



# Net Investment Income Tax & Material Participation

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# What is the Net Investment Income Tax?

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- NIIT is an additional 3.8% tax imposed on certain Net Investment Income of individuals, estates, and trusts with income above statutory threshold amounts.
- Effective with first tax year beginning on or after January 1, 2013.

# Application to Trusts and Estates

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- General rule:
- Subject to the tax if they have undistributed NII, and MAGI over the dollar amount at which the highest tax bracket begins for each taxable year
- Threshold is updated each year by the IRS
- 2013 threshold is \$11,950
- 2014 threshold is \$12,150

# Trust and Estate MAGI

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- MAGI is computed as with an individual with the following additional deductions:
- Personal exemption
- Certain distributions to beneficiaries
- Costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in the estate or trust

# Trust Material Participation

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- Material participation requirements under IRC Section 469 apply to the 3.8 percent surtax under IRC Section 1411.
- IRC Section 469(h)(1) defines material participation as participation that is regular, continuous and substantial.
- Regulations have never been issued defining material participation for estates and trusts.

# *Mattie K. Carter Trust v. United States*

- District Court decision that allowed the trust to count the participation of the employees in the business as well as the activities of the trustee, to determine material participation.
- IRS position that only the participation of the trustee should be viewed for the determination of material participation.
- *The Mattie K. Carter Trust v. United States, 2003-1 U.S.T.C. (N.D. Tex. 2003)*

# Technical Advice Memorandum 201317010

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- Trust owned stock of S corporation in which trustee did not participate in the day-to-day operations of the business.
- In addition to trustee, the trust had a “special trustee” that had limited authority to sell and vote the company stock. Special trustee was also the president of a QSSS of the S corporation.

# Technical Advice Memorandum 201317010 (continued)

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- IRS concluded that the trust did not materially participate in the activities of the company for purposes of IRC Section 469.

# *Frank Aragona Trust v. Commissioner*

- Although the passive activity law was enacted in 1986 and has always applied to trusts, there has never been regulatory guidance on how to determine whether a trust is passive in a business.
- On March 27, 2014, the Tax Court issued an opinion in *Frank Aragona Trust v. Commissioner* that offers some guidance of the issues involved with determining whether a trust is passive.
- *Frank Aragona Trust v. Commissioner, T.C., No. 5392-11, 142 T.C. No. 9, 3/27/14*

# *Frank Aragona Trust v. Commissioner* (continued)

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- The Aragona Trust's position:
  - Met requirements for “real estate professional” exception
- IRS position:
  - Did not meet these requirements for two reasons:
    - By definition a “trust” could not perform “personal services;” only an individual can. (*Tax Court rejected*)
    - **The activities of a trustee can only “count” if performed in the “capacity” as trustee.**

# *Frank Aragona Trust v. Commissioner (continued)*

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- Tax Court Holding
  - When determining whether a trustee “materially participates” in an activity, the trustee’s activities performed in other capacities do indeed count.
  - This conclusion was derived from state fiduciary law.
- Therefore, whether or not a trust’s income from a business is subject to 3.8% surtax depends on whether or not the trust is passive.
- This suggests that if a trust own an interest in a closely-held business, it’s important to consider naming family members as co-Trustees.

# Thank You

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Questions?