



# The Financial and Estate Planning Council of Metropolitan Detroit, Inc.

August 2014

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## President's Message

It is hard to believe the summer is almost gone!! I want to thank all of the golfers, tennis players and diners; the members of the committee especially, Brad Kreiner and Bernie Kent; and our wonderful speaker, Tom Kendziorski of The Arc, for making our Spring Charity Event a rousing success. If you missed the event, you missed a glorious spring day.

We are looking for member - written articles for our quarterly newsletter on council-related subjects. The articles may be up to "2" pages long and will be reviewed and edited, if necessary, by our Newsletter committee prior to publication. Submissions may be sent to the Council office.

You won't want to miss our upcoming Spouses' Night event on September 23rd. It will be held at the DIA and will feature an address from Graham W. J. Beal, the DIA director, on "What's New at the DIA" and a tour of the American, Cracchiolo, and Modern and Impressionist Galleries. We are cosponsoring this event with the Planned Giving Roundtable. Space is limited so register early.

The National Association of Estate Planning Councils is holding their 51st Annual Conference from November 5-7, 2014 in San Antonio, Texas. As you may have noticed in the last newsletter, the theme is a multi-disciplinary approach to Estate Planning. The Board members who have attended in the past highly recommend this conference. It is open to all members; if you are interested, please call our Executive Director, Kris Wolfe for a brochure.

Prior to our annual dinner and election meeting on November 18th at the Inn of St. John's in Plymouth, we will feature a CPE event with Boston's Natalie Choate, the IRA guru. Mark your calendars for an informative session.

The Council is looking for new members to serve on the Board. If you have an interest, to paraphrase Uncle Sam, we need you, particularly if you have an insurance or financial planning background. The Board is made up of all disciplines, and we are currently short on these categories. Please call me or any Board member to find out more or to volunteer your services. The terms are two years.

I wish you a wonderful end to your summer and look forward to seeing you on September 23rd.

*Teresa Schafer Sullivan, President* ✦

## Material Participation of Trusts

*Shawn A. Strand, JD*

In *Frank Aragona Trust v. Commissioner*, the U.S. Tax Court held that a trust is eligible to qualify as a real estate professional for purposes of the passive activity exception under Section 469(c)(7) of the Internal Revenue Code of 1986, as amended (the "Code") and such trust can materially participate in an activity through the performance of services by its trustees that perform activities as employees of the trust's wholly-owned limited liability company ("LLC"). The Tax Court's decision was a great win for the taxpayer, but most practitioners were left wishing the Tax Court had provided more definitive guidance on how a trust can materially participate in an activity. This is especially true given the enactment of Code Section 1411 whereas of the beginning of 2013, certain taxpayers, including trusts, are generally subject to a 3.8% net investment income tax on passive income.

The Frank Aragona Trust (the "Trust") was formed in 1979 by Frank Aragona. Frank Aragona was the trustee and his five children were the beneficiaries. Upon Frank Aragona's death in 1981, the five children became trustees of the Trust, along with one additional independent trustee.

The Trust owned and managed several rental real estate

### WELCOME TO OUR NEW MEMBERS

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properties, with three of the five children-trustees taking an active role in the business of the Trust. In 1999, the Trust formed the LLC to manage the various rental real estate properties in which the Trust owned an interest, and hired numerous, unrelated individuals to do so. In addition, the LLC began to compensate the three trustees for working full-time in connection with such rental real estate properties.

The passive loss rules in Code Section 469 prevent losses from passive activities, to the extent that they exceed the income from all passive activities, from being deducted from other income. In general, the term “passive activity” includes any rental activity. However, Code Section 469(c)(7)(B) provides a so-called “real estate professional” exception if a taxpayer can meet both of the following tests: (i) More than one-half of the personal services performed in trades or businesses by the taxpayer are performed in real property trades or businesses; and (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. Thus, to qualify as a “real estate professional,” a taxpayer must perform a certain quantum of “personal services” in real estate trades or businesses in which the taxpayer “materially participates.”

In 2005 and 2006, the Trust incurred losses with respect to its rental real estate activities and determined that it qualified as a real estate professional under Code Section 469(c)(7)(B). The IRS, however, asserted that the Trust’s activities were passive based on its position that a trust cannot perform “personal services” as required to qualify as a “real estate professional.” Alternatively, the IRS asserted that even if the Trust could perform personal services for purposes of Code Section 469(c)(7)(B), only activities of the trustees in their capacity as trustees could be counted towards the material participation requirement, not activities of trustees as employees of the LLC.

There are no regulations addressing the material participation requirements for trusts. Treasury Regulation Section 1.469-8, captioned “Application of section 469 to trust, estates and their beneficiaries,” is reserved. Likewise, Treasury Regulation Section 1.465-5T(a), captioned “Material participation of trusts and estates,” is reserved. Absent statutory and regulatory guidance, the general “regular, continuous, and substantial” test under Code Section 469(h) is the sole standard for determining whether a trust satisfies the material participation requirements of Code Section 469.

In *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Tex. 2003), the U.S. District Court for the Northern Dis-

trict of Texas held that a trust materially participated in an activity through work performed in the activity not only by the trustee, but also the trust’s other agents and employees. Despite *Mattie K. Carter*, the IRS continued to assert that a trust materially participates in an activity only if its fiduciaries, in their capacity as such, are involved in the operations of the trust on a regular, continuous, and substantial basis. See, e.g., Technical Advice Memorandums 200733023 and 201317010.

In *Frank Aragona Trust*, the IRS focused on the activities of the trustees acting in their capacity as fiduciaries, for purposes of Code Section 469. The IRS noted that a trustee’s duties are performed on behalf of and for the benefit of the trust’s beneficial owners. Therefore, the IRS stated that, in cases where a trust is the owner of an interest in a trade or business, it was appropriate to look only to the work performed in the trustee’s capacity as a fiduciary in furtherance of the trust’s purposes. Although the IRS did not dispute that three trustees of the Trust may have worked the requisite number of hours in the Trust’s real property trades or businesses and rental real estate activities, it argued that those hours could not be counted because such work was performed by the three trustees as employees of the LLC and not as fiduciaries of the Trust.

The Trust successfully argued that because the three trustees were fiduciaries of the Trust, they necessarily performed all work on the Trust’s properties in a fiduciary capacity. That is, all of their services, including any performed for or through or compensated by the LLC, were required to be performed in the best interest of the Trust and its beneficiaries and were otherwise subject to the fiduciary standards of conduct generally applicable to trustees.

The Michigan Supreme Court long ago held that trustees who also work for a subsidiary of the trust must act for the subsidiary at all times in a manner consistent with their fiduciary duties to the trust. In *Estate of Walter S. Butterfield*, 418 Mich. 241, 341 N.W. 2d 453 (1983), the Michigan Supreme Court held that “[t]rustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy.” In fact, the court in *Butterfield* went so far as to say that “where a corporation is wholly owned by the trust and directly holds and controls all of the corporation’s assets, courts are less reluctant to ignore the corporate entity and to consider the corporation...an adjunct of the trust.”



51st Annual Conference

November 5 - 7, 2014

Marriott Rivercenter



## "THE MULTI-DISCIPLINARY APPROACH TO ESTATE PLANNING"

Complete Details Available At:

[http://www.naepc.org/assets/national/files/51st%20Annual%20Conference%20Early%20Bird%20Brochure\(1\).pdf](http://www.naepc.org/assets/national/files/51st%20Annual%20Conference%20Early%20Bird%20Brochure(1).pdf)



### The Robert G. Alexander Webinar Series Offered by NAEPC

#### Continuing Education Credit

Continuing education credit will be available at each webinar for Accredited Estate Planner® designees. In addition, a certificate of completion will be made available for those professionals that feel the program satisfies their continuing education requirements and are able to self-file. Councils may also file the program in their home state for programs offered in a group setting.

#### Registration Fees

- \$40 / Accredited Estate Planner® designee (dues must be current at the time of registration)
- \$60 / member of an affiliated local estate planning council or at-large member of NAEPC
- \$100 / individual non-member
- \$250 / council meeting or group gathering (council dues must be current at the time of registration)

#### Upcoming Programs

**September 10, 2014 · 3:00 pm - 4:00 pm ET**

**In-home, Private-duty Care is on the Rise: Understanding the Impact of New Legislation and How to Help Clients with Employment Risks & Responsibilities**  
Tom Breedlove of CARE.com

This sponsored webinar is available at no-charge to NAEPC members! To Register:  
<https://secure.confertel.net/tsregister.asp?course=584222>

**September 17, 2014 · 1:00 pm – 3:00 pm ET**

**Estate Planning Law Specialist Exam Live Review Course**  
Randy Gardner, JD, LL.M., MBA, CPA, CFP®

Please contact Susan Austin-Carney, Estate Law Specialist Board Program Administrator, for more information about this program. Susan can be reached at 866-226-2224 or [susan@naepc.org](mailto:susan@naepc.org).

#### Pre-conference Sneak Peek!

**October 15, 2014 (please note special date) · 3:00 pm - 4:00 pm ET**  
**Increasing Client Receptivity from The Right Side of the Table**  
Todd Fithian

To Register: <https://secure.confertel.net/tsregister.asp?course=584224>

**December 10, 2014 · 3:00 pm - 4:00 pm ET**

**Avoiding the Twilight Zone of Estate Administration**  
M. Holly Isdale, JD

To Register: <https://secure.confertel.net/tsregister.asp?course=584225>

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Michigan statutory law adopted the principle of *Butterfield*. MCL 700.7802(6) provides in part: “If the trust is the sole owner of a corporation or other form of enterprise, the trustee shall elect or appoint directors or other managers to manage the corporation or enterprise in the best interests of the trust beneficiaries.” In commenting on MCL 700.7802(6), the Reporter for the Michigan Trust Code stated: “It requires trustees to vote stock in the interests of the beneficiaries. It also requires trustees owning all of the stock of an enterprise to look through the enterprise structure for their duties to manage the enterprise in the interests of the beneficiary. The trustee cannot use the corporate form, and the formulations of duties as a director or officer, to change its fundamental duties to the trust beneficiaries.” Estate and Protect Individuals Code (EPIC) with Reporters’ Commentary, 436 (2010). These principles apply with equal force to a trust’s ownership of all of the interests in an LLC. See George F. Bearup, “Business Relationships Under the Michigan Trust Code,” Michigan Bar Journal 32, 33 (May 2010) (“When a trustee...exercises any power of control over ... LLC units, the trustee must always act ‘in the best interests of the trust beneficiaries.’”).

While mere employees may owe certain duties under Michigan law, those duties are substantially lower than the fiduciary duties owed by trustees. See, e.g., *Torok v. Reliable Architectural Metals*, 1997 Mich. App. Lexis 1326 (“The duty owed by a trustee to beneficiary... and by a doctor to patient are examples of a fiduciary duty....However, there is no support for [the] argument that a fiduciary duty exists between a sole shareholder and the employee of a corporation”). None of the three trustees performing services for the Trust in *Frank Aragona Trust* regarded himself or herself as a mere employee who, as such, could behave with less punctiliousness than a fiduciary. This understanding comported with the legal obligations under which the three of them labored, as set forth in *Butterfield* and Michigan statutory law.

The Tax Court agreed with the Trust’s position in *Frank Aragona Trust*, stating that “[t]he trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary.” Therefore, the Tax Court held that, in considering the activities of the trustees in their roles as trustees and as employees of the LLC, the Trust materially participated in its real estate operations. The Tax Court stated in a footnote that it did not need to decide whether the activities of the Trust’s non-trustee

employees would count towards the material participation requirement.

### Conclusion

The Tax Court’s holding in *Frank Aragona Trust* is important for trusts seeking to qualify for the real estate professional exception under Code Section 469(c)(7). Further, the case provides much needed guidance on material participation by trusts by affirming that activities of trustees can be counted even when the trustee is also an employee of an entity through which the trust conducts its business activities. This is relevant not only for the passive activity rules, but also for the application of the 3.8% net investment income tax to trusts.

Most practitioners would have liked the Tax Court in *Frank Aragona Trust* to have gone even further, by affirming the Texas District Court’s holding in *Mattie K. Carter* that the activities of non-trustee employees of a trust can be counted for purposes of determining material participation. Regardless, the Tax Court’s holding that activities of trust’s trustee-employees count for purposes of determining material participation of the trust still provides potential planning opportunities for trusts.

The IRS has not indicated whether it will appeal the Tax Court’s decision in *Frank Aragona Trust*. Recently, Adrienne Mikolashek, Branch 2 attorney, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), noted that the IRS is still considering whether to undertake a regulation project under Code Section 469 to provide guidance on what constitutes material participation by a trust or estate. Until such additional guidance is available, taxpayers are left with *Frank Aragona Trust*, *Mattie K. Carter*, and the general material participation definition of “regular, continuous, and substantial” under Code Section 469(h).

*Mr. Strand is a tax attorney with extensive experience advising clients regarding corporate and partnership taxation, mergers and acquisitions, tax-exempt entities, individual tax collection matters and taxation of captive insurance companies.*

*This article is intended for general information purposes only and is not intended to provide, and should not be used in lieu of, professional advice. The publisher assumes no liability for readers’ use of the information herein and readers are encouraged to seek professional assistance with regard to specific matters. Any conclusions or opinions are based on the individual facts and circumstances of a particular matter and therefore may not apply in other matters. All opinions expressed in these articles are those of the authors and do not necessarily reflect the views of The Financial and Estate Planning Council of Metropolitan Detroit.*

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