' material participation in the S corporation's activities.

More specifically, the IRS said:

"*As Special Trustee, A lacked the power to commit Trust A and Trust B to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y …*"

Under the IRS's view it will be very difficult for any trust to meet the standard of material participation. The implications are that corporate operating losses are not deductible by the trust in computing its income. Furthermore, the passive income attributable to a trust's ownership of S Corporation stock is subject to the additional 3.8 percent tax for trusts with income in excess of $11,950 in 2013. The tax rate on net investment income for trusts with income above this amount is 43.4 percent. Ouch!

Bottom Line

The TAM's conclusion is at odds with the only court case on this issue in Mattie K. Carter Trust v. U.S., 256 F.Supp.2d 536 (N.D. Tex. 2003). Although technical advice memorandums are not precedential, given the lack of authoritative guidance on how trusts materially participate, any new pronouncement is significant because it shows that this issue is far from resolved.

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