# Passive Activity Rules and Their Relationship to Trusts

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A recent U.S. Tax Court case (*Frank Aragona Trust v. Commissioner)* has shed some light on whether or not trusts may be eligible to deduct losses from real estate activities in full, or if these losses have to be suspended under the "passive activity rules".

A passive activity can either be a business in which one does not materially participate, or a rental real estate activity. The tax consequences of whether or not an activity is considered passive or "nonpassive" can be significant. The passive loss rules (generally speaking) state that losses from these types of activities can only be deducted against passive income from other passive activities, and not against income from wages, investment income, and other nonpassive types of income. Losses from these activities that are not absorbed against income from other passive activities are suspended, and carried forward until there is either passive income against which to absorb it, or upon disposition of the activity, in which case any accumulated suspended loss from that activity is allowed as a deduction.

Another important issue as it relates to passive activities is that income from passive activities are considered "net investment income", and therefore such income is subject to the 3.8% "Net Investment Income" tax. This tax became effective in 2013, and was implemented as part of the Affordable Care Act ("Obamacare").

As stated above, real estate rental activities are generally treated as passive activities, no matter how significantly the owner participates in the activity, also known as "material participation". There is an exception to this rule for qualifying "real estate professionals" (REP). If one qualifies as a REP, the losses from rental real estate activities are not subject to the passive loss rules, and are therefore deductible in the year of loss. There are two tests the one must pass in order to qualify as a REP:

1. The individual must perform more than 750 hours of services in real property trades or businesses in which they materially participate.
2. More than 1/2 of the personal services performed by the individual during the year in trades or businesses are performed in real property trades or businesses in which they materially participate.

The trust in the Tax Court case under discussion contended that it qualified as a REP, and deducted its real estate losses in full. However, the IRS disagreed, arguing that a trust can't perform personal services, unlike an individual. This would not enable the trust to meet the second requirement above. Also, the IRS felt that only a trustee's activities should count, but not if they were acting in the capacity as an employee. The Tax Court disagreed on both of these issues, and sided with the taxpayer.

Since the passive loss rules were implemented in 1986, there has never been direction as to whether or not trusts that have invested in real estate activities were considered to be passive or nonpassive investors. This case has created a set of guidelines to follow. This case was also timely as it relates to the new 3.8% net investment income tax. State income taxes also figure into the equation, since if a loss is nonpassive and therefore deductible, it is likely that the loss is deductible for state income tax purposes as well. The highest federal and state tax rates total approximately 60% (including the net investment income tax and the net effect of the itemized deduction and personal exemption phaseouts) which make this a critical issue for trusts that invest in real estate.