April 5, 2013

Mr. Steven T. Miller  
Acting Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20024

Re: Comments Concerning Proposed Treasury Regulations under Section 1411

Dear Acting Commissioner Miller:

Enclosed are comments concerning proposed Treasury regulations under section 1411. These comments represent the view of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Rudolph R. Ramelli  
Chair, Section of Taxation

Enclosure

cc: Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury  
William J. Wilkins, Chief Counsel, Internal Revenue Service  
Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of Treasury  
David H. Kirk, Attorney, Office of Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service
ABA SECTION OF TAXATION
COMMENTS CONCERNING PROPOSED
TREASURY REGULATIONS UNDER SECTION 1411

These comments (“Comments”) are submitted on behalf of the ABA Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by William D. Klein, C. Wells Hall III, Laura D. Howell-Smith, and Thomas J. Nichols of the Committee on S Corporations; Jeanne Sullivan, Timothy J. Leska, and Bryan Rimmke of the Committee on Partnerships and LLCs; Robert D. Schachat and Todd A. Keating of the Committee on Real Estate; Lewis J. Saret and David A. Berek of the Committee on Fiduciary Income Tax; David L. Rice, Jonathan E. Strauss and Elizabeth Nelson of the Committee on Individual and Family Taxation; Andrew L. Oringer, Elizabeth E. Drigotas, and Kathryn J. Kennedy of the Committee on Employee Benefits; and Jason Yen and Richard C. Williams of the Committee on Foreign Activities of U.S. Taxpayers. These Comments were reviewed by Bahar A. Schippel of the Section’s Committee on Government Submissions and by W. Curtis Elliott, Jr., Council Director for the Committee on S Corporations; Eric B. Sloan, Council Director for the Committee on Partnerships and LLCs and the Committee on Real Estate; Mary Ann Mancini, Council Director for the Committee on Fiduciary Income Tax; Fred F. Murray, Council Director for the Committee on Individual and Family Taxation; Pamela Baker, Council Director for the Committee on Employee Benefits; and Brian P. Trauman, Council Director for the Committee on Foreign Activities of U.S. Taxpayers.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal income tax principles addressed by these Comments, or have advised clients on the application of such rules, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: April 5, 2013
EXECUTIVE SUMMARY

The following Comments are submitted in response to the request for comments made by the Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) in Notice of Proposed Rulemaking dated December 5, 2012, regarding Proposed Treasury Regulation section 1.469-11 and Proposed Regulation sections 1.1411-0 through 1.1411-101 (the “Proposed Regulations”) issued under section 1411 of the Internal Revenue Code of 1986, as amended (the “Code”). The Treasury and the Service requested taxpayer comments by March 5, 2013. A public hearing has been scheduled for Tuesday, April 2, 2013, beginning at 10:00 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington D.C.

We want to express our appreciation to the Treasury and the Service for their guidance on a number of difficult issues under section 1411 and the invitation for taxpayer comments on many specific issues. In many cases, we agree with the positions taken in the Proposed Regulations. The following is a summary of our Comments on the specific issues on which comments were invited, and other areas where we believe that comments are appropriate.

I. Comments on Proposed Regulation Section 1.469-11(b)(3)(iv) - Grouping for Taxpayers Subject to Section 1411

A. Grouping of Rental Activities with Trade or Business Activities for Purposes of Section 469 and Section 1411

We agree with the approach of the Service generally in incorporating the rules of section 469 for purposes of section 1411. We recommend that the final Regulations be clarified to provide that if a rental activity is insubstantial in relation to a trade or business activity (under the rules of Regulation section 1.469-4(d)(1)), then section 1411 should be applied with respect to the grouped activity (including the rental activity) as a whole for all purposes under section 1411.

B. Regrouping Election under Proposed Regulation Section 1.469-11

We recommend two changes to the regrouping election rules: (i) S corporations and partnerships be permitted to change their groupings in light of the application of section 1411 for any tax year that begins during 2013 or 2014, and (ii) all taxpayers, regardless of whether they have net interest income (“NII”) or modified adjusted gross income (“MAGI”) above the threshold, be permitted a “fresh start” in terms of section 469 groupings in light of the application of section 1411 for any tax year that begins during 2013 or 2014.

2 References to a “section” in the text of these Comments are to a section of the Code, unless otherwise indicated.
II. Comments on Proposed Regulation Section 1.1411-2 - Application to Individuals

A. Consideration of Losses Triggered under Section 469(g)(1) in Computing NII upon the Disposition of an Entire Interest in a Passive Activity

We recommend that the final Regulations treat section 469(g) losses triggered upon the disposition of an entire interest in a passive activity to be properly allocable deductions against gross income and net gain described in section 1411(c)(1)(A)(i) through (iii).

III. Comments on Proposed Regulation Section 1.1411-3 - Application to Estates and Trusts

A. Application of Section 1411 to Cemetery Perpetual Care Fund Trusts

We recommend no change to the Proposed Regulations.

B. Application of Section 1411 to Alaska Native Settlement Trusts

We recommend that the final Regulations permit Alaska Native Settlement Trusts to elect under section 646 to be treated as individuals, rather than as trusts, for purposes of section 1411.

C. Application of Section 1411 to Qualified Funeral Trusts

We recommend no change to the Proposed Regulations

D. Application of Section 1411 to Pooled Income Funds

We recommend that the final Regulations expressly provide that the charitable set-aside deduction that is available for a pooled income fund’s long-term capital gains for income tax purposes will reduce a pooled income fund’s NII.

E. Application of Section 1411 to Unexpired Interests in Trusts and Estates Devoted to Charitable Purposes

We recommend that the final Regulations add a new paragraph (3) of section 1.1411-3(d) to provide that the tax imposed by section 1411 (the “NII Tax”) does not apply to an estate, where all unexpired interests in the estate are devoted to one or more of the purposes described in section 170(c)(2)(B).

F. Application of Section 1411 to Distributions from Charitable Remainder Trusts

We recommend that the final Regulations provide the trustees of charitable remainder trusts (“CRTs”) with an election to use an alternative method by which the amount of distributed NII would be determined on a class-by-class basis within each tier described in Regulation section 1.664-1(d)(1).
G. Application of Section 1411 to Foreign Estates and Trusts with U.S. Beneficiaries

We recommend that the final Regulations provide that section 1411 not be applied to a foreign estate or a foreign trust but rather to U.S. beneficiaries upon receipt of a distribution from a foreign estate or from a foreign trust.

H. Accumulation Distributions from Foreign Estates and Trusts to U.S. Persons

We recommend that the final Regulations provide that undistributed net investment income (“UNII”) of a foreign estate or trust be tracked and treated in a manner similar to undistributed net income within the meaning of section 665(a) (“UNI”), provided that 1411 not apply to income accumulated before 2013.

Under our recommendation, the throwback rules would also apply to UNII. The trustee would supply information identifying any UNII that was distributed to the beneficiary in a manner similar to the identification of UNI. To the extent the beneficiary does not receive sufficient information under section 6048, we recommend that the final Regulations provide that the beneficiary can elect the “default” method permitted under chapter 1.

I. Application of Material Participation Rules to Trusts and Trustees

Because of the uncertainty of current law under chapter 1, we recommend that the Service issue guidance regarding material participation for a trust or estate for purposes of section 1411. We recommend that this guidance be issued as a new proposed regulation package rather than including these rules in these final Regulations.

J. Treatment of Disposition of Stock in an S Corporation by a Qualified Subchapter S Trust (“QSST”) as a Disposition by the Income Beneficiary for Purposes of Determining Material Participation

We recommend that the final Regulations clarify that when a QSST disposes of S corporation stock, the disposition will be treated as a disposition of the S corporation stock by the income beneficiary for purposes of determining material participation under sections 469 (and presumably section 465).

K. Clarification of the Application of Section 1411 upon the Disposition by an ESBT of Stock in an S Corporation on the Installment Basis Under Regulation Section 1.641(c)-1(d)(3) and Regulation Section 1.1361-1(j)(8)

We recommend that the final Regulations clarify that when an electing small business trust (“ESBT”) disposes of S corporation stock, the rules under Regulation sections 1.641(c)-1(d)(3) and 1.1361-1(m)(5)(ii) apply for purposes of section 1411 and permit the use of the installment method upon the sale or disposition of stock in an S corporation by an ESBT in determining the NII Tax.
Comments on Proposed Regulation Section 1.1411-4 – Definition of NII

A. Allowance of all Chapter 1 Deductions Attributable to Section 1411(c)(1)(A) Income as Properly Allocable Deductions

We recommend that the final Regulations provide that the properly allocable deductions that may be taken into account in determining NII include all of the chapter 1 deductions that are allowed against chapter 1 gross income from rent, dividends, royalties, annuities and interest, other gross income derived from a trade or business and net gains attributable to the disposition of property other than property held in a trade or business. Total NII may not be reduced below zero, however.

B. Allowance of Deduction of Section 165 Losses Incurred in the Trade or Business of Trading Financial Instruments or Commodities for Purposes of Section 1411

We recommend that the final Regulations explicitly allow section 165 losses from the business of trading in financial instruments and commodities (the “trading business”) to be included as properly allocable deductions of a trading business under section 1411(c)(1)(A)(ii).

C. NOL Deductions for Purposes of Section 1411

We believe that it is an appropriate policy choice to exclude NOLs in the determination of NII, due to the unduly complex and administratively difficult regulations that would be required to allocate an NOL to items of gross income or net gain subject to section 1411.

We further agree with the Proposed Regulations that to the extent a taxpayer has certain loss carryforwards that are tracked separately from NOLs deductible under section 172, such as a carryforward of investment interest under section 163(d), a suspended passive activity loss that is allowed in a later year under section 469(b), or a capital loss carryforward under section 1212, those losses may be taken into account in determining NII in the tax year in which they are taken into account in determining adjusted gross income (“AGI”). Finally, we agree that the NOLs deductible under section 172 should continue to be taken into account in determining a taxpayer’s MAGI.

D. Application of Section 1411 to Gain Not Recognized Under Chapter 1; Properly Allocable Deductions

We recommend no change to these provisions of the Proposed Regulations.

E. Calculation of Itemized Deductions Properly Allocable to NII

We recommend that the final Regulations provide that all deductions properly allocable to NII, including those for state and local income tax, be taken into account in calculating the NII Tax. The limitations of sections 67 and 68 should be applied to reduce the amount of these deductions for purposes of section 1411 only to the extent that the aggregate amount of deductions allowed in a specific category affected by the limitations under section 67 or the
aggregate amount of all itemized deductions allowed under section 68 is less than the aggregate amount of NII deductions allowed in that category or of all NII deductions, respectively.

V. Comments on Proposed Regulation Section 1.1411-5 – Trades or Businesses to Which Tax Applies

A. Section 162 Trade or Business Standard for Rental Real Estate Activities--The Real Estate Professional

We recommend that the Service consider one of the two following alternatives: (a) the final Regulations provide that, if a real estate professional materially participates in his or her rental real estate activities, that taxpayer’s rental income is not treated as NII; or (b) the final Regulations include additional examples to illustrate situations that do and do not rise to the level of a rental real estate trade or business for purposes of section 1411.

B. Treatment of Recharacterized Income and Gain as Subject to Section 1411

We recommend that the final Regulations clarify that determining whether income is NII shall be based on its recharacterized status as non-passive under section 469 and the Regulations thereunder, and the rule should be clarified in the final Regulations.

C. Treatment of Guaranteed Payments for the Use of Capital as a Distributive Share of Partnership Income for Purposes of Section 1411

We recommend that the final Regulations provide clear rules governing the treatment of income from guaranteed payments to a partner for the use of capital by a partnership. We suggest the application of a two-step process: (a) the character of guaranteed payment income would be determined based upon the income and activities of the payor partnership, and (b) once the guaranteed payment income has been so characterized, such income would only constitute NII to the extent that it constitutes Category 1, 2 or 3 income (as determined at the partner level).

VI. Comments on Proposed Regulation Section 1.1411-6 – Income on Investment of Working Capital Subject to Tax

A. Treatment of Gain Attributable to Working Capital Consisting of Cash and Other Liquid Assets

We recommend that the final Regulations provide that highly liquid assets, such as cash, Treasury Bills, Treasury Notes, certificates of deposit, assets subject to repurchase agreements and other short-term debt instruments with maturities of less than one year, are presumed to not have appreciated or depreciated in value, and are excluded from the computations necessary to determine the “asset sale gain” component of the section 1411(c)(4) calculation.
VII. Comments on Proposed Regulation Section 1.1411-7 – Exception for Dispositions of Interests in Partnerships and S Corporations

A. Application of Section 1411(c)(4) to the Disposition of an Interest in a Partnership or S Corporation–General Comments

We recommend that the final Regulations be revised to conform to the statutory language of section 1411(c)(4) so as to include gain from the disposition of a partnership interest or S corporation stock as NII “only to the extent of” the net gain that would be taken into account as NII by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition.

B. Application of Section 1411(c)(4) to the Disposition of an Interest in a Partnership or S Corporation–Computational Issues

We recommend that neither the S corporation/partnership entity nor the individual partner/S corporation shareholder owner be required to report the detailed information set forth in items (3) through (6) of Proposed Regulation section 1.1411-7(d) on their income tax returns, including the fair market value, adjusted basis, and the transferor’s allocable share of gain or loss with respect to each property of the entity, and information regarding whether each property was held in (or attributable to) a trade or business not described in Proposed Regulation section 1.1411-5.

We recommend instead that the final Regulations require the entity to report a single asset sale gain figure for each of its trades or businesses (or a single asset sale gain figure if there is only one trade or business, or if all trades or businesses of the entity are treated similarly for purposes of section 1411) on the K-1 for the individual owner disposing of his or her interest (if relevant for computation of the NII Tax).

C. Application of Section 1411(c)(4) to Sales of Interests in Tiered Entities

We recommend that, in the case of a sale of an interest in a top-tier S corporation or partnership, the final Regulations clarify that, in order to calculate the asset sale gain component under section 1411(c)(4), gain must be determined on the basis that the top-tier S corporation or partnership, as well as each passthrough partnership entity in which it holds a direct or indirect passthrough interest, engages in a hypothetical asset sale transaction.

Similarly, in the case of a sale of an interest in a lower-tier entity, we recommend that the final Regulations clarify that gain should be determined under section 1411(c)(4) on the basis of the hypothetical sale of the assets of the lower-tier entity and of each of the lower-tier partnership entities in which it holds a direct or indirect passthrough interest.

We further recommend that a top tier S corporation or partnership entity be allowed, at its option, to calculate the asset sale gain component under section 1411(c)(4) with respect to minority interests in a lower-tier partnership below a certain threshold, such as 10% to 20%, on the basis of the hypothetical sale of the interest in the lower-tier passthrough entity itself, rather than having to engage in the potentially laborious and difficult task of trying to calculate asset sale gain on the basis of the hypothetical sale of all of the assets of the lower-tier partnership.
entity where the top-tier entity may not have sufficient information or influence to cause that calculation to be properly performed. The foregoing election should not be applicable if the assets of the lower-tier partnership are actually sold as part of the transaction triggering section 1411 and the proceeds distributed to the top-tier entity.

D. **Application of Section 1411(c)(4) to the Disposition of an Interest in a Partnership or S Corporation—Allocation of Goodwill Value**

We recommend that the final Regulations eliminate the special rule in the Proposed Regulations that requires goodwill to be allocated among trades or businesses on the basis of the relative fair market value of the other property held in each trade or business (i.e., other than cash and the goodwill itself). Instead, we recommend the final Regulations provide for the allocation of the value of goodwill among separate trades or businesses based on fair market value of such goodwill, in the same manner as other assets.

E. **Treatment under Section 1411 of Section 731 and Section 1368 Gain Resulting from a Distribution of Property or Money from a Partnership or S Corporation**

We recommend that the final Regulations adopt certain rebuttable presumptions with respect to gain resulting from a distribution from a partnership or an S corporation. In the event that the entity is engaged in the trading business or other investment activities, or is engaged in another trade or business which is a passive activity with respect to the S corporation shareholder or partner receiving the distribution, then the gain associated with such distribution would be presumed to be subject to the NII tax. This presumption should be rebuttable by a statement attached to the taxpayer’s income tax return for the year in question that explains why all or a portion of the gain is not NII, accompanied by information that supports the representation, as described below. However, if the entity is not engaged in any trading business or other investment activities and the recipient S corporation shareholder or partner is active in all of the trades or businesses in which the entity is engaged, then such gain would be presumed to be exempt from tax.

VIII. **Comments on Proposed Regulation Section 1.1411-8 – Exception for Distributions from Qualified Plans**

A. **Application of Section 1411 to a Distribution by a Tax-Qualified Plan of Employer Securities That Include Net Unrealized Appreciation That is Not Taxable to the Participant for Purposes of Chapter 1**

We recommend that the final Regulations address the application of section 1411 to the subsequent disposition of employer securities distributed from a tax-qualified plan where the distribution involves net unrealized appreciation (“NUA”) in the employer securities, as well as the treatment of dividends payable with respect to such securities post-distribution, by providing that: (i) section 1411 does not apply to the NUA on the subsequent disposition of the securities, as this amount is part of the distribution from the qualified plan; and (ii) section 1411 does apply to any post-distribution appreciation in the value of the securities and to any post-distribution dividends on such shares.
IX. **Comments on Proposed Regulation Section 1.1411-9 – Exception for Self-employment Income**

We have no comments at this time.

X. **Comments on Proposed Regulation Section 1.1411-10 – Controlled Foreign Corporations and Passive Foreign Investment Companies**

A. **Treatment of Income Inclusions from CFCs and PFICs as NII**

We recommend that the final Regulations eliminate the elective regime and treat subpart F and section 1293 inclusions as dividends for section 1411 purposes. In the alternative, we recommend that the final Regulations adopt a lookthrough approach whereby U.S. shareholders or qualified electing fund (“QEF”) shareholders determine whether section 1411 applies to subpart F or section 1293 inclusions as if the taxpayers earned the income directly.

B. **Application of Portfolio Income Rule under Regulation Section 1.469-2T(c)(3) to Subpart F Inclusions for Purposes of Section 1411**

We recommend that the final Regulations clarify whether the portfolio income rules under Temporary Regulation section 1.469-2T(c)(ii) apply for purposes of Proposed Regulation section 1.1411-10(b). To the extent that a taxpayer has subpart F or section 1293 inclusions as part of a passive activity, we recommend that income should be included as Category 2 NII and not subject to paragraphs (c) through (g) of Proposed Regulation section 1.1411-10, in spite of the portfolio income exception.

C. **Ability to Make Election under Proposed Regulation Section 1.1411-10(g) on an Amended Return**

We recommend that the final Regulations clarify that a taxpayer is permitted to make an election under Proposed Regulation section 1.1411-10(g) (a “10(g) Election”) on its original or an amended return for the first taxable year beginning after December 13, 2013, during which the taxpayer holds stock of a controlled foreign corporation (“CFC”) or QEF and the taxpayer is subject to tax under section 1411.

D. **Ability to File Protective Election under Proposed Regulation Section 1.1411-10(g)**

We recommend that the final Regulations permit taxpayers who reasonably believe they are not subject to tax under section 1411, or would not be subject to such tax in a taxable year had they made a 10(g) Election, to file a protective 10(g) Election preserving their right to treatment under Proposed Regulation section 1.1411-10(g) if it is later determined that they were (or would have been) subject to tax under section 1411 in such taxable year.
E. **Section 743 Basis Adjustments Where Partnership Holds Stock of CFC or PFIC**

If the final Regulations retain the rule that provides that a holder has a different basis for income tax and NII Tax purposes, we recommend that: (i) any rules regarding adjustments to basis under section 743 for purposes of section 1411 provide that the basis adjustment is solely for purpose of the transferee partner and that the basis adjustment is the same for both sections 743 and 1411; (ii) although section 743 permits adjustments to basis only if a section 754 election is in effect or there is a substantial built-in loss, consideration be given to permitting transferee partners to adjust the basis of partnership property for purposes of section 1411, notwithstanding that these conditions may not be satisfied; and (iii) in light of the foregoing and the uncertainty of current law under chapter 1, the Service should issue guidance regarding basis adjustments for purposes of section 1411 as a new Proposed Regulation package rather than including the rules in these final Regulations.
BACKGROUND

Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 (the “2010 Health Care Act” or the “Act”\(^3\)) added section 1411 as new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012. Chapter 2A imposes a new tax on unearned income, including income passed-through to partners, members of LLCs taxed as partnerships, and S corporation shareholders. Specifically, section 1411(a)(1) imposes a 3.8% tax on the lesser of: (a) NII, or (b) the excess of MAGI\(^4\) over $250,000 in the case of married taxpayers filing a joint return, $125,000 for married taxpayers filing a separate return, and $200,000 for all other taxpayers.

NII is defined as the sum of: (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in section 1411(c)(2) (“Category 1”), (ii) other gross income derived from a trade or business described in section 1411(c)(2)\(^5\) (“Category 2”), and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in section 1411(c)(2) (“Category 3”), minus the deductions allowed by subtitle A (income taxes) which are properly allocable to such gross income or net gain.\(^6\) Items of interest, dividends, annuities, royalties, and rents which pass through a partnership, LLC or S corporation to its partners, members or shareholders will retain their character as NII and will be subject to the 3.8% NII Tax.

The Preamble to the Proposed Regulations (the “Preamble”) noted that the tax on NII is an income tax, not a “Medicare” tax, and “(a)mounts collected under section 1411 are not designated for the Medicare Trust Fund.” The new tax is subject to the estimated tax provisions, and is not deductible in computing any tax imposed by subtitle A of the Code.\(^7\)

The Proposed Regulations, by their terms, are to be effective for taxable years beginning after December 31, 2013, except that Proposed Regulation section 1.1411-3(c)(2) (special rules for CRTs) is proposed to apply to taxable years beginning after December 31, 2012. Although the Proposed Regulations are not law, taxpayers may rely on the Proposed Regulations for purposes of compliance with section 1411 until the effective date of the final Regulations.\(^8\)

To the extent the Proposed Regulations provide taxpayers with the ability to make an election, taxpayers may make the election, including regroupings described in Proposed Regulation section 1.469-11(b)(3)(iv), provided that the election is made in the manner described

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\(^3\) Pub. L. 111-152, 124 Stat. 1029.
\(^4\) MAGI is generally defined as adjusted gross income increased by the excess of: (1) the amount excluded from gross income under I.R.C. § 911(a)(1) (foreign source income of the taxpayer); over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under I.R.C. § 911(d)(6) (denial of double benefits) with respect to the amounts excluded from gross income under I.R.C. § 911(a)(1). Prop. Reg. § 1.1411-2(c), 77 Fed. Reg. 72,611, 72,635 (2012).
\(^5\) A trade or business described in I.R.C. § 1411(c)(2) is a trade or business that is a passive activity (within the meaning of I.R.C. § 469), or a trade or business of trading in financial instruments or commodities (as defined in I.R.C. § 475(e)(2)).
\(^6\) I.R.C. § 1411(c)(A)(i).
\(^7\) 77 Fed. Reg. 72,611, 72,612, 72,613 (2012), citing JCT 2011 Explanation, JCS-2-11, March 24, 2011, at 364.
\(^8\) 77 Fed. Reg. 72,611, 72,632 (2012).
in the applicable provision.\(^9\) Any election made in reliance on the Proposed Regulations will be in effect for the year of the election, and will remain in effect for subsequent taxable years. However, if final Regulations provide for the same or a similar election, taxpayers who opt not to make an election in reliance on the Proposed Regulations will not be precluded from making that election pursuant to the final Regulations.\(^{10}\)

The Preamble states that there is no indication in the legislative history of section 1411 that Congress intended, in every event, that a term used in section 1411 (chapter 2A of the Code) would have the same meaning ascribed to it for other Federal income tax purposes (such as chapter 1 of the Code).\(^{11}\) Accordingly, the definitional rules set forth in the Proposed Regulations are designed to promote the fair administration of section 1411 while preventing circumvention of the purposes of the statute.

However, under the Proposed Regulations, except as otherwise provided, chapter 1 principles and rules apply in determining the tax under section 1411.\(^{12}\) Consistent with this general approach, except as otherwise provided in the Proposed Regulations, gain that is not recognized under chapter 1 for a taxable year is not recognized for that year for purposes of section 1411 (for example, gain deferred or excluded under section 453 (installment method), section 1031 (like-kind exchanges), section 1033 (involuntary conversions), or section 121 (sale of principal residence)), \(^{13}\) and the deductions allowed by subtitle A that are properly allocable to gross income or net gain included in NII are taken into account.\(^{13}\)

Proposed Regulation section 1.1411-1(b) also provides generally that all references to an individual’s adjusted gross income shall be treated as references to adjusted gross income (as defined in section 62) and that all references to an estate’s or trust’s adjusted gross income shall be treated as references to adjusted gross income (as defined in section 67(e)) under chapter 1. As noted in the Preamble and as provided in Proposed Regulation section 1.1411-10, there may be adjustments to adjusted gross income as a result of investments in CFCs and passive foreign investment companies.

The Proposed Regulations further clarify that the deferral or disallowance provisions of chapter 1 used in determining AGI apply to the determination of NII (for example, section 163(d) (limitation on investment interest), section 265 (expenses and interest relating to tax-exempt income), section 465(a)(2) (at risk limitations), section 469(b) (passive activity loss limitations), section 704(d) (partner loss limitations), section 1212(b) (capital loss carryover limitations), or section 1366(d)(2) (S corporation shareholder loss limitations)).\(^{14}\)

Similarly, except as limited by the Proposed Regulations, deductions that are suspended or carried over under chapter 1 from a prior taxable year, for example, by reason of the

\(^{10}\) 77 Fed. Reg. 72,611, 72,632 (2012).
\(^{11}\) 77 Fed. Reg. 72,611, 72,613 (2012).
\(^{12}\) 77 Fed. Reg. 72,611, 72,613 (2012).
\(^{13}\) 77 Fed. Reg. 72,611, 72,613 (2012); Prop. Reg. § 1.1411-4(a)(1)(iii), 77 Fed. Reg. 72,611, 72,638 (2012) (NII includes “(n)et gain (to the extent taken into account in computing taxable income) attributable to the disposition of property . . .”).
limitations of section 163(d) (limitation on investment interest), section 465(a)(2) (at risk limitations), section 469(b) (passive activity loss limitations), section 704(d) (partner loss limitations), section 1212(b) (capital loss carryover limitations), or section 1366(d)(2) (S corporation shareholder loss limitations), and that are allowed for the current taxable year in determining adjusted gross income, are also allowed for the determination of NII. This result applies whether or not the taxable year from which the deduction is carried precedes the effective date of section 1411.\textsuperscript{15}

The Proposed Regulations modify the chapter 1 rules in certain respects in order to prevent circumvention of the purposes of the statute. For example, substitute interest and dividends, which are included in gross income under chapter 1, are NII even though these amounts are not categorically “interest” and “dividends” under chapter 1. In addition, while an item of income that is specifically excluded from gross income under chapter 1 generally also is excluded from NII under section 1411 (for example, tax-exempt interest), distributions described in section 959(d) or section 1293(c), excess distributions under section 1291 that are dividends, and gains that are treated as excess distributions under section 1291 are treated as NII under chapter 2A.

Section 1411 and new Chapter 2A of the Code effectively create a new tax and a new tax base, on top of the income tax, alternative minimum tax, self-employment tax and payroll taxes that continue to apply to tax other forms of income. As noted above, the Preamble states that, except as otherwise provided, the chapter 1 principles and rules relating to the income tax will apply in determining the tax under section 1411. Only in certain situations do the Proposed Regulations set forth definitional rules varying from chapter 1 principles “to promote the fair administration of section 1411 while preventing the circumvention of the statute.” We agree with the approach taken in the Proposed Regulations, namely that Chapter 1 principles should apply for purposes of section 1411 unless good cause exists to vary from those principles in identified instances. This approach serves the purpose of mitigating the unavoidable complexity involved in imposing a completely new tax on selected types of income in certain circumstances. Thus, in addition to the Comments and recommendations discussed in detail below, we suggest that the final Regulations include a statement in the text of the Regulations that “except as otherwise provided in these regulations, Chapter 1 principles and rules apply in determining the tax under section 1411.”

Our Comments are intended to assist the Treasury and the Service in finalizing the Regulations in a form that will provide effective guidance to taxpayers and tax practitioners. Unless specifically stated, our Comments should not be read as a tacit agreement with any particular provision of the Proposed Regulations. In many cases, we agree with the approach taken in the Proposed Regulations and recommend that such provisions of the Proposed Regulations be finalized without change. In other cases, we make specific suggestions and recommendations for change.

\textsuperscript{15} 77 Fed. Reg. 72,611, 72,613 (2012); Prop. Reg. § 1.1411-4(f), 77 Fed. Reg. 72,611, 72,639 (2012).
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I. Comments on Proposed Regulation Section 1.469-11(b)(3)(iv) - Grouping for Taxpayers Subject to Section 1411

A. Grouping of Rental Activities with Trade or Business Activities for Purposes of Section 469 and Section 1411

1. Summary

Regulation section 1.469-4 provides rules for grouping a taxpayer’s trade or business activities and rental activities for purposes of applying the passive activity rules of section 469. While the section 469 rules treat rental income as trade or business income in these cases, the Proposed Regulations appear to indicate that, in order to be excluded from section 1411, the rental activity must be independently analyzed and must independently qualify as a section 162 trade or business activity. This appears to unduly complicate the tax rules, and seems inconsistent with the policy behind the trade or business exceptions in section 1411.

2. Recommendation

We agree with the approach of the Service generally in incorporating the rules of section 469 for purposes of section 1411. We recommend that the final Regulations be clarified to provide that if a rental activity is insubstantial in relation to a trade or business activity (under the rules of Regulation section 1.469-4(d)(1)), then section 1411 should be applied with respect to the grouped activity (including the rental activity) as a whole for all purposes of section 1411, including subdivisions (c)(1)(A)(i) and (iii), as well as subdivision (c)(1)(A)(ii) that covers passive activities. In these cases, provided the taxpayer materially participates in the grouped activity, we recommend that income from such activity be excepted from the definition of NII.

3. Explanation

Under Regulation section 1.469-4(d)(1), if a rental activity is insubstantial in relation to a trade or business activity, the rental activity is grouped with the trade or business activity for purposes of applying the rules of section 469. In such case, provided the taxpayer materially participates in the grouped activity, the income from such activity is treated as non-passive trade or business income under section 469. The rules of section 469 adopt a reasonable approach to characterizing insubstantial amounts of rental income earned in connection with a trade or business activity, and applying the same rule for purposes of section 1411 would be consistent with the policy behind the trade or business exceptions contained in section 1411 (namely, trying to shield individuals actively engaged in ongoing businesses from being subject to this new tax).

Accordingly, we recommend that the same grouping rule apply for purposes of section 1411. In this case, rental activity income determined to be insubstantial and related to a trade or business would be grouped with the trade or business activity for purposes of both sections 469 and 1411, and no separate grouping would be required for purposes of section 1411. The Service

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was faced with very similar policy considerations in designing the “insubstantial” test for purposes of the passive activity grouping rules and arrived at a reasonable method for determining when renting property to an active trade or business should logically be treated as part of that activity. There seems to be no compelling reason to adopt a more restrictive rule for purposes of section 1411. In addition to adding an unnecessary level of complexity by having two different grouping rules for sections 469 and 1411 in just this one instance, the rule appears inconsistent with the above-stated policy behind the trade or business exceptions of section 1411.

**B. Regrouping Election under Proposed Regulation Section 1.469-11**

1. **Summary**

Proposed Regulation section 1.469-11(b)(3)(iv) allows an individual, estate, or trust that has NII and meets the MAGI threshold to regroup its activities for purposes of Regulation section 1.469-4 in 2013, 2014, or the first taxable year thereafter in which section 1411 applies to such taxpayer, regardless of how the activities were grouped in the preceding taxable year. Under the Proposed Regulations, a taxpayer may utilize this provision only once, and the regrouping must be made in 2013, 2014, or the first year otherwise allowable. Additionally, once the regrouping election is made, it will apply in all subsequent years.

2. **Recommendation**

We recommend two changes to the regrouping election: (i) S corporations and partnerships be permitted to change their groupings in light of the application of section 1411 for any tax year that begins during 2013 or 2014; and (ii) all taxpayers, regardless of whether they have NII or MAGI above the threshold, be permitted a “fresh start” in terms of section 469 groupings in light of the application of section 1411 for any tax year that begins during 2013 or 2014.

3. **Explanation**

We commend the Service for recognizing the increased importance that section 1411 places on grouping decisions under Regulation section 1.469-4. Without permitting regroupings, taxpayers would be bound by their original grouping decisions, some of which may have been made as many as 20 years ago, under the consistency rule of Regulation section 1.469-4(e).

Nevertheless, we believe it is consistent with the spirit of the Proposed Regulations to expand the regrouping option. Under Regulation section 1.469-4(d)(5), activities aggregated at the entity level cannot be fragmented at the owner level. As a consequence, under the rule of the Proposed Regulations, partnerships and S corporations that have owners subject to section 1411 will be unable to change their activity groupings that were made at the entity level. Although we are aware that section 1411 does not apply to partnerships and S corporations directly, we believe there is authority to allow these entities to change the groupings reported to their owners.

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and that the disclosure required under Rev. Proc. 2010-13,\textsuperscript{18} may operate to improve tax administration in this complex area.

In addition, while we are aware that the purpose of the Proposed Regulation is to assist those taxpayers subject to section 1411, this restriction places lower income taxpayers at a disadvantage from a passive activity loss perspective and may whipsaw other taxpayers whose income is adjusted upon audit.

II. Comments on Proposed Regulation Section 1.1411-2 - Application to Individuals.

A. Consideration of Losses Triggered under Section 469(g)(1) in Computing NII upon the Disposition of an Entire Interest in a Passive Activity

1. Summary

The Preamble requests comments on whether the losses triggered under section 469(g)(1) upon the disposition of an entire interest in a passive activity should be taken into account in determining the taxpayer’s net gain on the disposition of the activity under section 1411(c)(1)(A)(iii) or whether the losses should be considered deductions properly allocable to gross income and net gain described in section 1411(c)(1)(A)(i) through (iii).

2. Recommendation

We recommend that the final Regulations consider section 469(g) losses triggered upon the disposition of an entire interest in a passive activity to be properly allocable deductions against gross income and net gain described in section 1411(c)(1)(A)(i) through (iii).

We also recommend the following example to illustrate this rule –

During 2013, Taxpayer’s MAGI is well above the relevant NII thresholds, and he disposes of his entire interest in passive activity A resulting in a long term capital loss of $2,000. Taxpayer had suspended passive activity losses (“PALs”) of $10,000 related to passive activity A.

Taxpayer has the following other income and expenses during 2013: interest income: $3,000, dividend income: $4,500, ordinary income from passive activity B: $3,500, other long-term capital gain: $2,000, investment expenses: $700.

Prior to taking into account any of the $10,000 suspended PAL from passive activity A, Taxpayer would have the following income in each of the three categories under Proposed Regulation section 1.1411-4(a)(1): Category 1: $7,500, Category 2: $3,500, Category 3: $0 (other long term capital gain of $2,000 reduced by long term capital loss of $2,000 resulting from disposition of entire interest in passive activity A).

\textsuperscript{18} 2010-4 I.R.B. 329.
Under section 469(g), the suspended PAL would first be applied to passive income generated from passive activity B. After the netting, there would be $6,500 of suspended PAL that would be converted to a section 469(g) loss and would be free to offset non-passive income.

At this point, Taxpayer would have the following income in each of the three categories under Proposed Regulation section 1.1411-4(a)(1): Category 1: $7,500, Category 2: $0, Category 3: $0.

Because there is no income in either Category 1, 2 or 3, the $6,500 section 469(g) loss would be allocated entirely to income in Category 1. This netting would result with the following income in each of the three categories under Proposed Regulation section 1.1411-4(a)(1): Category 1: $1,000, Category 2: $0, Category 3: $0.

The $1,000 sum of the three categories would then be reduced by the $700 of investment expenses resulting in the Taxpayer having NII of $300.

3. **Explanation**

Under chapter 1 of the Code, section 469(a) disallows passive activity losses and passive activity credits for the taxable year for individuals, estates, trusts, closely-held C corporations, and personal service corporations. Section 469(b) provides that, except as otherwise provided, any loss or credit from an activity that is disallowed under section 469(a) will be treated as a deduction or credit allocable to such activity in the next taxable year.

Section 469(g)(1)(A) provides that if during the taxable year a taxpayer disposes of such taxpayer’s entire interest in a passive activity (or former passive activity) to an unrelated person, and if all gain or loss realized on such disposition is recognized, the excess of (i) any loss from such activity for such taxable year (determined after the application of section 469(b)), over (ii) any net income or gain for such taxable year from all other passive activities (determined after the application of section 469(b)), shall be treated as a loss that is not from a passive activity.

When a taxpayer disposes of a passive activity (or former passive activity) with current and suspended passive losses that exceed the gain on disposition, we recommend that the net passive income and net passive losses from all of the taxpayer’s other passive activities be netted for purposes of section 1411 before any excess passive income is applied against the current and suspended passive losses from the activities disposed of, consistent with the treatment under section 469. Any excess losses from the activity disposed of are treated as not from a passive activity and then may be used against all other income including portfolio and other investment income.

Technical Advice Memorandum 974002 further clarifies that to the extent that the taxpayer may have realized any gain on disposition, the disposition gain must first be applied against current and suspended losses from the activity disposed of, then the net income or gain for such taxable year from all other passive activities should be netted. Any excess loss from the

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19 TAM 9742002 (July 3, 1997).
activity disposed of is treated as non-passive. Any net gain would be passive income if the activity was passive in the year of the sale.\textsuperscript{20} Correspondingly, gain on disposition is not passive income if the activity is not a passive activity in the taxable year of disposition.\textsuperscript{21}

In order to avoid two parallel tax universes for taxpayers, we recommend that the final Regulations consider section 469(g) losses in the computation of NII in essentially the same manner as they operate under chapter 1. If a taxpayer disposes of all or substantially all of a passive activity in a fully taxable transaction to an unrelated person, current and suspended passive losses would first reduce any net gain attributable to the activity disposed of under section 1411(c)(1)(A)(iii). Then any excess passive loss attributable to that activity would be a deduction properly allocable to section 1411(c)(1)(A)(ii) gross income attributable to the disposed of activity and any gross income from any other passive activity trade or business of the taxpayer, even if such properly allocable deduction exceeds the total amount of section 1411(c)(1)(A)(ii) gross income.

III. Comments on Proposed Regulation Section 1.1411-3 - Application to Estates and Trusts

A. Application of Section 1411 to Cemetery Perpetual Care Fund Trusts

1. Summary

The Preamble to the Proposed Regulations provides that section 1411 applies to cemetery perpetual care funds described in section 642(1).\textsuperscript{22} Certain cemetery perpetual care funds created by a taxable cemetery corporation for the care and maintenance of cemetery property are taxed as trusts for income tax purposes. These funds receive a deduction for distributions made for the care and maintenance of gravesites which the cemetery corporation is legally obligated to maintain. The distribution deduction is limited to an amount equal to five dollars multiplied by the aggregate number of such gravesites.

2. Recommendation

We recommend no change to the Proposed Regulations.

3. Explanation

Certain cemetery perpetual care funds are taxed as trusts for purposes of subchapter J. We see no administrative reason why such perpetual care funds should not be treated the same as other trusts for purposes of section 1411.

\textsuperscript{20} Reg. § 1.469-2T(c)(2)(i)(A)(2).
\textsuperscript{21} Reg. § 1.469-2T(c)(2)(i)(A)(3).
\textsuperscript{22} 77 Fed. Reg. 72,611, 72,615 (2012).
B. Application of Section 1411 to Alaska Native Settlement Trusts

1. Summary

The Preamble to the Proposed Regulations provides that section 1411 applies to an Alaska Native Settlement Trust established under Section 646. An Alaska Native Settlement Trust is a trust established to preserve native Alaskan heritage and promote the health and welfare of its beneficiaries, and will be classified as a trust for income tax purposes. The income tax treatment of the trust is governed by section 646 for any tax year for which the trust has made a section 646 election.

A section 646 election exempts an Alaska Native Settlement Trust from the general trust taxation rules. Instead, an electing Alaska Native Settlement Trust pays tax on its taxable income, other than net capital gain, at the lowest income tax rate applicable to an unmarried individual specified in section 1(c). For 2013, this rate is 15%, as opposed to the general trust rates under section 1(e) beginning at 15% and increasing to as much as 39.6%. An electing Alaska Native Settlement Trust pays tax on its net capital gains at the rate of tax that would apply to such gain if the taxpayer were subject to tax on its other taxable income at only the lowest rate specified in section 1(c).

Distributions made by an electing Alaska Native Settlement Trust to its beneficiaries are not taxable to the beneficiaries, as the electing Alaska Native Settlement Trust pays the tax at the trust level.

2. Recommendation

We recommend that the final Regulations permit Alaska Native Settlement Trusts to elect under section 646 to be treated as individuals, rather than as trusts, for purposes of section 1411.

3. Explanation

Section 646 permits Alaska Native Settlement Trusts to pay income tax at the lowest marginal rate applicable to an individual. Therefore, in order to ensure consistent tax treatment, we recommend that Alaska Native Settlement Trusts be permitted to elect to be taxed like individuals, rather than like trusts, for purposes of section 1411.

C. Application of Section 1411 to Qualified Funeral Trusts

1. Summary

The Preamble to the Proposed Regulations provides that section 1411 applies to a qualified funeral trust (“QFT”) described in section 685. A QFT is a “pre-need” funeral trust.

24 I.R.C. § 646(c).
25 I.R.C. § 646(b)(1).
26 I.R.C. § 646(b)(2).
27 I.R.C. § 646(e).
which qualifies for special income tax treatment. In order to qualify as a QFT, a trust must be established by a contract between a purchaser and provider of funeral or burial merchandise or services and the sole purpose of the trust must be to hold and invest the trust funds to provide burial or funeral services on the death of a trust beneficiary. The trustee must make an election for the trust to be treated as a QFT. But for the election, each beneficiary of the trust would be taxed on his or her share of the trust income as a grantor trust.

If the Trustee of such trust makes an election, the normal income tax trust rules do not apply to the QFT. Instead, a QFT is taxed at the rates applicable to estates and trusts under section 1(e), with the funds held for each beneficiary treated as a separate trust.

2. **Recommendation**

We recommend no change to the Proposed Regulations.

3. **Explanation**

QFTs are treated as trusts for purposes of subchapter J. We see no administrative reason why a QFT should not be treated the same as other trusts for purposes of both chapter 1 and section 1411.

D. **Application of Section 1411 to Pooled Income Funds**

1. **Summary**

The Preamble to the Proposed Regulations provides that section 1411 applies to a pooled income fund. A pooled income fund is a collective investment vehicle created and maintained by certain qualified charitable organizations to allow a donor to retain an income interest in the donor’s contribution (either for the benefit of the donor or a beneficiary selected by the donor) while irrevocably contributing the remainder interest in the donor’s contribution to the qualified charitable organization. Pooled income funds are taxed as trusts, although they are exempted from the application of the grantor trust rules. Accordingly, the NII Tax will be applied to a pooled income fund.

A pooled income fund’s governing instrument must provide that the fund’s fiduciary accounting income be paid to the fund’s income beneficiaries, with each beneficiary entitled to a proportionate share of such income based on the contribution made to the fund by such beneficiary or on such beneficiary’s behalf. The pooled income fund is permitted a distribution deduction under section 661 for all income earned that is distributed to the income beneficiaries. As the governing instrument requires that all fiduciary accounting income be paid to the fund’s

29 I.R.C. § 685(b).
30 I.R.C. § 685(b).
31 I.R.C. § 685(b).
32 I.R.C. § 685(a).
33 I.R.C. § 685(c).
34 I.R.C. § 642(c) and the Regulations thereunder.
35 Reg. § 1.642(c)-5(a)(2).
36 Reg. § 1.642(c)-5(b)(7), -5(c)(1).
income beneficiaries, the NII will be limited to the fund’s capital gains and similar fund level tax items in the absence of additional deductions.

A pooled income fund also generally receives a charitable set-aside deduction for any long-term capital gain that is earmarked for the fund’s charitable remainder beneficiary. Under the Proposed Regulations, however, it is not clear that the charitable set aside deduction for long-term capital gains that is allowed in calculating the pooled income fund’s income tax is fully allowed in calculating the pooled income fund’s NII Tax. Instead, the Proposed Regulations suggest that only a share of the charitable set-aside deduction will be considered for purposes of reducing a pooled income fund’s NII.

2. Recommendation

We recommend that the final Regulations expressly provide that the charitable set-aside deduction that is available for a pooled income fund’s long-term capital gains for income tax purposes will also reduce a pooled income fund’s NII. We do not recommend any change to the Proposed Regulations with respect to a pooled income fund’s short-term capital gains.

3. Explanation

The Proposed Regulations treat long-term capital gains of a pooled income fund inconsistently with their treatment under subchapter J. We recommend that the final Regulations be revised to provide that the charitable set-aside deduction will reduce a pooled income fund’s NII in full.

No revision is necessary with respect to short-term gains. The application of the NII Tax to a pooled income fund’s short-term capital gains for which no income tax deduction is allowed or long-term capital gains that are ineligible for the charitable set-aside deduction is consistent

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37 I.R.C. § 642(c)(3). The charitable set-aside deduction for long-term capital gains is not allowed in two scenarios. First, for taxable years beginning after January 2, 2004, no amount of net long-term capital gain will be considered as permanently set aside for a charitable organization if the pooled income fund’s governing instrument and local law give the trustee the power (whether exercised or not) to satisfy the income beneficiaries’ right to income with either: (i) an amount equal to a fixed percentage of the fair market value of the fund’s assets (i.e., a unitrust amount), whether determined each year or averaged over multiple years; or (ii) an amount that takes into account unrealized appreciation in the value of the fund’s assets. Reg. § 1.642(c)-2(c). The charitable set-aside deduction is also not allowed to the extent the trustee distributes proceeds from the sale or exchange of the pooled income fund’s assets as income as described in Reg. § 1.642(c)-5(a)(5)(i).

38 Prop. Reg. § 1.1411-3(e)(4) states in part, “In computing the estate’s or trust’s undistributed net investment income, the estate or trust shall be allowed a deduction for amounts of net investment income that are allocated to amounts allowable under section 642(c). In the case of an estate or trust that has items of income consisting of both net investment income and excluded income (as defined in paragraph (e)(5) of this section), the allowable deduction under this paragraph (e)(4) must be allocated between net investment income and excluded income in accordance with § 1.642(c)-2(b) as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. For an estate or trust with deductions under both sections 642(c) and 661, see § 1.662(b)-2 and Example 2 in paragraph (f) of this section.” See also, Jonathan G. Blattmachr, Mitchell M. Gans, and Diana S. C. Zeydel, “Medicare Tax: Imposition of the 3.8% Medicare Tax on Estates and Trusts”, Estate Planning, scheduled for publication in April 2013.
with the general policy of coordinating the deductions available against the income tax and NII Tax.\(^{39}\)

E. **Application of Section 1411 to Unexpired Interests in Trusts and Estates Devoted to Charitable Purposes**

1. **Summary**

Section 1411(a)(2) imposes the 3.8% NII Tax on the lesser of (A) the estate’s or trust’s undistributed NII for such taxable year; or (B) the excess, if any, of (i) the estate’s or trust’s AGI as defined in section 67(e) for such taxable year over (ii) the dollar amount at which the highest tax bracket begins for such taxable year (which, for 2013, is $11,950).\(^{40}\)

Proposed Regulation section 1.1411-3 provides that the NII Tax applies only to certain types of trusts and estates.\(^{41}\) The general rule is that section 1411 applies to all estates and trusts subject to part I of subchapter J of chapter 1 of subtitle A of the Code.\(^{42}\) Proposed Regulation section 1.1411-3(b) indicates the types of trusts which are specifically excluded from the application of section 1411.\(^{43}\) Similarly, Proposed Regulation section 1.1411-3(d) contains special rules for the application of section 1411 to estates.

Of particular interest, Proposed Regulation section 1.1411-3(b)(1) specifically excludes from the application of section 1411 a trust, all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B) (hereinafter referred to as “Charitable Purpose Trusts”).\(^{44}\) Conversely, there is no corresponding exclusion in Proposed Regulation section 1.1411-3(d) that exempts from the NII Tax an estate, all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B) (hereinafter referred to as “Charitable Purpose Estates”). Accordingly, Charitable Purpose Trusts are automatically exempt from the NII Tax, but Charitable Purpose Estates are subject to the NII Tax and need to rely on the charitable deduction in section 642(c) to eliminate the tax liability.\(^{45}\)

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\(^{39}\) See I.R.C. § 1411(c)(1)(B) (stating that NII is determined by reducing investment income by “the deductions allowed by this subtitle (i.e., for income tax purposes) which are properly allocable to such gross income or net gain.”)


\(^{41}\) 77 Fed. Reg. 72,611, 72,635 (2012).


\(^{43}\) 77 Fed. Reg. 72,611, 72,635 (2012).

\(^{44}\) Prop. Reg. § 1.1411-3(b)(1), 77 Fed. Reg. 72,611, 72,635 (2012).

\(^{45}\) Pursuant to Reg. § 1.642(c)-1(a), any part of the gross income of an estate which pursuant to the terms of the will (1) is permanently set aside during the taxable year for a purpose specified in I.R.C. § 170(c), or (2) is to be used exclusively for religious, charitable, scientific, literary or educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance, or operation of a public cemetery not operated for profit, is allowed as a deduction to the estate in lieu of the limited charitable contributions deduction authorized by I.R.C. § 170(a).
2. **Recommendation**

We recommend that the final Regulations add a new paragraph (3) of section 1.1411-3(d) to provide that the NI T does not apply to an estate where all unexpired interests in the estate are devoted to one or more of the purposes described in section 170(c)(2)(B).

3. **Explanation**

The current regulatory scheme creates an unnecessary inconsistency between the treatment of Charitable Purpose Trusts and Charitable Purpose Estates. Further, as the ultimate result (i.e., no tax) can be achieved for both Charitable Purpose Trusts and Charitable Purpose Estates, the inconsistency creates a trap for the unwary to the potential detriment of charitable organizations. This trap exists because, unlike Charitable Purpose Trusts which are automatically exempt from the NI T, Charitable Purpose Estates are subject to the NI T and must alternatively set aside the NI T and take the charitable deduction to achieve the same result.

Additionally, this inconsistency could adversely impact the decision to make an election under section 645. Under section 645(a), an executor of an estate and the trustee of a qualified revocable trust may elect to treat and tax the trust as part of the estate (the “645 election”). Congress provided for the 645 election in 1997 because it determined that differences between the income tax rules for estates and trusts “may have discouraged individuals from utilizing revocable trusts for estate planning where they might otherwise be appropriate or efficient.” The differences between the income tax treatment of estates and revocable trusts include, but are not limited to: (1) estates are allowed a charitable deduction for amounts permanently set aside for charitable purposes while post-death revocable trusts are allowed a charitable deduction only for amounts paid to charities and (2) the active participation requirement of the passive loss rules under section 469 is waived in the case of estates (but not revocable trusts) for two years after the owner’s death. Therefore, to minimize these and other income tax differences, Congress allowed for the 645 election to treat a revocable trust as part of the decedent’s estate during a reasonable period of administration.

Assuming a wholly charitable disposition by a decedent, a trustee of the decedent’s formerly revocable trust and the executor of the related estate would normally join in a 645 election to minimize the cost and burden of administration and for consistency in the income tax treatment of the estate and trust. However, unless an estate and trust have the same clear exemption from the NI T, the trustees of a Charitable Purpose Trust may hesitate to join in an otherwise useful election. Whereas the 645 election is generally made so that the trust can take advantage of the more favorable estate income tax rules, the specific exemption from the NI T creates an advantage for the trust causing the decision to make an otherwise beneficial 645 election to be more difficult. We recommend adding a new paragraph (3) to Proposed Regulation section 1.1411-3(d) that exempts Charitable Purpose Estates from the NI T.

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47 See Reg. § 1.642(c)-1(a).
48 See I.R.C. § 469(i)(4).
F. Application of Section 1411 to Distributions from Charitable Remainder Trusts

1. Summary

Proposed Regulation section 1.1411-3(c)(2) provides special computational rules for calculating the portion of distributions from a CRT that is subject to section 1411.49 Specifically, it provides that distributions from a CRT to a beneficiary for a taxable year consist of NII, and are therefore subject to section 1411, in an amount equal to the lesser of (1) the total amount of the distributions for that year; or (2) the current and accumulated NII of the CRT. Further, current and accumulated NII is deemed to be distributed before amounts that are not items of NII. As such, the Proposed Regulation tasks the trustee of a CRT with classifying the income of a CRT into either NII or non-NII amounts.

The Preamble of the Proposed Regulations states that the Treasury and the Service considered an alternative method of determining how much of the distributed amount of NII would be subject to the NII Tax, in which NII would be determined on a class-by-class basis consistent with the class determination under section 664(b).50 This method would determine the NII and non-NII amounts for each tier of income under section 664(b). All distributions would be considered to be made by the first tier, and the NII and non-NII amounts would be determined at that level before taking into consideration NII and non-NII amounts of the second tier. However, the Treasury and the Service dismissed this as a viable method because “that the recordkeeping and compliance burden that would be imposed on trustees by this alternative would outweigh the benefits.”51

2. Recommendation

We recommend that the final Regulations provide trustees of CRTs with an election to use an alternative method by which the amount of distributed NII would be determined on a class-by-class basis within each tier described in Regulation section 1.664-1(d)(1).

3. Explanation

(a) Taxation of CRT Distributions Generally

A CRT must provide for the distribution of a specified payment, at least annually, to one or more persons (at least one of which is a noncharitable beneficiary).52 The payment period must be for the life or lives of the individual beneficiaries (all of whom must be living at the time the trust is created) or for a term of no more than twenty years.

The tax character of distributions in the hands of the recipient is determined by the rules set forth in section 664(b) and the Regulations thereunder, which for this purpose supersede all

50 77 Fed. Reg. 72,611, 72,616 (2012).
51 77 Fed. Reg. 72,611, 72,616 (2012).
52 I.R.C. § 664(b); Reg. § 1.664-1(d)(1).
other provisions of the Code. The so-called “tier” rules are applicable for every taxable year of the trust. Regardless of the actual trust income for a particular year, all distribution amounts are deemed to be made first from ordinary income, second from capital gains, third from “other income” (typically tax-exempt income), and, last, from trust corpus. Current and previously undistributed income of each tier must be exhausted in the order set forth above before income earned in the next tier is deemed distributed.

Regulation section 1.664-1(d)(1)(ii)(a) indicates that the income categories and classes are used to determine the character of a CRT distribution in the hands of the recipient in the year of the distribution, and that the character determination is made as of the end of the trust’s taxable year. The character of a distribution in the recipient’s hands is determined by treating the distribution as issued from each category in the following order: (i) from ordinary income to the extent of the trust’s ordinary income for the taxable year and its undistributed ordinary income for prior years; (ii) from capital gain to the extent of the trust’s capital gains as determined under Regulation section 1.664-1(d)(1)(iv); (iii) from other income to the extent of the trust’s other income for the taxable year and undistributed other income for prior years; and (iv) from corpus. Corpus is defined as the net fair market value of the trust’s assets less the total undistributed income (but not loss) in the preceding categories.

(b) Determination of NII of a CRT under the Proposed Regulations

Under Proposed Regulation section 1.1411-3(c)(2), current and accumulated NII of a CRT is deemed to be distributed before amounts that are not items of NII for purposes of section 1411. As such, in addition to the four-tier characterization process described above, the Proposed Regulation provides for a further classification of income into NII and non-NII amounts. Once all income of the trust is categorized as either NII or non-NII, any distribution made from the trust will be subject to section 1411 to the extent the CRT had current or accumulated NII, without regard for the tier system defined by section 664(b).

(c) Proposed Alternative Method of Determining Current and Accumulated NII Deemed Distributed

The determination of NII and non-NII amounts at the CRT-level in the manner prescribed in the Proposed Regulations produces fair results as to the amount of each distribution that should be subject to section 1411 in most circumstances. However, where a CRT is funded with non-NII assets (e.g., qualified plan proceeds, stock option income, or non-Roth Individual Retirement Accounts), such broad application of the NII/non-NII categorization may lead to inequitable results. Therefore, we recommend that the final Regulations provide alternative methods of determining NII and non-NII amounts as a sub-class of each of the four tiers under section 664(b) for trusts that find themselves in this situation.

Specifically, we recommend that each of the four tiers should be further divided into either NII or non-NII subclasses. Proposed Regulation section 1.1411-3(c)(2) then would apply

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53 See I.R.C. § 664(b); Reg. § 1.664-1(d)(1).
54 I.R.C. § 664(b).
56 I.R.C. § 664(b); Reg. § 1.664-1(d)(1).
at the tier-level as opposed to the CRT overall. The general principle that current and accumulated NII of a CRT are deemed to be distributed before amounts that are not items of NII for purposes of section 1411 would continue in place, but this rule would be applied on a tier-by-tier basis (e.g., this priority rule would apply to tier one amounts until all tier one amounts were deemed completely distributed, after which the rule would apply to tier two and its sub-divided NII and non-NII amounts). In the same manner as section 664(b) generally, all current and accumulated income, both NII and then non-NII amounts, of a particular tier must be exhausted in the order set forth in section 664(b) before applying the rule to a subsequent tier’s current and accumulated income.

(d)  Assessment of Compliance Burden

Under section 664(b), the trustee of a CRT is tasked with the responsibility of accounting for income in each of these four tiers in order to clearly reflect each type of income and ensure the noncharitable beneficiary is recognizing the appropriate type of income. The Proposed Regulations add an additional task under Proposed Regulation section 1.1411-3(c)(2), in which the trustee must determine whether distribution amounts are current and accumulated NII of the trust or non-NII amounts at the CRT-level. The alternative method would create an additional burden on the trustee of creating a “sub-category” to differentiate NII and non-NII amounts within each section 664(b) tier. By creating “sub-categories,” the NII calculated on each distribution will more accurately reflect the underlying nature of the income and avoid the noncharitable beneficiary recognizing NII on non-NII distributable amounts. Further, the trustee is already tasked with the responsibility of categorizing all income into the previously mentioned four tiers under section 664(b), as well as into NII and non-NII amounts under Proposed Regulation section 1.1411-3(c)(2). Although adding an additional characterization would be an additional burden to the trustee, this would be elective and would not be significantly more burdensome than the trustee’s existing responsibilities.

(e)  Example in Which the Proposed Regulations Lead to Inequitable Results

Suppose that in 2013, a CRT were funded with a distribution from a non-Roth Individual Retirement Account (“IRA”) valued at $1 million through a beneficiary designation. Under Regulation section 1.664-1(d)(1)(a)(1), the $1 million distribution would be characterized as ordinary income (“tier one”) Assume that this $1 million was reinvested generating the following income in tax year 2013: $30,000 of investment income (“tier one” income) and $20,000 of long-term capital gains (“tier two” income). At the end of 2013, the CRT would have $1,030,000 of tier one amounts and $20,000 of tier two amounts. Further, current and accumulated NII of the trust under Proposed Regulation section 1.1411-3(c)(2) would be $50,000.

Assume that during tax year 2013, $70,000 of distributions were made to a noncharitable beneficiary. Under section 664(b), the noncharitable beneficiary would categorize the entire $70,000 distribution as tier one ordinary income. Further, under Proposed Regulation section 1.1411-3(c)(2)(i), $50,000 of the distribution would be treated as NII (distributions from a CRT to a beneficiary for a taxable year consist of NII in an amount equal to the lesser of: (1) the total amount of the distributions for that year, $70,000; or (2) the current and accumulated NII of the
The $50,000 would include the $20,000 tier-two long-term capital gain, even though $20,000 was not deemed to have been distributed under section 664.

Under the proposed alternative elective method, if current and accumulated NII were calculated per tier, the result would differ. At the end of 2013, the $1,030,000 tier one amount will consist of $30,000 of current and accumulated NII, and $1 million of non-NII amounts as a result of the non-Roth IRA proceeds. Tier two would still consist of the $20,000 long-term taxable gain, all of which would be current and accumulated NII. As such, if the NII/non-NII categories were instead analyzed at the tier-level, only $30,000 of the distribution would be considered NII. The remaining $40,000 would be attributable to the non-NII amounts under tier one attributable to the non-Roth IRA. This treatment would more accurately align with the deemed distribution characterization under section 664 for chapter 1 purposes.

(f) Comparison to Other Elections

The Proposed Regulations already provide for similar elections. Proposed Regulation section 1.1411-10(g) allows taxpayers to elect to treat section 951 income (income from Controlled Foreign Corporations) and section 1293 income (income from Passive Foreign Investment Companies) as NII in the same manner and in the same taxable year as such amounts are included in income for chapter 1 purposes.\(^57\)

We believe it would be helpful to provide a similar election to determine the NII portion of a CRT distribution using the same structure as is used to determine the character under section 664(b) for chapter 1 purposes. Once such election is made by the trustee of a CRT, the election would apply to all distributions the taxpayer would receive from the CRT. The election should not be revocable, except with the Commissioner’s consent. Any automatic extension of time to make the election should be made consistent with the election under Proposed Regulation section 1.1411-10(g).

G. Application of Section 1411 to Foreign Estates and Trusts with U.S. Beneficiaries

1. Summary

For purposes of computing U.S. taxable income, a foreign estate or a foreign trust is treated as a nonresident alien individual who is not present in the U.S. at any time\(^58\) and thus is subject to U.S. income tax only on effectively connected income and certain U.S.-sourced non-effectively connected income.\(^59\)

With respect to distributions from a foreign estate or a foreign trust, a foreign estate or trust is governed by the same basic distributable net income (“DNI”) regime within the meaning of Regulation section 1.643(a)-6 as a domestic estate or trust; however, the DNI of a foreign estate or trust includes the excess of capital gains over capital losses.\(^60\) To the extent a foreign

\(^{57}\) 77 Fed. Reg. 72,611, 72,648 (2012).

\(^{58}\) I.R.C. § 641(b).

\(^{59}\) I.R.C. § 872(a).

\(^{60}\) I.R.C. § 643(a)(6)(C).
estate or trust distributes (or is deemed to distribute) only amounts attributable to its DNI for the current taxable year, the foreign estate or trust is regarded for U.S. income tax purposes as a mere conduit – the distributed (or deemed distributed) income is deductible by the foreign estate or trust61 and is includible in the gross income of the beneficiaries.62 The character of the income distributed (or deemed distributed) by a foreign estate or trust also flows through to the beneficiaries.63 The beneficiaries are not taxed when the foreign estate or trust earns the income but only when the income is distributed (or deemed distributed).64

2. Recommendation

We recommend that the final Regulations provide that section 1411 not be applied to a foreign estate or a foreign trust but rather to U.S. beneficiaries upon receipt of a distribution from a foreign estate or from a foreign trust.

3. Explanation

The Preamble of the Proposed Regulations states that except as otherwise provided in the Code, Code principles and rules of chapter 1 apply in determining the tax under section 1411.65 For example:

- Gain that is not recognized under chapter 1 for a taxable year is also not recognized for that year for purposes of section 1411; and
- Deferral or disallowance provisions of chapter 1 used in determining adjusted gross income also apply to the determination of net investment income.

The Preamble further states that section 1411 should not apply to foreign estates and foreign trusts that have little or no connection to the United States.66

Section 1411(e)(1) provides that section 1411 does not apply to a nonresident alien individual (a non-U.S. person). For purposes of section 1411, consistent with utilizing chapter 1 principles, the definition of a U.S. person is tied to that in section 7701(a)(30)(A) of chapter 1.67 Section 7701 also excludes foreign estates and trusts as well as nonresident alien individuals in defining “U.S. person,” and subchapter J generally taxes estates and trusts in the same manner as individuals. Accordingly, since for purposes of chapter 1 a foreign estate or trust is generally treated the same as a nonresident individual, we recommend that section 1411 also not apply directly to a foreign estate or a foreign trust.

Furthermore, applying section 1411 only to U.S. beneficiaries at the time of a distribution (or a deemed distribution) and not directly to the foreign estate or trust would ensure that foreign estates or trusts with no U.S. beneficiaries will not be wrongly “taxed” and also would greatly

61 I.R.C. §§ 651(a) and 661(a).
62 I.R.C. §§ 652(a) and 662(a).
63 I.R.C. §§ 652(b) and 662(b).
64 I.R.C. §§ 652(a) and 662(a).
65 77 Fed. Reg. 72,611, 72,613 (2012).
66 77 Fed. Reg. 72,611, 72,613 (2012).
simplify administration. If section 1411 were to apply at the estate or trust level, either a new withholding mechanism would need to be created or the section 1411 tax would necessarily become subject to the current section 1441 withholding mechanism. Then a process would have to be provided so that a foreign estate or a trust that is not otherwise required to file a return with the Service could either: (i) avoid withholding of the section 1411 tax by providing documentation (perhaps on a new Service form similar to the existing W-8 forms) to the withholding agent certifying that there are no U.S. beneficiaries; or (ii) obtain a refund of the section 1411 tax withheld by the withholding agent by filing a claim with the Service, attaching proof that no NII was distributed to a U.S. beneficiary. Either of these scenarios would greatly increase the administrative complexity for both the taxpayers and the Service. It would be inconsistent and contradictory to require section 1411 withholding for items of investment income such as portfolio interest and capital gains otherwise determined to be exempt from income tax withholding for various policy reasons.

Applying section 1411 to U.S. beneficiaries upon receiving current distributions of NII from a foreign estate or foreign trust would be consistent with the general operation of subchapter J and also would simplify the administration of the section 1411 tax for both the taxpayers and the Service.

H. Accumulation Distributions from Foreign Estates and Trusts to U.S. Persons

1. Summary

The Proposed Regulations provide as a general rule that section 1411 does not apply to foreign estates and foreign trusts unless NII is earned or accumulated for the benefit of, or distributed to, U.S. persons.\(^{68}\) The Treasury and the Service requested comments regarding the extent to which section 1411 should apply to accumulation distributions to U.S. persons, including the means by which to identify such distributions.

2. Recommendation

We recommend that the final Regulations provide that UNII of a foreign estate or trust be tracked and treated in a manner similar to UNI, provided that section 1411 not apply to income accumulated before 2013.

Under our recommendation, the throwback rules\(^{69}\) would also apply to UNII. The trustee would supply information identifying any UNII that was distributed to the beneficiary in a manner similar to the identification of UNI. To the extent the beneficiary does not receive sufficient information under section 6048, we recommend that the final Regulations provide that the beneficiary can elect the “default” method set forth in Notice 97-34.\(^{70}\)

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\(^{68}\) 77 Fed. Reg. 72,611, 72,616 (2012).

\(^{69}\) Reg. § 1.665(a)-0A.

\(^{70}\) Notice 97-34, § V-B, 1997-1 C.B. 422.
3. Explanation

Under current law, for each year that a foreign trust does not distribute all of its current year DNI within the meaning of Regulation section 1.643(a)-6, the trustee must keep track of the amount of UNI for that year. If a later distribution exceeds DNI, the excess amount is “thrown back” to the earliest year in which the trust had UNI.

It would make sense for this same structure to apply to UNII. Proposed Regulation section 1.1411-3(e) provides a method of calculation for undistributed NII. The trustee would be required to keep track of this amount in the same way it keeps track of UNI. In many cases, UNII may be the same number as UNI. However, we recommend that it be tracked separately in case there are any years in which the numbers differ. In order to work within the system that already exists, UNII would be identified with UNI in the year that it is earned and be “thrown back” under the same parameters that currently exist for UNI.

For example, assume UNI of $20,000 – $5,000 for year 1 and $15,000 for year 2. Also assume UNII of $10,000 – $2,000 in year 1 and $8,000 in year 2. In year 3, the Trustee makes a distribution equal to DNI. In that year, the trust had no NII. Despite the fact that a distribution was made that exceeded NII, we recommend that no UNII be treated as being distributed in year 3. Otherwise, the beneficiary would be required to run a throwback calculation solely for purposes of determining taxes due to UNII when no calculation would be required for UNI.

Next, assume in year 4, DNI is $10,000, NII is $2,000 and the Trustee makes a distribution of $15,000. Under the current throwback rules, $5,000 of UNI in year 1 would be treated as being distributed. The current NII would also be treated as being distributed. In addition, we recommend that UNII of $2,000 (the amount generated in year 1) be treated as being distributed. Although the total distribution exceeds the sum of the current NII in year 4 and UNII from year 1, we do not recommend that UNII from year 2 be treated as being distributed. Again, this allows the beneficiary to run one throwback calculation for year 1 that includes both UNI and UNII. Otherwise, a throwback calculation for year 2 would be required solely for UNII. When UNI for year 2 is later treated as distributed, another calculation would be required for year 2. This later calculation would need to take into account that there was UNII that was treated as already distributed in that year and that the tax attributable to that UNII had already been paid. This adds another layer of complexity that can be avoided by applying the uniform methodology described above for both purposes.

The accumulation distribution tax and interest charge is based on the concept that accumulated trust income should be taxed in the year earned and based on the beneficiary’s facts and circumstances for that year. In fact, the first line of Form 4970, which is used to compute the Tax on Accumulation Distribution of Trusts, states in this regard: “Amount of current distribution that is considered distributed in earlier tax years”. The application of the section 1411 tax to income earned prior to 2013 is contrary to this approach. In addition, the rules pertaining to the computation of DNI have varied over the years, and the computation of UNII would have to be reconciled to the computation of UNI. Trustees and beneficiaries which

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71 Reg. § 1.643(a)-6.
72 Reg. § 1.665(a)-0A.
tracked UNI would now have to compute UNII on a historical basis, which could be very costly. If a trustee provides UNI, but not UNII, for years prior to 2013, does the beneficiary use the actual method for income tax and the default method\textsuperscript{73} for the section 1411 tax?

These required calculations are only possible if the trustee provides the necessary information for the beneficiary to run these calculations. Under the current throwback rules, if the trustee does not provide the required information to the beneficiary in order for a proper calculation to be made on the beneficiary’s tax return, Notice 97-34\textsuperscript{74} and Form 3520 outline a “default” calculation that the beneficiary can use.\textsuperscript{75} We recommend that this same default calculation be available for UNII if the necessary information is not supplied by the trustee. So assume a beneficiary had received NII distributions of $5,000 in year 1, $3,000 in year 2, and $6,000 in year 3 and then did not receive any information about NII for the distribution in year 4 of $6,000. The beneficiary would total the previous three years NII distributions ($14,000) and then multiply this number by 1.25 ($17,500). The beneficiary would then divide this number by 3 ($5,833). The beneficiary would treat $5,833 as current NII and $167 as accumulated NII (subject to applicable interest charges).\textsuperscript{76} Again, this allows the beneficiary to work within the system that already exists. We recommend the default method for UNII be adjusted to allocate UNII on a pre- and post-2013 basis for the portion of the distribution considered UNI.

\begin{itemize}
\item \textbf{I. Application of Material Participation Rules to Trusts and Trustees}
\item \textbf{1. Summary}
\end{itemize}

Section 1411(c)(2)(A) includes in NII income from a trade or business that is “a passive activity (within the meaning of section 469).” While section 469 applies to individuals, estates, trusts, closely held C corporations, and personal service corporations,\textsuperscript{77} the conflux of subchapter J and section 469 creates difficulties in applying the passive activity rules in the case of trusts and estates. The hybrid nature of a trust or estate – sometimes being separately taxed on income, sometimes passing all income out to be taxed at the beneficiary level, and sometimes both – complicates the application of the section 469 rules which are better adapted for a single taxpayer – either a taxable entity (individual or C corporation) or a flow-through entity (partnership or S corporation).

In the over 27 years since Congress enacted section 469, the Treasury and the Service have not issued any administrative guidance or promulgated any Regulations regarding how a trust or estate can meet the material participation rules.\textsuperscript{78} The Proposed Regulations under section 1411 provide no guidance on the standard for material participation in a trade or business by a trust or estate. The preamble indicates that “section 469 and the Regulations thereunder

\textsuperscript{73} Notice 97-34, 1997-1 C.B. 422 (June 23, 1997), describes the default method as one in which the U.S. beneficiary will be allowed to treat a portion of the distribution as a distribution of current income based on the average of distributions from the prior three years, with only the excess amount of the distribution treated as an accumulation distribution (and therefore subject to the interest charge of I.R.C. § 668).
\textsuperscript{74} 1997-1 C.B. 422 (June 23, 1997)
\textsuperscript{75} Notice 97-34, § V-B.
\textsuperscript{76} See Schedule A, lines 31-38, of Part III of Form 3520 (2012).
\textsuperscript{77} I.R.C. § 469(a)(2).
\textsuperscript{78} See Reg. §§ 1.469-5T(g) and 1.469-8, both reserved for Regulations regarding the application of I.R.C. § 469 to estates, trusts and their beneficiaries.
provide rules for determining whether trade or business activities and certain rental activities are passive.” 79 While that may be true generally, it is not the case when it comes to guidance in making that determination for trusts or estates.

One of the many effects of section 1411 is that it will generate increased focus on defining activities as passive or active. Although providing how a trust or estate may materially participate in activities for section 469 purposes is beyond the scope of the section 1411 Regulations, in light of the new significance of material participation for section 1411 purposes, additional guidance could help reduce both uncertainty on the part of taxpayers and the potential for litigation over these matters.

2. **Recommendation**

Because of the uncertainty of current law under chapter 1, we recommend that the Service issue guidance regarding material participation for a trust or estate for purposes of section 1411. We recommend that this guidance be issued as a new proposed regulation package rather than including these rules in these final Regulations.

In this regard, we recommend that the new proposed regulation package would provide that material participation by a trust or estate can be accomplished through meeting at least one of three tests:

(a) The fiduciary materially participates under the standards that apply to individuals under previously promulgated Regulations. 80

(b) The fiduciary, based on all of the facts and circumstances, participates in the activity on a regular, continuous and substantial basis during the year. 81

(c) The fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the conduct of the activity. 82

3. **Explanation**

The recommended alternative tests for material participation by a trust take into account the hybrid nature of a trust by allowing it to qualify based on the actions of the fiduciary (individual tests) and also those employed by the fiduciary in certain circumstances (similar to a closely held C corporation). When considering the efforts of the fiduciary, any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in

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80 See Temp. Reg. § 1.469-5T(a)(1)-(5).
82 Based upon Temp. Reg. § 1.469-1T(g) (rules for C corporations). This regulation was in turn based on I.R.C. § 469(c)(7)(C).
another role, for instance as an officer or an individual investor. If there are multiple fiduciaries, time spent by the fiduciaries could be aggregated for purposes of determining material participation.

Applying only the standards for an individual to be a material participant in an activity would ignore the obvious differences between individuals and trusts. In what is apparently the only court case to address the issue to date, the court in *Mattie K. Carter Trust* found the trust to be analogous to a closely held C corporation and concluded that “the material participation of the Carter Trust in the ranch operations should be determined by reference to the persons who conducted the business of the ranch on Carter Trust’s behalf, including [the trustee].” The Service took the position that when determining active and passive activities under section 469, only the activities of the fiduciary are to be considered when meeting the standard of regular, continuous, and substantial participation. The taxpayer argued that the participation of the trust’s other employees and agents also should be included since the trust could only participate in an activity through its fiduciaries, agents and employees much like a corporation.

The court held for the taxpayer, finding that a trust was most analogous to a corporation and that the acts of its agents would be deemed acts of the taxpayer. Based on the activities of the trust through its trustee, fiduciaries, employees, and agents, the material participation requirement was satisfied. The Court noted that it had studied the “snippet” of legislative history purporting to provide insight on how Congress intended section 469 to apply to a trust’s participation in a business, including the Senate Finance Committee Report and the footnote in the Joint Committee on Taxation’s Explanation, but did not find it helpful.

In private rulings, the Service has taken the position that it is appropriate in the trust context to look only to the activities of the fiduciary to determine material participation. The IRS Audit Technique Guide for Passive Activity Loss (the “ATG”), addresses material participation by trusts. The ATG states that the Service will generally not raise an issue if the trustee meets one of the material participation tests included in Regulation section 1.469-5T(a). We view this position as too restrictive given the hybrid nature of trusts and estates.

The approach outlined above would maintain the approach outlined in private rulings requiring material participation by the fiduciary, but would also allow certain trusts which meet the requirements to be treated analogous to a closely held C corporation and apply similar standards to qualify for active treatment.

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84 In TAM 200733023 (Aug. 17, 2007), the Service took the position that a trust satisfies the material participation test only if the fiduciaries (i.e., the trustee or trustees) are involved in the operations of the trust’s business activities on a regular, continuous, and substantial basis. See also PLR 201029014 (July 23, 2010).
85 TAM 200733023 (Aug. 17, 2007).
J. Treatment of Disposition of Stock in an S Corporation by a QSST as a Disposition by the Income Beneficiary for Purposes of Determining Material Participation

1. Summary

The Preamble states that the Treasury and the Service invite taxpayer comments on whether special coordination rules are necessary to deal with dispositions of stock in an S corporation by a QSST.86

If an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Regulation section 1.1361-1(j)(8) provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST.87 However, section 1361(d)(1)(C) and the last sentence of Regulation section 1.1361-1(j)(8) provide that “solely for the purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST shall be treated as a disposition by the income beneficiary.”

2. Recommendation

We recommend that the final Regulations clarify that when a QSST disposes of S corporation stock, the disposition will be treated as a disposition of the S corporation stock by the income beneficiary for purposes of determining material participation for purposes of section 1411 as it does under section 469 and presumably under section 465. We further recommend that the final Regulations confirm that the special rule stated in the last sentence of Regulation section 1.1361-1(j)(8) applies for purposes of section 1411 as it does for section 469 and 465.

3. Explanation

Under the Proposed Regulations, except as otherwise provided, chapter 1 principles and rules apply in determining the tax under section 1411.88 Consistent with this general approach, except as otherwise provided in the Proposed Regulations, gain that is not recognized under chapter 1 for a taxable year is not recognized for that year for purposes of section 1411. Proposed Regulation section 1.1411-7(b)(2) reserves any discussion of the treatment of the sale of an interest in an S corporation by a QSST for purposes of section 1411.

If the Regulations are finalized, without further clarification regarding the sale of S corporation stock by a QSST, it is possible that the operating income of an S corporation may be

86 77 Fed. Reg. 72,611, 72,628 (2012).
87 Similarly, the Service has ruled that when there is a deemed sale of an S corporation’s assets resulting from a I.R.C. § 338(h)(10) election that is allocable to shares of stock held in a QSST, the tax consequences of the sale is to be reported by the trust and not the income beneficiary. See PLR 199920007 (Feb. 8, 1999) and PLR 9828006 (Apr. 6, 1998). Further, it has ruled that when an S corporation sells assets pursuant to a plan of complete liquidation combined with a complete liquidation, the consequences of the sale of the assets are to be reported by the trust and not the income beneficiary. See PLR 199905011 (Nov. 4, 1998).
88 77 Fed. Reg. 72,611, 72,613 (2012).
taxable to a QSST beneficiary who materially participates in the trade or business activities of the S corporation prior to the sale of the stock by the QSST. Such income would not be subject to the tax on NII as a result of the beneficiary’s material participation. However, since gain or loss resulting from the sale of S corporation stock by the QSST will be reported by the QSST and taxed to the trust, it is not clear that the beneficiary’s material participation would be attributed to the trust. In some cases, this could result in an unintended result, for example, when the trust is not considered to be actively participating in the trade or business of the S corporation with the result that the gain would be subject to the NII Tax.

Such a result would or could be avoided if the proceeds of sale are distributed by the trust to the “active” or “materially participating” beneficiary in the same taxable year. In this case, the gain would be part of the trust’s DNI, deductible by the trust and carried out to the beneficiary, and considered net gain to the beneficiary attributable to the disposition of a “non-passive” interest in the trade or business of the S corporation under the rules of Proposed Regulation section 1.1411-3(e)(3), the rules for the disposition of interests in S corporations under section 1411(c)(4), and Proposed Regulation section 1.1411-7.

On the other hand, assuming the last sentence of Regulation section 1.1361-1(j)(8) is applicable for purposes of section 1411, as well as sections 465 and 469, the disposition of S corporation stock by a QSST would, for purposes of making the passive activity determination, be treated as a disposition by the income beneficiary, with the same tax result, regardless of whether the trust permits the distribution of principal or whether the trustee makes a distribution of the proceeds of sale. In such cases, it would be likely that the trust would distribute at least enough of the proceeds to permit the QSST beneficiary to pay the applicable federal and state tax liabilities resulting from the sale of the stock.

K. Clarification of the Application of Section 1411 upon the Disposition by an ESBT of Stock in an S Corporation on the Installment Basis Under Regulation Section 1.641(c)-1(d)(3) and Regulation Section 1.1361-1(j)(8)

1. Summary

Regulation section 1.641(c)-1(d)(3) provides that the gain or loss resulting from the sale of S corporation stock by an ESBT be reported by the S portion of the ESBT. Capital losses are permitted only to the extent of the capital gains of the trust.

Consistent with the Regulations under section 1361, which treat gains on the sale of S corporation stock on the installment basis by a QSST as income of the trust, the ESBT Regulations permit the use of the installment method upon the sale or disposition of stock in an S corporation by an ESBT. The gain recognized under the installment method is taken into account by the S portion of the ESBT. Although the trust no longer holds the S corporation stock, it continues to pay trust-level taxes on the gain as recognized under the installment method. The final ESBT Regulations provide that the interest on the installment obligation from

89 I.R.C. § 641(d)(1) provides that the portion of an ESBT that consists of stock in one or more S corporations (“S portion”) is taxed as a separate trust.
90 Reg. § 1.1361-1(j)(8).
91 Reg. § 1.641(c)-1(d)(3)(ii).
the sale or disposition of stock in an S corporation is included in the gross income of the non-S portion of the ESBT.\textsuperscript{92}

Regulation section 1.1361-1(m)(5)(ii), in effect, keeps the ESBT election alive with respect to the S portion as long as the installment payments are being made with respect to the disposition of S corporation stock. On the other hand, the interest portion is carved out and allocated to the non-S portion, subject to the normal rules of subchapter J. If all of the proceeds of the sale are distributed to beneficiaries, the interest amount would be passed out as a separately stated component of DNI. The capital gain portion, on the other hand, would be taxed at the trust level and then distributed tax-free to the beneficiary as a return of capital or non-taxable principal distribution of the trust.

2. **Recommendation**

We recommend that the final Regulations clarify that when an ESBT disposes of S corporation stock, the rules under Regulation sections 1.641(c)-1(d)(3) and 1.1361-1(m)(5)(ii) apply for purposes of section 1411 and permit the use of the installment method upon the sale or disposition of stock in an S corporation by an ESBT in determining the NII Tax.

3. **Explanation**

The Preamble confirms that chapter 1 principles and rules apply in determining the tax under section 1411, and the Proposed Regulations “preserve the chapter 1 treatment of the ESBT as two separate trusts for computational purposes but consolidate the ESBT into a single trust for determining the AGI threshold in section 1411(a)(2)(B)(iii).”\textsuperscript{93} It would be helpful if the final Regulations confirm that the installment method would be respected for purposes of determining the NII Tax upon the sale or disposition of stock in an S corporation by an ESBT consistent with the rules under Regulation sections 1.641(c)-1(d)(3) and 1.1361-1(m)(5)(ii).

IV. **Comments on Proposed Regulation Section 1.1411-4 – Definition of NII**

A. **Allowance of all Chapter 1 Deductions Attributable to Section 1411(c)(1)(A) Income as Properly Allocable Deductions**

1. **Summary**

Section 1411(c)(1)(B) provides that NII means the sum of certain gross income and net gain over deductions allowed by this subtitle which are properly allocable to such gross income or net gain. Proposed Regulations section 1.1411-4(f)(3) provides that unless specifically stated otherwise, only properly allocable deductions described in paragraph (f) may be taken into account in determining NII.

\textsuperscript{92} Reg. § 1.641(c)-1(g)(3).
\textsuperscript{93} 77 Fed. Reg. 72,611, 72,616 (2012).
2. **Recommendation**

We recommend that the final Regulations provide that the properly allocable deductions that may be taken into account in determining NII include all of the chapter 1 deductions that are allowed against chapter 1 gross income from rent, dividends, royalties, annuities and interest, other gross income derived from a trade or business and net gains attributable to the disposition of property other than property held in a trade or business. Total NII may not be reduced below zero, however.

3. **Explanation**

While we agree that the enumerated deductions provided in paragraph (f) of the Proposed Regulations are properly allocable to gross income or net gain described under section 1411(c)(1)(A), we believe that paragraph (f) should provide that properly allocable deductions include all of the deductions that are allowed against chapter 1 income that is the same as the section 1411(c)(1)(A) type of income. The Preamble provides that the theme of the Proposed Regulations was to be consistent with chapter 1 unless it was necessary to be inconsistent. Further, the Preamble provides that only amounts paid or incurred by a taxpayer to produce gross income or net gain described in section 1.1411-4 may be deducted in determining NII. However, section 1.1411-4(f) does not include as a deduction against NII all of the amounts paid or incurred by a taxpayer to produce gross income or net gain described in section 1.1411-4. In addition, a rule that provides that allocable deductions include all of the chapter 1 deductions that are allowed for amounts paid or incurred by a taxpayer to produce gross income or net gain described in section 1.1411-4 would reduce administrative complexity and eliminate any needed future revisions as tax laws change. Alternatively if the final Regulations do not provide that all chapter 1 deductions attributable to section 1411(c)(1)(A) income are properly allocable deductions, we recommend that the final Regulations provide that the following additional items are properly allocable deductions:

(a) Fiduciary fees and other tax administrative expenses for trusts and estates deductible under Regulation section 1.212-1(l).

Consistent with the treatment under chapter 1, fiduciary fees deductible under section 212 that are attributable to section 1411(c)(1)(A) income should be properly allocable deductions. If such fiduciary fees are not properly allocable deductions, estate and trust administration would be more complicated. Estates and trusts must currently compute distributable net income (“DNI”) for both regular tax and alternative minimum tax (AMT) purposes. If fiduciary expenses deductible under section 212 are not properly allocable deductions, a fiduciary would have to include a third calculation of DNI.

To determine the amount of such expenses attributable to section 1411(c)(1)(A) income, we recommend that fiduciary expenses attributable to section 1411(c)(1)(A) income be allocated using “any reasonable method” similar to the provision for state taxes under Proposed Regulation section 1.1411-4(f)(3)(C).

(b) Section 691 deductions for estate taxes paid on income in respect of decedent
Because section 691(d)(4) treats estate taxes allocable to capital gains in respect of a decedent as a reduction in the taxable gain, any estate tax allowed as a deduction under 691(c)(4) reduces NII automatically. (This reduction typically applies to gain on installment sales entered into by a decedent.) Therefore, it seems equitable to allow estate taxes allocable to other investment income such as accrued interest or taxable annuities as a deduction in determining UNII. The formulas provided in Regulation section 1.691(c)-1 to calculate taxable income easily could be used for the UNII calculation.

(c) Section 691(c) successor in interest deduction

For estates and other successors in interest to a decedent, section 691(c) allows a number of deductions that would otherwise be denied (since the successor is a different taxpayer than the decedent). These deductions include a number of sections that would affect the calculation of UNII: for example, sections 163, 164 and 212. We suggest that a cross-reference to Section 691(c) be inserted into the final Regulations to clarify that successors in interest may deduct the appropriate proportion of the deductions allowed under 691(c) in the UNII calculation.

(d) Section 642(h) excess deductions on termination of an estate or trust

Section 642(h) provides that upon the termination of an estate or trust any excess deductions pass to beneficiaries. The excess deductions attributable to section 1411(c)(A)(1) income should be allowed as properly allocable deductions. Under section 1411, UNII is reduced by distributions of NII to beneficiaries of trusts and estates who must include their distributed share of NII in their own gross income in calculating their NII. It seems equitable to allow any excess deductions that pass to beneficiaries to be taken into account in determining their NII.

(e) Section 72(b)(3) deductions for unrecovered annuity basis

Section 72(b)(3) allows a deduction for unrecovered basis in an annuity, should the annuitant die with unrecovered basis. Typically, this means the annuitant has died before their life expectancy. The deduction is allowed in the year of death. If the annuity would have produced income subject to tax under section 1411 had the annuitant continued living, it seems equitable to allow this deduction in calculating NII for the year of death. This deduction would typically apply to private annuities, charitable gift annuities, and commercial annuities, all of which would be subject to the tax under section 1411.

(f) Section 1341 deduction where taxpayer restores substantial amount held under claim of right

For certain taxpayers who had to include amounts in taxable income in a prior year and then must repay that income in a later year, section 1341 allows those taxpayer to claim a credit for the reduction in tax in a prior year. Since some of the types of income that might be restored under section 1341 may be subject to the tax under section 1411, it would be equitable for the final Regulations to include a provision under the 1411 regulations similar to section 1341 to the extent that 1341 would apply for chapter 1 purposes in a particular year.
B. Allowance of Deduction of Section 165 Losses Incurred in the Trade or Business of Trading Financial Instruments or Commodities for Purposes of Section 1411

1. Summary

The Proposed Regulations appear to provide that all gross income from the business of trading financial instruments and commodities (the “trading business”) is included in section 1411(c)(1)(A)(ii) but that section 165 losses from the trading business may be used only to reduce gains included in section 1411(c)(1)(A)(iii). Thus, under the Proposed Regulations, losses incurred in the trading business do not reduce income from the trading business. In addition, since the net gain included in section 1411(c)(1)(A)(iii) cannot be below zero, losses in the trading business may not effectively reduce income and gains recognized in the trading business. This result appears inconsistent with the statutory purpose of defining and taxing NII.

2. Recommendation

We recommend that the final Regulations explicitly allow section 165 losses from the trading business to be included as properly allocable deductions for purposes of section 1411(c)(1)(A)(ii). Specifically, we recommend that Proposed Regulation section 1.1411-4(f) be amended to allow section 165 losses recognized in the trading business be excepted from the restriction in Proposed Regulation section 1.1411-4(f)(4).

3. Explanation

NII is defined as the sum of: (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in section 1411(c)(2) (“Category 1”), (ii) other gross income derived from a trade or business described in section 1411(c)(2) (“Category 2”), and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in section 1411(c)(2) (“Category 3”), minus the deductions allowed by subtitle A (income taxes) which are properly allocable to such gross income or net gain.

A trade or business described in section 1411(c)(2) is: (i) a trade or business that is a passive activity (within the meaning of section 469); or (ii) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)) (a “trading business”).

The Joint Committee Report94 contemplates that NII in each category of is to be reduced by deductions properly allocable to such category. It explains:

Net investment income is investment income reduced by the deductions properly allocable to such income.

Investment income is the sum of three categories of income and gain: (i) gross income from interest, dividends, annuities, royalties, rents (other than income derived from any trade or business to which the tax does not apply), (ii) other gross income derived from any business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.

In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer or the trade or business consists of trading financial instruments or commodities (as defined in section 475(e)(2)). The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation.95

Proposed Regulation section 1.1411-4(c)(2) provides that gains from marking to market under section 475(f) or section 1256 and any realized gain from disposition of property held in a trading business is classified as other gross income included in Category 2 of NII and not as net gain included in Category 3.96 Proposed Regulation section 1.1411-4(f) generally describes the deductions that may be used to reduce NII and specifically provides that deductions allowed under paragraph (f) do not include section 165 losses, whether described in section 62 or section 63(d).97 Proposed Regulation section 1.1411-4(f)(4) further provides that losses deductible under section 165 may be used only in determining net gain under Category 3. Finally, Proposed Regulation section 1.1411-4(d)(2) provides that net gain included in Category 3 cannot be less than zero. It appears that under these rules trading losses that exceed other net gains in Category 3 cannot reduce trading gains included in Category 2. As a result, the income from the trading business included as NII may be significantly more that the trader’s net income from the trading business. We believe this is inconsistent with congressional intent and with the definition of NII in section 1411(c)(1).

C. NOL Deductions for Purposes of Section 1411

1. Summary

The Preamble to the Proposed Regulations requests comments on whether NII should take into account an NOL deduction. The Preamble and the Proposed Regulations provide that NII does not take into account an NOL deduction allowed under section 172 because, when an item becomes part of an NOL that is carried to another year under the current reporting regime, it generally is no longer properly allocable to a specific type of income, and rules to determine the portion of a NOL properly allocable to specific items of gross income or net gain subject to section 1411 would be unduly complex and not administrable. The Preamble makes it clear that capital loss carryforwards may be applied even if the carryforwards are from years prior to the effective date of section 1411.98 To the extent that a taxpayer has a capital loss carryforward

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95 Id. at 135 (emphasis added).
98 Specifically, the Preamble states: “[A]ny otherwise allowable deductions not taken into account for section 1411 purposes may only be taken into account in another taxable year to the extent allowed for chapter 1 purposes (such as a carryforward of investment interest under section 163(d), a suspended passive activity loss that is allowed in a
from a prior year that is attributable to investment-type assets, such carryforwards may be applied to reduce capital gains from the current years that would otherwise constitute NII.99

2. Recommendation

We believe that it is an appropriate policy choice to exclude NOLs in the determination of NII, due to the unduly complex and administratively difficult regulations that would be required to allocate an NOL to items of gross income or net gain subject to section 1411.

We further agree with the Proposed Regulations that to the extent a taxpayer has certain loss carryforwards that are tracked separately from NOLs deductible under section 172, such as a carryforward of investment interest under section 163(d), a suspended passive activity loss that is allowed in a later year under section 469(b), or a capital loss carryforward under section 1212, those losses may be taken into account in determining NII in the tax year in which they are taken into account in determining AGI. Additionally, as stated in the Preamble, we agree that the NOLs deductible under section 172 should continue to be taken into account in determining a taxpayer’s MAGI.100

3. Explanation

Proposed Regulation section 1.1411-4(f) provides that only amounts paid or incurred by a taxpayer to produce NII may be deducted in determining the NII Tax. For purposes of computing such deductions, the deduction allowed by section 172 for NOLs is not taken into account for purposes of determining NII for any taxable year. We agree that it is appropriate to exclude NOLs allowed under section 172 from the determination of NII as the rules designed to determine the portion of an NOL properly allocable to items of NII likely would be unduly complex and difficult to administer.

Additionally, we agree with the provisions of the Proposed Regulations that permit a taxpayer to take into account certain specific deduction/loss carryforwards described in Proposed Regulation section 1.1411-4(f) to offset NII in another taxable year to the extent allowed for chapter 1 purposes (such as carryforwards of investment interest under section 163(d),101 suspended passive activity losses that are allowed in a later year under section 469(b),102 and capital loss carryforwards under section 1212).103

We also agree with the Proposed Regulations, to the extent they provide that NOLs allowed under section 172 may be taken into account for purposes of determining a taxpayer’s

100 “In determining a taxpayer’s modified adjusted gross income (in the case of an individual) or adjusted gross income (in the case of an estate or trust), however, net operating losses continue to be taken into account.” Preamble, 77 Fed. Reg. 72,611, 72,621 (2012).
When a taxpayer’s MAGI is below the threshold level, the taxpayer is not subject to the NII Tax.

D. Application of Section 1411 to Gain Not Recognized Under Chapter 1; Properly Allocable Deductions

1. Summary

Under the Proposed Regulations, except as otherwise provided, chapter 1 principles and rules apply in determining the tax under section 1411. Consistent with this general approach, except as otherwise provided in the Proposed Regulations, gain that is not recognized under chapter 1 for a taxable year is not recognized for that year for purposes of section 1411. Proposed Regulation section 1.1411-4(f)(3) states that allowable expenses paid or incurred to produce gross income or net gain are allowed as deductions reducing Category 1 NII.

2. Recommendation

We recommend no change to these provisions of the Proposed Regulations.

3. Explanation

We agree with the approach of the Proposed Regulations that income and deductions not recognized under chapter 1 for a taxable year should not be recognized for that year for purposes of section 1411. Specifically, we agree with Proposed Regulation section 1.1411-4(f)(3)(ii), which states that the allowance of deductions against NII are subject to restriction under provisions such as section 163(d) (relating to investment expenses), section 67 (relating to the two percent floor on miscellaneous deductions), and section 68 (relating to the overall limitation on itemized deductions).

Proposed Regulation section 1.1411-4(a)(1)(iii) provides that only gain that is otherwise taken into account under the Code for purposes of computing taxable income is includible in NII. If non-recognition applies for other income tax purposes, it will therefore also apply for purposes of computing NII. We agree with this provision. If NII did not incorporate the non-recognition provisions otherwise provided for income tax purposes, timing differences would result between computation of taxable income and computation of NII. Such differences would add considerable complexity to the computation of NII and would increase administrative and compliance burdens.

For the same reasons, we agree with Proposed Regulation provisions to the effect that the allowance of certain properly allocable deductions against NII are subject to restriction under chapter 1 provisions, such as section 163(d) (relating to investment expenses), section 67.
E. Calculation of Itemized Deductions Properly Allocable to NII

1. Summary

We agree with the conclusion reflected in the Proposed Regulations that itemized deductions properly allocable to NII should be allowed as deductions in calculating NII under section 1411. An example of such deductions would be state and local income taxes attributable to NII. Proposed Regulation section 1.1411-4(f)(3) provides a complicated, three-tier structure in order to determine the portion of itemized deductions that is allocable to NII.

2. Recommendation

We recommend that the Final Regulations provide that all deductions, properly allocable to NII, including those for state and local income tax, be taken into account in calculating the NII Tax. The limitations of sections 67 and 68 should be applied to reduce the amount of these deductions for purposes of section 1411 only to the extent that the aggregate amount of deductions allowed in a specific category affected by the limitations under section 67 or the aggregate amount of all itemized deductions allowed under section 68 is less than the aggregate amount of NII deductions allowed in that category or of all NII deductions, respectively.

3. Explanation

Most taxpayers subject to the NII Tax will incur deductions properly allocable to NII, such as state and local income taxes on items of NII. We recommend that the final Regulations apply a “but for” test in order to determine the portion of itemized deductions, including state and local income taxes, properly allocable to NII.

Existing sections of the Code and Regulations apply such a “but for” test in a number of other circumstances. Perhaps the most analogous of these is section 111 and Regulation section 1.111-1, which address the calculation of amounts includable in gross income from the recovery of previously deducted items. Under that section, amounts deducted in a taxable year that are recovered by the taxpayer in a later year are includable in the taxpayer’s income in the later taxable year only to the extent that the earlier deduction conferred a tax benefit to the taxpayer, i.e., the deduction actually reduced the amount of tax owed by the taxpayer. In other words, under section 111, a taxpayer recognizes income only to the extent that the aggregate amount of deductions allowed would have been lower “but for” the refunded deducted amounts.

For example, if an individual has $20,000 in aggregate itemized deductions, including $8,000 of state and local income taxes, but only $10,000 of deductions are allowed for the taxable year as a result of the reduction under section 68, the entire $8,000 of state and local taxes will be treated as “allowed” for purposes of determining whether a refund of that $8,000 of state and local income taxes is taxable under section 111. Thus, even though some itemized deductions are effectively disallowed under section 68, the individual taxpayer would still be

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taxable on the full $8,000 if it were refunded, because his or her allowable deductions for the year in which the taxes were paid would have been less “but for” the state and local income taxes that were paid.

We believe that a similar test should be applied when determining the amount of deductions properly allocable to NII. As applied to section 1411, we believe that a taxpayer should be entitled to deduct amounts properly allocable to NII to the extent that the aggregate amount of deductions allowed would have been lower “but for” the NII deductions. This approach would be administratively simpler than the approach in the Proposed Regulations and is consistent with the approach taken by the Service in other situations under the Code.108

In summary, it seems appropriate to use the same test to determine whether current deductions have been allowed and are therefore properly allocable to NII as is used to determine whether prior deductions have been allowed and, therefore, taxable upon their refund.

V. Comments on Proposed Regulation Section 1.1411-5 – Trades or Businesses to Which Tax Applies

A. Section 162 Trade or Business Standard for Rental Real Estate Activities- The Real Estate Professional

1. Summary

Under the approach of the Proposed Regulations, the issue of whether the rental real estate activity of a taxpayer, who qualifies as a real estate professional under section 469(c)(7) and materially participates in the rental activity, constitutes a section 162 trade or business is of paramount importance in determining whether the net rental income of that taxpayer is subject to section 1411. Under current law, the amount and quality of activity required to constitute a section 162 rental trade or business is unclear. Given the number of individuals who are real estate professionals under section 469(c)(7) and own and operate rental real estate as well as the importance of this issue to real estate professionals, we respectfully request additional guidance.

2. Recommendations

We recommend that the Service consider one of the two following alternatives: (a) the final Regulations provide that, if a real estate professional materially participates in his or her rental real estate activities, that taxpayer’s rental income is not treated as NII (the “per se rule”); or (b) the final Regulations include additional examples to illustrate situations that do and do not rise to the level of a rental real estate trade or business for purposes of section 1411.

3. Explanation

(i) Per Se Rule

Under section 469(c)(2) and the Regulations thereunder, except as provided in section 469(c)(7), income from any rental activity is passive without regard to whether the taxpayer

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108 See also Reg. § 1.111-1.
materially participates in the activity. However, a taxpayer who meets the real estate professional exception under section 469(c)(7) may treat rental real estate activities as non-passive if the taxpayer materially participates in such activities. The Proposed Regulations incorporate the real estate professional exception for purposes of determining whether a rental real estate activity is passive. However, the Proposed Regulations caution that a taxpayer who qualifies as a real estate professional is not necessarily engaged in a trade or business under section 162 with respect to the rental real estate activities, even if the taxpayer materially participates in such activities. Thus, the Proposed Regulations further require such activities to constitute a trade or business under section 162 (which is not a requirement under section 469).

We commend Treasury and the Service for their attempt to tie the “trade or business” determination in section 1411 to the section 162 definition of trade or business in order to facilitate the administration of section 1411 and simplify taxpayer compliance. However, we note that Regulation section 1.469-9(b)(1) provides that, for purposes of the real estate professional exception, “any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under section 212” is treated “as if [it] … involved the conduct of a trade or business.” Congress specifically cross-referenced section 469 in section 1411(c)(2)(A) and appears to have intended to exclude from NII, income and gain from non-passive trade or business activities, as characterized under the section 469 Regulations. Under these rules, we recommend that the rental real estate activities in which a real estate professional materially participates – which the section 469 Regulations treat as trade or business activities – be excluded from NII. This would be a much-simplified approach to implementing the complex statutory provisions of section 1411 and would be consistent with the goal of coordinating the operation of the principles of chapter 1 in determining the tax under section 1411.

(ii) Illustrative Examples

If a per se rule is not adopted, we urge Treasury and the Service to provide additional examples in Proposed Regulation section 1.1411-5(b)(2) specifically addressing the real estate professional exception. We acknowledge that defining the scope of a section 162 trade or business

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109 The Preamble to the Proposed Regulations states:

If a taxpayer meets the requirements to be a real estate professional in section 469(c)(7)(B), the taxpayer’s interests in rental real estate are no longer subject to section 469(c)(2), and the rental real estate activities of the taxpayer will not be passive activities if the taxpayer materially participates in each of those activities. However, a taxpayer who qualifies as a real estate professional is not necessarily engaged in a trade or business (within the meaning of section 162) with respect to rental real estate activities. If the rental real estate activities are section 162 trades or businesses, the rules in section 469(c)(7) and § 1.469-9 will apply in determining whether a rental real estate activity of a real estate professional is a passive activity for purposes of section 1411(c)(2)(A). However, if the rental real estate activities of the real estate professional are not section 162 trades or businesses, the gross income derived from such activity will not be excluded under section 1411(c)(1)(A)(i) by the ordinary course of a trade or business exception.

business is beyond the scope of the section 1411 Regulations. However, given the importance of this issue for real estate professionals and the fact that such taxpayers are demonstrably in a real estate trade or business that includes rental real estate assets, we believe additional illustrative examples may avoid unnecessary controversy. We suggest the following two examples for your consideration:

Example 1. Rental Real Estate Activity–Not a Trade a Business. A, an unmarried individual, is a commercial real estate broker who also owns ten (10) office buildings, each through a single-member limited liability company disregarded for federal tax purposes. A has elected to treat each of his rental properties as a single rental real estate activity under § 1.469-9(g). Further assume that A has met both requirements of section 469(c)(7)(B) through his brokerage and rental activities and also materially participates in this grouped rental real estate activity. For each rental property, A has entered a lease agreement with a tenant pursuant to which such tenant is responsible for all operating expenses of the building, such as real estate taxes, insurance premiums, and maintenance costs, in addition to the rent (i.e., triple net lease). A also hired an unrelated property management company to manage all ten (10) buildings in exchange for a monthly fee. From time to time, A visits each building to ensure it is being maintained properly. A’s income from the rental real estate activity is passive income subject to section 1411.

Example 2. Rental Real Estate Activity–Trade or Business. Same facts as Example 1, except that, rather than hiring an unrelated property management company to manage the building, A (individually or through A’s employees) manages each building by undertaking the following activities: (i) marketing any available space, (ii) showing such space to potential tenants, (iii) negotiating and preparing leases, (iv) cleaning and maintaining common areas, (v) receiving calls from tenants for repairs, (vi) overseeing any repairs or capital improvements, (vii) paying bills, (viii) maintaining financial books, (ix) painting and cleaning available space for new tenants, and (x) when necessary, evicting tenants. These activities, performed personally by A or through A’s employees, are sufficient to constitute a section 162 trade or business. Consequently, paragraph (b)(1)(i) of this section is satisfied and A’s rental income derived from this rental real estate activity is not subject to section 1411.

Although A’s rental activity is not a passive activity under section 469 in either Example 1 or Example 2 (because A is a real estate professional under section 469(c)(7) that materially participates in this grouped rental real estate activity), A’s limited involvement in the rental real estate activities in Example 1 does not constitute a section 162 trade or business. In contrast, A’s activities in Example 2 rise to the level of a section 162 trade or business.

Thus, despite owning the same rental real estate assets, A’s rental income in Example 1 constitutes gross income from rents within the meaning of Proposed Regulation section 1.1411-
4(a)(1)(i) while A’s rental income in Example 2 is excluded from NII under the exception for non-passive trade or business activities.

B. Treatment of Recharacterized Income and Gain as Subject to Section 1411

1. Summary

As described in the Preamble to the Proposed Regulations, section 469 and the Regulations thereunder contain a number of provisions that recharacterize income as non-passive, and contain other rules that recharacterize an activity itself as a non-passive activity. Specifically, the Preamble provides that, “if a taxpayer has gross income from rents from an activity described in Regulation section 1.469-2(f)(6) that is not derived in the ordinary course of a trade or business, the gross income from rents will be subject to section 1411.” 110 This language appears only in the Preamble of the Proposed Regulations despite the fact that it provides an operative rule for interpreting section 1411. In addition, the Preamble discusses the application of the characterization of income as portfolio income for purposes of section 469 and suggests that such characterization may apply for purposes of section 1411.

2. Recommendation

We agree that determining whether income is NII based on its recharacterized status as non-passive is an appropriate policy choice, and recommend that the rule should be stated in operative language of the final Regulations. Second, we respectfully request that the statement be expanded to state the converse. For example, if the Regulation section 1.469-2(f)(6) recharacterized income was derived in the ordinary course of a section 162 trade or business, it would not be NII for purposes of section 1411. Third, we believe that the section 469 rules relating to portfolio income should be properly and explicitly coordinated with the statutory language of section 1411.

3. Explanation

The Preamble notes that the section 469 Regulations recharacterize income from certain activities as non-passive111 and explains that despite the fact that such income is non-passive income for purposes of section 1411, in most cases the income will be NII if the income is identified in Proposed Regulation section 1.1411-4(a)(1)(i) and the income is not derived in the ordinary course of a trade or business. In some cases, the recharacterized income will be derived in the ordinary course of a trade or business and it would be helpful if the language of the Regulations explained that income recharacterized as non-passive under section 469 is treated as non-passive for purposes of section 1411 as well.

The Preamble also notes that section 469(e)(1)(A)(i)(I) provides that gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business are “portfolio” income. The Preamble implies that the characterization of such income as

“portfolio” under section 469 applies for purposes of section 1411. In contrast, the Proposed Regulations relating to CFC and QEF inclusions are inconsistent with the portfolio income rules of section 469. Proposed Regulations section 1.1411-10(b) provides that certain subpart F and QEF inclusions may be income from a passive activity. Under section 1.469-2T(c)(3)(i)(A), income attributable to a CFC and a QEF is generally treated as portfolio income and not passive activity income.

It would be helpful if the final Regulations address the circumstances under which the characterization of income as portfolio for purposes of 469 applies for purposes of section 1411. In this connection, we note that it would be inconsistent with the language of section 1411 to incorporate the section 469 portfolio income recharacterization rules to income generated by a section 162 trade or business activity that is characterized under section 469 as non-passive.

C. Treatment of Guaranteed Payments for the Use of Capital as a Distributive Share of Partnership Income for Purposes of Section 1411

1. Summary

The Proposed Regulations do not contain a specific rule regarding the classification of the income received by a partner from a partnership as a guaranteed payment for the use of capital by the partnership. For purposes of chapter 1 of the Code, notwithstanding that guaranteed payments are regarded as a partner’s distributive share of ordinary income for all purposes of the internal revenue laws other than section 61(a) (relating to the timing of the partner’s recognition of income) and section 162(a) (relating to the deductibility of the payment by the partnership), the Service has, on occasion, treated guaranteed payments as “interest” income recognized by the recipient. In addition, unless recharacterized pursuant to Regulation section 1.469-7, guaranteed payments generally are treated as portfolio income pursuant to section 469, and, according to the Preamble to the Proposed Regulations, portfolio income is per se NII. Finally, the Preamble and Proposed Regulation section 1.1411-4(a)(1)(i) provide that “substitute interest payments” constitute NII, unless they are derived in the ordinary course of a trade or business not described in Proposed Regulation section 1.1411-5. The Proposed

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112 I.R.C. § 469(l) provides wide authority for Treasury to determine which income and gain is not subject to I.R.C. § 469. In contrast, I.R.C. § 1411 incorporates only the characterization of trade or business income as a passive activity within the meaning of I.R.C. § 469 (see I.R.C. § 1411(c)(2)(A)) and does not provide authority to expand the statute beyond its terms.
113 For example, Reg. § 1.469-2(f)(10) recharacterizes certain non-passive trade or business income as portfolio income for purposes of coordination with I.R.C. § 163(d). I.R.C. § 1411 does not appear to provide the authority for Treasury to characterize trade or business income as income that is not derived in a trade or business.
114 As compared to guaranteed payments for the use of capital by the partnership, guaranteed payments for services do not constitute NII pursuant to I.R.C. § 1411(c)(6), which provides that NII does not include any item taken into account in determining self-employment income. In addition, pursuant to Reg. § 1.1402(a)-1(b) (promulgated prior to enactment of I.R.C. § 1402(a)(13)), it is possible for guaranteed payments for the use of capital to constitute income taken into account in determining self-employment income.
115 Reg. § 1.1707-1(c).
116 See, e.g., Reg. § 1.469-2(e)(2)(ii); GCM 38133 (October 10, 1979); GCM 36702 (April 12, 1976). But see PLR 8728033 (April 13, 1987) and PLR 8639035 (June 27, 1986).
117 Reg. § 1.469-2(e)(2)(ii).
119 77 Fed. Reg. 72,611, 72,613, 72,618 (2012).
Regulations do not define “substitute interest payments,” and, therefore, one could interpret the Regulations as requiring the treatment of guaranteed payments for the use of capital as a “substitute interest payment” that represents NII (unless eligible for exclusion under the ordinary course of a trade or business exception).

2. **Recommendation**

We recommend that the final Regulations provide clear rules governing the treatment of income from guaranteed payments to a partner for the use of capital by the partnership (“GP Capital Income”). We suggest the application of a two-step process: (a) the character of GP Capital Income would be determined based upon the income and activities of the payor partnership, and (b) once the GP Capital Income has been so characterized, such income would only constitute NII to the extent that it constitutes Category 1, 2 or 3 income (as determined at the partner level).

3. **Explanation**

We believe that it is more appropriate for GP Capital Income to be analyzed as a distributive share of partnership income consistent with section 707(c) and the Regulations thereunder. If it is the position of the Treasury and the Service that GP Capital Income constitutes “interest” or “substituted interest payments” as such term is used in Proposed Regulation section 1.1411-4(a)(1)(i), or that GP Capital Income is per se NII as portfolio income pursuant to section 469, as opposed to a distributive share of partnership income, we suggest the final Regulations give clear guidance to taxpayers.

VI. **Comments on Proposed Regulation Section 1.1411-6 – Income on Investment of Working Capital Subject to Tax**

A. **Treatment of Gain Attributable to Working Capital Consisting of Cash and Other Liquid Assets**

1. **Summary**

Section 1411(e)(3) provides that, in determining NII, a rule shall apply similar to the one contained in section 469(e)(1)(B), which provides that income, gain or loss that is attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business. For many, if not most, S corporations and partnerships, the vast majority of their working capital is invested in cash and other very liquid assets for obvious business reasons. There is typically very little, if any, gain or loss associated with these types of assets.

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120 The Preamble indicates that substitute interest payments represent payments made to a transferor of a security in a securities lending transaction or a sale-repurchase transaction. 77 Fed. Reg. 72,611, 72,618 (2012).

121 We recognize that this type of rule would require additional rules for the apportionment of the expense for the guaranteed payments among classes of income (e.g., based upon a proportion of gross revenue, net income (excluding the guaranteed payment), or specific tracing)) that would make the rules more complex and difficult to administer, particularly in situations where the partnership recognizes an overall loss for the relevant taxable year, exclusive of the guaranteed payment. The statutory language of I.R.C. § 707, however, appears to compel this result.
2. **Recommendation**

We recommend that the final Regulations provide that highly liquid assets, such as cash, Treasury Bills, Treasury Notes, certificates of deposit, assets subject to repurchase agreements and other short-term debt instruments with maturities of less than one year are presumed to not have appreciated or depreciated in value, and are excluded from the computations necessary to determine the “asset sale gain” component of the section 1411(c)(4) calculation.

3. **Explanation**

As explained in more detail in the Comments below relating to section 1.1411-7 of the Proposed Regulations, the calculation of asset sale gain at the entity level is a critical component for determining the taxability of gain upon sale of a partnership interest or S corporation stock under section 1411(c)(4). The determination of this asset sale gain could be made substantially more complicated in many cases if small amounts of unrealized gain or loss on working capital assets had to be taken into account.

In the vast majority of asset sale transactions, liquid assets, such as those described in the recommendation, are treated by both parties as having no inherent gain or loss, and are treated as the equivalent of cash. This makes sense, because working capital, by its very nature, is intended to be available for current use in the business. Treating these assets as having no inherent gain or loss is thus well grounded in reality, and would potentially avoid cumbersome calculations that would result in very little additional increase or decrease in tax.

VII. **Comments on Proposed Regulation Section 1.1411-7 – Exception for Dispositions of Interests in Partnerships and S Corporations**

A. **Application of Section 1411(c)(4) to the Disposition of an Interest in a Partnership or S Corporation- General Comments**

1. **Summary.**

Section 1411(c)(4) provides that “[i]n the case of a disposition of an interest in a partnership or S corporation . . . gain from such disposition shall be taken into account under clause (iii) of paragraph (1)(A) only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest” (emphasis added). For purposes of the portion of these Comments relating to section 1411(c)(4), the “net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest” shall hereinafter be referred to as “asset sale gain.” Thus, section 1411(c)(4) provides that “[i]n the case of a disposition of an interest in a partnership or S corporation . . . gain from such disposition shall be” included for purposes of the NII Tax “only to the extent of” asset sale gain.

Notwithstanding this statutory language, Proposed Regulation section 1.1411-7 effectively provides that gain from any such disposition shall be excluded “only to the extent of” asset sale gain. In particular: (i) Proposed Regulation section 1.1411-7(a)(1) provides that all gain from the disposition of an interest in a partnership or S corporation shall be included for
purposes of the NII Tax, although such gain may “be adjusted in accordance with paragraph (c) of this section,” but only “[i]n the case of a disposition of an interest in a partnership or S corporation described in paragraph (a)(2) of this section”; 122 (ii) Proposed Regulation section 1.1411-7(a)(2) effectively provides that the adjustment provided for in paragraph (c) will only apply if the partnership or S corporation is engaged in at least one trade or business which does not constitute “trading in financial instruments or commodities” (previously defined in these Comments as the “trading business”) and that is not a passive activity with respect to the owner who is disposing of his or her interest in the partnership or S corporation; 123 and (iii) Proposed Regulation section 1.1411-7(b) effectively provides that gain upon the disposition of an interest in a partnership or S corporation shall be excluded only to the extent that such owner is able to establish the amount of asset sale gain that would be excluded with respect to such interest. 124

2. Recommendation.

We recommend that the final Regulations conform to the statutory language of section 1411(c)(4) so as to include gain from the disposition of a partnership interest or S corporation stock as NII “only to the extent of” the net gain that would be taken into account as NII by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition.

3. Explanation.

The approach taken by the Proposed Regulations does not appear to be consistent with the current statutory language. The Preamble states that “under the proposed regulations, the exception in section 1411(c)(4) is only applicable where the property is held in a trade or business not described in section 1411(c)(2) [which covers passive activities and “trading businesses”],” and cites the 2010 and 2011 Joint Committee on Taxation Explanations for the Act. 125 However, the legislative history cited in the Preamble supports the opposite conclusion, namely that gain would be taken into account at the shareholder or partner level only to the extent that asset sale gain would be taxable to a partner/S corporation shareholder owner under section 1411(c)(4). 126 In particular the 2010 Joint Committee on Taxation Report states as follows:

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124 77 Fed. Reg. 72,611, 72,643, 72,644 (2012).
125 77 Fed. Reg. 72,611, 72,626 (2012).
126 We understand that the heading for I.R.C. § 1411(c)(4), namely “Exception for Certain Active Interests in Partnerships and S Corporations,” could be cited as support for the approach taken in the Proposed Regulations. However, headings are not to be given any legal effect under the Code. See I.R.C. § 7806(b); Grapevine Imports, Ltd. v. U.S., 71 Fed. Cl. 324, 331 & fn 6 (2006) (recognizing that “section 7806(b) . . . strictly instructs that the heading of a section is utterly without legal significance,” that “[c]ase law makes amply clear that the provision prohibits courts from relying on the heading of a section in construing the language therein,” and thus “the Code incorporates, in part, the ‘wise rule that the title of a statute cannot limit the plain meaning of the text.’”) (citation omitted); Brown-Forman Corp., 94 T.C. No. 58 (1990) (rejecting taxpayer’s argument regarding expenditure allocation rules under I.R.C. § 994(b)(2) as relying on a section heading and ignoring the statute’s plain language); A.O.D. 1977 770 (Feb. 25, 1977) (disagreeing with a district court decision that relied upon Subchapter and Part headings for interpreting I.R.C. § 4161); 1 Mertens Law of Fed. Income Tax’n § 3.14 (“Absent a statement
In the case of the disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account (citing footnote 286, which provides “For this purpose, a business of trading financial instruments or commodities is not treated as an active trade or business.”) (emphasis added).

Moreover, the 2011 Joint Committee on Taxation Report states as follows:

In the case of a disposition of a partnership interest or stock in an S corporation, gain or loss is taken into account only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account (citing footnote 976, which provides: “For this purpose, a business of trading financial instruments or commodities is not treated as an active trade or business.”) (emphasis added).

This distinction, namely whether gain is included only to the extent that asset sale gain would be taxable to the partner or S corporation shareholder versus gain being excluded only to the extent that asset sale gain would be non-taxable is likely to make a substantial difference to certain partner/S corporation shareholder owners, as well as create substantial compliance burdens for many such owners who would otherwise be unaffected by the NII Tax. For example, in a simple situation where a sole shareholder of an S corporation is active in the corporation’s business and has a zero dollar external basis in his or her stock where the S corporation has assets worth $1 million with a $400,000 internal basis (and to simplify the analysis, no liabilities or working capital), choosing between these two approaches would mean the difference between the S corporation shareholder paying NII Tax on $0 or $400,000 of gain if he or she were to sell all of the stock for $1 million (i.e., the net value of the S corporation’s assets). In addition, as can be seen from the discussion regarding compliance burden in the next section, it would also mean the difference between engaging in a substantial amount of compliance activity in order to determine the gain that would be subject to tax in an asset sale vs. simply excluding all of the gain at the shareholder level without any additional compliance activity for a shareholder, such as this one, who is active in a business other than a trading business.

We understand the rationale of the Treasury and the Service for wanting to apply section 1411(c)(4) in the manner suggested in the Proposed Regulations. In particular, the rationale seems to be that the $600,000 portion of the gain in the above example equal to the asset sale gain is clearly excluded under the policy behind the trade or business exclusions contained within section 1411, whereas the additional $400,000 in gain experienced at the shareholder level in the above example is more akin to financial gain or loss, similar to gain from the sale of indicating clear congressional intent to place authoritative weight on the statutory labeling of a Code section, courts look instead to the operation of a provision for its effect.”)

127 This issue could also arise in the partnership setting where there is no I.R.C. § 754 election in place.
C corporation stock and arguably appropriately included within the NII Tax base. However, this approach does not appear to be consistent with the statutory language or the legislative history. Applying those authorities to the above example, the statutory language provides that “gain from such disposition shall be taken into account . . . only to the extent of the net gain which would be so taken into account by the transferor if all property of the . . . S corporation were sold for fair market value immediately before the disposition of such interest.” Thus, the amount of this “net gain” in the example above would be zero dollars. Moreover, the legislative history cited in the Preamble and quoted above states that “only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account.” Since there is no property “which is not properly attributable to an active trade or business,” this legislative history also supports the conclusion that no gain should be includible in NII in the above example.

Moreover, policy considerations support the approach reflected in the statute and legislative history. In particular, the goal of the trade or business exclusions reflected throughout section 1411 appears to reflect an intent to shield active business owners from the financial and administrative burdens imposed by this new tax. This policy would not be well served by imposing the substantial compliance burdens described in the next section, as well as potentially significant additional tax cost, whenever an active S corporation shareholder or partner sells his or her own interest in the enterprise.

We also understand that the statutory language, as it stands today, appears to produce an unintended policy result in the event of a partnership or S corporation engaged in a trading business or for a passive S corporation shareholder or partner. For example, if the trade or business engaged in by the S corporation in the above-described example was a passive activity with respect to the sole shareholder, applying the statute as it is written would cause that shareholder to be taxed on only $600,000 of gain, instead of the entire $1 million of gain recognized by the shareholder upon the sale of his or her stock. We would support a technical correction for section 1411(c)(4) to subject all such gain to the NII Tax in these circumstances. However, we do not see how that result is correct under the current statutory language. Further, we do not believe that, to correct for this particular situation, the Regulations should adopt a rule that would impose a substantial burden, as discussed below, for a large number of partnerships and S corporations that should be outside the scope of section 1411.

B. Application of Section 1411(c)(4) to the Disposition of an Interest in a Partnership or S Corporation - Computational Issues

1. Summary

Regardless of which approach discussed in the preceding section is ultimately adopted in the Regulations, one unavoidable complexity of the application of section 1411(c)(4) is the need to separately calculate asset sale gain at the entity level whenever only a portion of the gain is taxable at the individual level under that section. The major compliance difference between the approach set forth in the Proposed Regulations versus the approach recommended above is that under the approach recommended above, active shareholders would not have any additional compliance burden (because all of their gain would be exempt from the NII Tax) whereas under
the approach taken in the Proposed Regulations, passive shareholders would not be subject to any cumbersome compliance burdens (because all of their gain would be included in NII).

In order to accommodate this allocation, Proposed Regulation section 1.1411-7(d)\textsuperscript{128} indicates that a partner/S corporation shareholder subject to section 1411(c)(4) must attach a statement containing all of the following to his or her tax return for the year of disposition:

1. A description of the disposed-of interest;
2. The name and taxpayer identification number of the entity disposed of;
3. The fair market value of each property of the entity;
4. The entity’s adjusted basis in each property;
5. The transferor’s allocable share of gain or loss with respect to each property of the entity;
6. Information regarding whether the property was held in (or attributable to) a trade or business not described in Proposed Regulation section 1.1411-5;
7. The amount of the net gain under Proposed Regulation section 1.1411-4(a)(1)(iii) on the disposition of the interest; and
8. The computation of the adjustment under paragraph (c) of this section.

Even for moderately-sized partnerships and S corporations, this could entail attaching dozens of additional pages to the individual tax returns of individual partners or S corporation shareholders because such entities easily could have assets numbering in the hundreds or thousands. We feel that these compliance burdens imposed on partnerships, S corporations, and their owners could be substantially reduced without significantly affecting the administration of the NII Tax.

2. **Recommendation**

We recommend that neither the S corporation/partnership entity nor the individual partner/S corporation shareholder owner be required to report the detailed information set forth in items (3) through (6) of Proposed Regulation section 1.1411-7(d) on their income tax returns.

We recommend instead that the final Regulations require the entity to report a single asset sale gain figure for each of its trades or businesses (or a single asset sale gain figure if there is only one trade or business, or if all trades or businesses of the entity are treated similarly for purposes of section 1411) on the K-1 for the individual owner disposing of his or her interest (if relevant for computation of the NII Tax).

\textsuperscript{128} 77 Fed. Reg. 72,611, 72,643, 72,644 (2012).
3. **Explanation**

Adopting the above recommendation should substantially reduce compliance burdens without jeopardizing the collection of the NII Tax by the Service for a number of reasons. First, it is not clear why it is necessary that all the information specified be attached to the individual owner’s return. It seems that merely maintaining adequate records, as is the case with numerous other provisions under the Code, should be sufficient. Second, it appears that all of the information listed in Items (c), (d), (e) and (f) above could be combined into a single number for each trade or business activity of the partnership or S corporation. Moreover, this number could be reported as a separately stated item on the K-1 of the partnership or S corporation for any partner or shareholder owner subject to section 1411(c)(4). This would dramatically decrease the filing and paperwork burdens associated with compliance with this section at the owner level, without significantly reducing the accuracy or reliability of the tax figures reported. Finally, it would appear that the actual net gain includible in NII could then be calculated in a relatively straightforward fashion at the owner level, based upon information already reported on the individual partner/S corporation shareholder owner’s Schedule D (Form 1040) and the K-1 information provided by the relevant partnership or S corporation.

**C. Application of Section 1411(c)(4) to Sales of Interests in Tiered Entities**

1. **Summary**

   It is common for S corporations and partnerships (“passthrough entities”), to own interests in other passthrough entities. This gives rise to questions regarding how section 1411(c)(4) should apply in the context of tiered structures involving multiple levels of passthrough entities. Although S corporation stock must be owned by individuals, estates, certain trusts and certain exempt organizations (and thus cannot be held by partnerships or other corporations, including S corporations), S corporations and partnerships may both own interests in partnerships. The Proposed Regulations do not address how section 1411(c)(4) should be applied in the context of such tiered structures.

   It seems clear that section 1411(c)(4) should apply to the sale of an interest in a tiered entity in a manner similar to the application of the section to a non-tiered structure involving essentially the same trade or business activities potentially subject to the NII Tax. However, it is unclear as to whether the asset sale gain should be determined on the basis of a hypothetical sale of all of the assets of the top-tier entity, including its ownership interest in the lower-tier passthrough entity(ies), or whether all of the passthrough entities in the tiered structure should be treated as selling all of their assets in the hypothetical asset sale. This issue arises in at least two contexts. The first is in the case where an owner of the top-tier passthrough entity sells his or her interest in the top-tier entity itself. The second situation is where the top-tier entity, or one of its lower-tier entities sells its interest in a lower-tier entity. While not clear in the Proposed Regulations, it would appear that section 1411(c)(4) should be applied on the basis of a hypothetical sale of the assets of the lower-tier entity(ies). These rules are important not only for computational purposes, but their application is critical in determining the proper grouping of the

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129 However, S corporations may own 100% of qualified subchapter S subsidiaries. See I.R.C. § 1361(b)(3)(B).
trade or business activities for purposes of determining material participation of the taxpayers under section 469 in determining whether gain is NII subject to tax under section 1411.

2. **Recommendation**

We recommend that, in the case of a sale of an interest in a top-tier S corporation or partnership, the final Regulations clarify that, in order to calculate the asset sale gain component under section 1411(c)(4), gain must be determined on the basis that the top-tier S corporation or partnership, as well as each passthrough partnership entity in which it holds direct or indirect passthrough interest, engages in a hypothetical asset sale transaction. Similarly, in the case of a sale of an interest in a lower-tier entity, we recommend that the final Regulations clarify that gain should be determined under section 1411(c)(4) on the basis of the hypothetical sale of the assets of the lower-tier entity and of each of the lower-tier partnership entities in which it holds a direct or indirect passthrough interest. However, we also recommend that a top-tier S corporation or partnership entity be allowed, at its option, to calculate the asset sale gain component under section 1411(c)(4) with respect to minority interests in lower-tier partnership entities below a certain threshold, such as 10% to 20%, on the basis of the hypothetical sale of the interest in the lower-tier passthrough entity itself, rather than having to engage in the potentially laborious and difficult task of trying to calculate asset sale gain on the basis of the hypothetical sale of all of the assets of the lower-tier partnership entity where the top-tier entity may not have sufficient information or influence to cause that calculation to be properly performed. The foregoing election should not be applicable if the assets of the lower-tier partnership are actually sold as part of the transaction triggering section 1411 and the proceeds are distributed to the top-tier entity.

3. **Explanation**

The difference between the overall approach taken in the Proposed Regulations and the approach recommended in Comment VII. A. described above could have an impact upon both the tax payable under section 1411(c)(4), as well as the compliance burden associated with calculating that tax, in a situation involving tiered entities. As for the tax itself, the asset sale gain calculated at the lower-tier entity level could often be higher than the asset sale gain calculated at the top-tier entity level if the top-tier entity’s interest in the lower-tier passthrough entity is a minority interest. This is because the minority interest owned by the top-tier entity would typically be subject to some type of minority, liquidity and/or other discounts that would reduce the value of that interest below what would be realized upon an asset sale and liquidation by the lower-tier entity.

As a general rule, it would seem that the policy behind section 1411(c)(4) would be better served by treating both the top-tier passthrough entity, as well as all of its lower-tier passthrough entities, as having sold their assets in order to calculate the asset sale gain taken into account under section 1411(c)(4). This is also consistent with the policy underlying section 1411(c)(4) to exempt asset sale gain attributable to the conduct of active trades or businesses (other than trading businesses), and the policy behind section 1.1411-4(b) of the Proposed Regulations, which seems to indicate that both the determination as to whether there is a “trade or business,” as well as whether that trade or business is a “trading business” should be made “at the entity level.” To illustrate this point, assume an S corporation that is engaged in a business other than
the trading business would realize $1 million of gain upon the sale of all of its assets, and an active 30% shareholder sells his or her stock in the S corporation. Even under the overall approach taken in the Proposed Regulations, that S corporation shareholder would be entitled to exclude the first $300,000 of gain upon such sale, i.e., the exclusion would be based upon the asset sale gain determined at the entity level. It would appear that the same methodology should apply for determining the asset sale gain for lower-tier partnership entities. Thus, again assuming the overall approach of the Proposed Regulation is adopted despite our recommendation in Comment VII.A. above, if an S corporation sells a 30% interest in a lower-tier partnership that would realize $1 million of gain upon the sale of all of its assets, up to $300,000 of gain realized upon the S corporation’s sale of its 30% partnership interest should be excluded from the NII Tax under section 1411(c)(4).

However, for a number of reasons, the policy rationale for this approach diminishes as the percentage interest of the top-tier entity in the lower-tier entity decreases. First, the smaller the percentage ownership interest of the top-tier entity in the lower-tier passthrough entity, the less likely it is that an asset sale by the top-tier entity would be accompanied by an asset sale by the lower-tier entity. For example, if the top-tier entity owns 90% of the lower-tier entity, there is a good chance that a buyer of the top-tier entity’s assets will also want to acquire all of the assets of the lower-tier entity as well. Conversely, the buyer of all of the assets of a top-tier entity that owns a 10% interest in a lower-tier entity will likely just acquire that 10% interest, because the owners of the remaining 90% of the lower-tier would normally be the ones to determine whether the lower-tier entity would engage in an asset sale. Second, the smaller the percentage interest of the top-tier entity in the lower-tier entity, the less likely it is that the top-tier entity will have the knowledge regarding and influence over the lower-tier entity in order to make sure that the lower-tier entity asset sale gain is properly calculated.

To illustrate this point further, supposing the above example where the lower-tier partnership would realize $1 million in gain upon an asset sale of its own assets, and again applying the overall approach reflected in the Proposed Regulations, if the top-tier S corporation owned a 90% interest in the lower-tier partnership entity, it seems reasonable to determine the amount of gain excluded under section 1411(c)(4) based upon the $900,000 of gain that would be excluded if the lower-tier partnership were to sell all of its assets. This conclusion is supported by the fact that the top-tier S corporation would probably be able to sell its 90% interest in the lower-tier partnership at full value, without any discount for marketability, liquidity, etc. However, if the top-tier S corporation owned only a 10% interest in the lower-tier partnership, procuring the necessary information to determine the section 1411(c)(4) exclusion on the basis of an asset sale at the lower-tier partnership entity level might be much more difficult and burdensome for the S corporation.

Finally, the statutory language of section 1411(c)(4) does not limit application of the section to sales of interests in S corporations and partnerships by taxpayers directly subject to the tax under section 1411. It would be logical and appropriate for the Regulations to confirm that section 1411(c)(4) applies to the sale of an interest in a lower tier partnership by any upper tier entity in a tiered structure where the owner of the top-tier entity is subject to tax under section 1411, in a manner similar to the sale of such interest in the top-tier entity by a taxpayer directly subject to the tax under section 1411. Moreover, any other approach could permit taxpayers to
transfer the assets of top-tier S corporations and partnerships to and from lower-tier entities prior to a sale of interests, thereby manipulating the application of section 1411(c)(4).

D. Application of Section 1411(c)(4) to the Disposition of an Interest in a Partnership or S Corporation – Allocation of Goodwill Value

1. Summary

Proposed Regulation section 1.1411-7(c)(5)(ii)(B) provides that, in making the calculations under section 1411(c)(4) of the Code, “the transferor’s gain or loss from goodwill will be attributable to the entity’s trades or businesses based on the relative fair market value of the property (other than cash) held in each trade or business.” At first glance this rule might appear relatively straightforward and easy to administer, but ultimately we believe it is somewhat circular and does not appear to recognize the economic reality that “goodwill” – while not a “hard” or “tangible” asset – is itself “property (other than cash)” held in, and attached to, a specific business. Although it is an intangible, goodwill nevertheless is often recorded on the balance sheets of businesses and is a separately identifiable element of value when a potential buyer looks to buy a business. In many instances, in fact, a buyer of a business may have little concern for, and attribute little value to, the tangible assets of the business, and is interested only in the goodwill and other intangible assets of the business. We believe that the rule set forth in the Proposed Regulations for allocating goodwill and in the example used to illustrate that rule would create arbitrary results in many circumstances that do not reflect the real values of separate lines of business held by a passthrough entity, especially where tangible assets and profitability are not directly correlated.

2. Recommendation

We recommend that the final Regulations eliminate the special rule in the Proposed Regulations that requires goodwill to be allocated among trades or businesses on the basis of the relative fair market value of the other property held in each trade or business (i.e., other than cash and the goodwill itself). Instead, we recommend that the final Regulations provide for the allocation of the value of goodwill among separate trades or businesses based on fair market value of such goodwill, in the same manner as other assets.

3. Explanation

The potential arbitrariness of the rule contained in the Proposed Regulations can be shown in a relatively simple example. For example, assume an S corporation has two businesses, one of which is a software development business that has little in the way of tangible assets but generates profits of $1 million per year, while the second is a manufacturing business that generates relatively little profit but has substantial fixed assets of $1 million used in its operations. In that case, the rule contained in the Proposed Regulations would require that, in the event of the sale of an interest in the S corporation, almost all of the S corporation’s goodwill would be allocated to the less profitable manufacturing business, instead of to the software development business where the goodwill actually resides.

If the S corporation sold its businesses to two buyers, one buying each division, the buyer of the software development business certainly would pay for the goodwill in that business.
Conversely, a buyer of the manufacturing business would not be willing to pay for the goodwill of the software development business.

We appreciate that requiring that the value of goodwill be allocated among separate trades or businesses based on the relative fair market value of such goodwill could be somewhat more difficult to administer in some instances than the rule prescribed in the Proposed Regulations. However, we believe that the rule we recommend would be more consistent with the requirement that the purchase price of business assets, including intangible assets, be allocated among the assets in a manner consistent with the fair market value of the assets as required under other provisions of the Code.\textsuperscript{130} An allocation of value to goodwill and other intangible assets based on relative fair market value is consistent with economic reality and less likely to create tax results inconsistent with tax policy than the mechanical rule contained in the Proposed Regulations. It is also more consistent with the rules that apply for other purposes under the Code.

E. \textbf{Treatment under Section 1411 of Section 731 and Section 1368 Gain Resulting from a Distribution of Property or Money from a Partnership or S Corporation}

1. **Summary**

In the Preamble, the Service and Treasury requested comments on how to apply section 1411 upon a distribution in which gain is recognized pursuant to section 731.\textsuperscript{131} An S corporation shareholder can also recognize gain on a distribution under section 1368(b). In both cases, it is necessary to determine the taxpayer’s share of section 1411 net asset sale gain for the entity.

2. **Recommendation**

We recommend that the final Regulations adopt certain rebuttable presumptions with respect to gain resulting from a distribution from a partnership or S corporation. In the event that the entity is engaged in the trading business or other investment activities, or is engaged in another trade or business which is a passive activity with respect to the S corporation shareholder or partner receiving the distribution, then the gain associated with such distribution would be presumed to be subject to the NII tax. This presumption should be rebuttable by a statement attached to the taxpayer’s income tax return for the year in question that explains why all or a portion of the gain is not NII, accompanied by information that supports the representation, as described below. However, if the entity is not engaged in any trading business or other investment activities and the recipient S corporation shareholder or partner is active in all of the trades or businesses in which the entity is engaged, then such gain would be presumed to be exempt from tax.

\textsuperscript{130} See, e.g., I.R.C. §§ 338, 1060.
\textsuperscript{131} 77 Fed. Reg. 72,611, 72,626 (2012).
3. **Explanation**

As noted in the Preamble, the deemed sale approach of Proposed Regulation section 1.1411-7 is administratively burdensome and, particularly in the case of a distribution from a partnership or an S corporation, is unnecessarily complex. If the overall approach in Proposed Regulation section 1.1411-7 (which is discussed in Comment VII. A. above) is adopted, then it would be helpful if the final Regulations created certain presumptions regarding the NII character of distributions under sections 731 and 1368(b).

Partnerships and S corporations are subject to varying rules relating to distributions of money and property from the entity to a partner or a shareholder. Certain of those rules are noted below in order to frame the issue of how section 1411 should apply to a distribution from a passthrough entity that causes gain recognition.

**Partnerships.** Under section 731(a)(1), gain is recognized when a partner receives a distribution of money (or a deemed distribution of money by reason of a reduction in the partner’s share of liabilities under section 752(b)\(^{132}\)) that exceeds the partner’s basis in the partnership interest. Section 731(a) provides that any gain or loss recognized on a distribution in excess of basis shall be considered gain or loss from the sale or exchange of the partnership interest of the distributee partner. Section 741 provides that gain or loss from the sale or exchange of a partnership interest is treated as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751.

Section 751(b) provides that to the extent a partner receives in a distribution partnership property which is unrealized receivables or inventory items which have appreciated substantially (“hot assets”) in exchange for all or a part of the partner’s interest in other partnership property (including money) or vice versa, such transaction shall be treated as a sale or exchange of such property between the distributee and the partnership. Thus, a distribution of cash or relief of liabilities under section 752(b) could result in an exchange under section 751(b) of the partner’s interest in hot assets for an increased share of money as well as potential capital gain under section 731 and section 741. The income triggered if section 751(b) applies may also be included in NII under section 1411(c)(1)(A)(iii)\(^{133}\).

**S Corporations.** Section 1368(b) provides that if a shareholder receives a distribution that exceeds the shareholder’s adjusted basis in the S stock, the excess is treated as gain from the sale or exchange of the stock. In the case of an S corporation having earnings and profits, section 1368(c) provides that a portion of a distribution that exceeds the S corporation’s accumulated adjustments account may be treated as a dividend (to the extent it does not exceed accumulated earnings and profits) and that any remaining amounts are treated in the manner provided by section 1368(b) (as recovery of basis and then as gain on sale of the stock). In addition, if an S corporation distributes property other than cash to its shareholder, the S

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132 I.R.C. § 752(b) provides in part that any decrease in a partner’s share of the liabilities of a partnership shall be treated as a distribution of money to the partner by the partnership.

133 See, e.g., Prop. Reg. § 1.1411-4(d)(3), 77 Fed. Reg. 72,611, 72,639 (2012) (referencing I.R.C. § 61(a)(3) and Reg. 1.61-6). Reg. § 1.61-6(c) makes it clear that only some gains from dealings in property are eligible for the maximum rate on capital gains.
corporation recognizes gain, but not loss, under section 311(b). In a liquidating distribution of property, however, the S corporation recognizes either gain or loss under section 336(a).

**Determination of Net Gain Subject to Tax Under Section 1411.** Section 1411(c)(1)(A)(iii) provides that NII includes, but is not limited to, net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business that is a non-passive trade or business activity that is not a trading business.134

Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or an S corporation, gain from such disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain that would be taken into account if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of the partnership or S corporation interest.

As provided in Proposed Regulation section 1.1411-4(b)(2), and consistent with the rules of section 469, the annual determination of whether a trade or business activity is a passive or a non-passive activity is made at the individual, estate or trust level. In contrast, the question of whether a trade or business is a trading business is made at the entity level. Thus, the determination of whether the partnership or S corporation is engaged in a business subject to the NII Tax may vary from owner-to-owner and from year-to-year and often must be made at the partner or shareholder level.

**Rebuttable Presumptions.** Consistent with the purpose of section 1411 and ease of administration, we recommend that gain recognized on a distribution from a partnership or an S corporation be presumed to be Category 3 NII whenever the entity is engaged in the trading business or other non-working capital investment activities or in any business which is a passive activity with respect to the partner or shareholder receiving the distribution. This presumption should be rebuttable by the taxpayer by attaching a statement to his or her income tax return for the year in question that explains why all or a portion of the gain is not NII. The statement should include information as to the relative value of the partnership’s or S corporation’s assets (including interests in lower-tier partnerships) that are used in a non-passive trade or business activity of the taxpayer that is not the business of trading financial instruments or commodities and any other information that supports excluding all or a portion of the gain from NII of the taxpayer. The taxpayer can determine relative fair market values based on the historic income streams reported by the partnership or S corporation, on information provided by the partnership or S corporation to support a deemed sale approach, by comparing the partner’s or shareholder’s share of NII before and after the distribution or by use of another reasonable method.135 On the other hand, if the partnership or S corporation is not engaged in any trading business or other non-working investment activities and the recipient partner or shareholder materially participated in all of the trades or businesses that the entity did engage in, then the distribution should be presumed to be exempt from the NII Tax, and no such complicated calculations should be required.

We recognize that the deemed sale approach of the Proposed Regulations provides a potentially more accurate measure of the NII inherent in the assets of a passthrough entity and recommend that taxpayers that have sufficient information may use that approach to substantiate the representation required to rebut the presumption of NII. Nevertheless, the cost of compliance with the deemed sale approach and taxpayers’ inability to obtain information from the partnership or S corporation may make that approach impractical or cost prohibitive in many situations. Thus, we suggest that alternatives be authorized by the final Regulations.

VIII. Comments on Proposed Regulation Section 1.1411-8 – Exception for Distributions from Qualified Plans

A. Application of Section 1411 to a Distribution by a Tax-Qualified Plan of Employer Securities That Include Net Unrealized Appreciation (“NUA”) That is Not Taxable to the Participant for Purposes of Chapter 1

1. Background

Section 402(e)(4) provides that if a participant takes a lump-sum distribution (as defined in section 402(e)(4)(D)) from a tax-qualified plan that includes NUA attributable to employer securities, the NUA is not included as part of the distribution for purposes of sections 402(a) and 72. In effect, the NUA is not subject to taxation upon distribution. Under Regulation section 1.402(a)-1(b)(2), NUA is the excess of the value of the employer’s securities at the time of distribution over the acquisition cost of the shares.

Thus, for example, if employer securities in an individual’s account under a tax-qualified plan cost $10,000 at the time they were contributed to an individual’s account, but have a fair market value at the time of distribution of $30,000, the $20,000 of appreciation is the NUA. The participant would pay tax at ordinary income rates on the $10,000 of cost. Under Notice 98-24, the $20,000 of NUA would be taxed at long-term capital gains rates upon ultimate disposition of the securities (regardless of the applicable holding period). Any subsequent appreciation in the value of the shares (beyond the $20,000 NUA) is subject to taxation at long- or short-term capital gains rates depending upon the actual holding period.

2. Recommendation

We recommend that the final Regulations address the application of section 1411 to the subsequent disposition of employer securities distributed from a tax-qualified plan where the distribution involves NUA, as well as the treatment of dividends payable with respect to such securities post-distribution, by providing that (i) section 1411 does not apply to NUA on the subsequent disposition of the securities, as this amount is part of the distribution from the qualified plan, and (ii) section 1411 does apply to any post-distribution appreciation in the value of the securities and to any post-distribution dividends on such shares.

\[\text{136 1998-1 C.B. 929.}\]
3. **Explanation**

The provisions of the Proposed Regulations with respect to distributions from tax-qualified plans set forth a clear exception and provide helpful examples and clarification. In the case of a distribution from a tax-qualified plan to which the NUA exception under section 402(e)(4) applies, the application of the rules could be more complicated because a portion of the distribution is subject to tax upon the subsequent disposition of the employer securities rather than at distribution. As we understand the manner in which section 1411 would apply under the Proposed Regulations, at the time of the subsequent disposition of the securities there could be a portion of the amount realized that would include the NUA previously distributed but not yet taxed, and which therefore would not then be subject to section 1411. Conversely, to the extent of any appreciation after the distribution, as well as any post-distribution dividends, there would be a portion of the amount realized that would be subject to section 1411. We suggest including examples in the final Regulations along the following lines to illustrate these points:

**Example 1:** Employee A is a participant in Plan B, sponsored by Company C. On January 15, 2014, A receives a distribution from Plan B of 100 Company C shares. The value of the shares at the time of distribution is $30,000, $20,000 of which qualifies as NUA. Employee A pays ordinary income tax on $10,000 of the distribution. On January 15, 2016, A sells all 100 Company C shares for $45,000. A recognizes $35,000 of long-term capital gain. Of this amount, $20,000 represents the NUA distributed in 2014 and, therefore, is excluded from NII. The remaining $15,000 is includible in NII subject to section 1411.

**Example 2:** The same facts as Example 1, except Company C pays quarterly dividends on distributed Company C shares. All dividends on the Company C shares that are paid after the January 15, 2014 distribution are includible in NII.

IX. **Comments on Proposed Regulation Section 1.1411-9 – Exception for Self-employment Income**

We have no comments at this time.

X. **Comments on Proposed Regulation Section 1.1411-10 – Controlled Foreign Corporations and Passive Foreign Investment Companies**

A. **Treatment of Income Inclusions from CFCs and PFICs as NII**

1. **Summary**

For federal income tax purposes, a United States shareholder of a CFC is required to include in income certain types of undistributed income earned by the CFC known as “subpart F income.”\(^\text{137}\) Similarly, a U.S. person that owns stock in a PFIC that is treated as a qualified electing fund (“QEF”) must include under section 1293 undistributed income earned by the PFIC (“section 1293 inclusions”). Distributions to U.S. shareholders out of previously taxed

\(^{137}\) See I.R.C. § 951(a).
earnings are not subject to tax and are not treated as dividends for purposes of chapter 1 of the Code.138

In order to account for the fact that a taxpayer is taxed currently on subpart F or section 1293 inclusions despite having not received an actual distribution, sections 961 and 1293 provide that a U.S. shareholder or QEF shareholder must increase her basis in the stock upon recognition of a subpart F or section 1293 inclusion and reduce her basis upon receiving a distribution out of previously taxed earnings. Similarly, section 1248, which treats some or all of the gain recognized on the sale of CFC or QEF stock as dividend income, excludes from earnings and profits undistributed subpart F or section 1293 inclusions, which have already been taxed as ordinary income.

Under section 1411, Category 1 NII includes only “interest, dividends, annuities, royalties, and rents”. The statute does not mention subpart F or section 1293 inclusions. The Proposed Regulations, as a default rule, provide that subpart F and section 1293 inclusions are not subject to tax under section 1411 despite being subject to tax under chapter 1 because they are not treated as dividends for chapter 2A purposes. Instead, actual distributions (including distributions out of previously taxed earnings) are taxed under chapter 2A. Because of timing differences in taxing income under chapter 1 versus chapter 2A under the default rule, the Proposed Regulations provide for separate conforming adjustments to properly determine gain recognition for chapter 2A purposes. In addition, the Proposed Regulations allow taxpayers to elect out of the default rule and instead treat all of their inclusions from CFC or QEF stock as Category 1 NII to conform the timing of tax under chapter 1 and chapter 2A.

2. **Recommendation**

We recommend that the final Regulations eliminate the elective regime and treat subpart F and section 1293 inclusions as dividends for section 1411 purposes. In the alternative, we recommend that the final Regulations adopt a lookthrough approach whereby U.S. shareholders or QEF shareholders determine whether section 1411 applies to subpart F or section 1293 inclusions as if the shareholders earned the income directly. Subsequent distributions out of previously taxed earnings would be ignored under this alternative, eliminating the need for separate calculations of tax attributes under chapter 1 versus chapter 2A.

3. **Explanation**

The Preamble states that subpart F and section 1293 inclusions do not fall within the purview of section 1411. In the case of subpart F, we understand that Treasury and the Service believe that subpart F inclusions are not “dividends” unless expressly provided by the Code. In support of this proposition, the Preamble cites *Rodriguez v. Commissioner*,139 where the government successfully argued that subpart F inclusions were not dividends for purposes of qualified dividend treatment under section 1(h)(11).140

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138 See I.R.C. §§ 959(d), 1293(c).
139 137 T.C. 174 (2011).
140 There is at least one context where the Service has treated subpart F inclusions as “dividends” under Chapter 1. For purposes of the unrelated business income tax, the Service has treated subpart F inclusions as dividends in
As a result, we understand that Treasury and the Service believe that the statutory definition of NII may not allow for taxing subpart F or section 1293 inclusions currently under chapter 2A. However, the Proposed Regulations’ view that subpart F and section 1293 inclusions cannot be dividends is in tension with the flexible approach that Treasury and the Service have taken with respect to substitute dividends. As is the case with subpart F inclusions, substitute dividends are not described under section 1411 and do not qualify for qualified dividend treatment. Nevertheless, because “it is appropriate to treat substitute payments in a manner that precludes their use to facilitate tax avoidance,” the Proposed Regulations include substitute dividends in the list of Category 1 NII, even though they are not described in the statute. The Treasury and the Service should adopt a similar flexible approach to treat subpart F and section 1293 inclusions as dividends solely for purposes of section 1411.

The reason for our recommendation is that the system provided in the Proposed Regulations is unduly complicated and poses significant compliance problems for taxpayers. Because the default rule described in the Proposed Regulations results in timing differences in treating subpart F and section 1293 inclusions under chapter 1 versus chapter 2A, taxpayers would now be subject to parallel universes of income tax accounting. As the Proposed Regulations indicate, taxpayers will have to (1) keep track of separate bases in their CFC stock, (2) perform different section 1248 calculations upon sale of stock in order to properly determine the amount of net gain under Category 3, (3) deduct at different times expenses that are properly allocable for chapter 1 versus chapter 2A purposes (and potentially keep track of carryover deductions solely for chapter 2A purposes), and (4) make separate adjustments to MAGI and AGI for purposes of determining whether section 1411 applies.

Ownership of CFC stock by partnerships or S corporations presents particularly difficult problems. The partner or S corporation shareholder will have to keep track of different adjusted bases in such partner’s partnership interest for chapter 1 versus chapter 2A purposes. In addition, for a partnership that has made a section 754 election (assuming that the election applies for both chapter 1 and chapter 2A purposes, as discussed in Comment X.E. below), a buyer of a partnership interest may have a different section 743(b) adjustment for chapter 2A purposes when the partnership owns CFC stock.

Furthermore, we believe that many other examples of disparate treatment under chapter 1 versus chapter 2A will surface as the Regulations are finalized and implemented. Inevitably, Treasury and the Service will need to issue more guidance in the future to address other disparities that arise.

The Proposed Regulations pose a significant compliance challenge not only for the most sophisticated taxpayers, but they may also prove difficult and burdensome for the Service to enforce. The provision in the Proposed Regulations allowing taxpayers to elect to treat subpart F and section 1293 inclusions as dividends may be a tacit recognition of the immense compliance burdens for taxpayers and the Service under the default regime. Given these burdens, we believe various private letter rulings. See, e.g., PLR 9407007 (Nov. 12, 1993). Congress has explicitly approved this result in a committee report. H.R. Rep. 108-755, at 314–15 (1996) (citing with approval six other PLRs reaching a similar conclusion and expressing disapproval of a PLR that reached a different conclusion).

141 77 Fed. Reg. 72,611, 72,618 (2012).
142 See, e.g., I.R.C. § 734(b) (optional basis adjustments).
that most taxpayers, if aware of the option, will choose to make the election because, for most individual taxpayers and their preparers, the compliance costs of the default regime will be outweighed by the benefits of deferring the NII Tax.

We believe that the better policy is to tax subpart F and section 1293 inclusions currently and not to have the parallel tax accounting regime created by the default treatment. Although offering taxpayers a way to elect into a regime of current taxation may be a way to limit the problems posed by the default regime, we do not believe it is a satisfactory solution for two reasons. First, a significant number of taxpayers, either out of preference or by accident, will still operate under the default regime, resulting in the compliance problems described above (and a possible trap for the unwary for those who are unaware of the disparate tax accounting rules under chapter 1 versus chapter 2A). Second, if current taxation of subpart F and section 1293 inclusions is the preferred tax policy result, then we believe that sound tax administration dictates that current taxation should be the rule for all taxpayers, rather than the result of an election. We believe that Treasury has the general regulatory authority to require current taxation under section 1411 in respect of subpart F and section 1293 inclusions.

In the alternative, we believe that a second-best solution would be for the final Regulations to adopt a lookthrough approach, whereby a U.S. shareholder or QEF shareholder would determine the portion of his or her subpart F or section 1293 inclusion that was attributable to income derived by the CFC or QEF that was described in section 1411. Lookthrough would avoid the statutory hurdle of treating subpart F or section 1293 inclusions as dividends while providing for current section 1411 tax on most inclusions. Perhaps more importantly, it would avoid the need to make conforming adjustments for chapter 2A purposes. We acknowledge that a lookthrough approach poses its own complications, but we believe it to be preferable to the approach adopted by the Proposed Regulations.

Existing Regulations already provide for lookthrough in respect of CFCs under certain circumstances. For example, Regulation section 1.951-1(a)(3) provides that for purposes of determining whether a domestic corporation is a personal holding company under section 542, the character of subpart F income “shall be determined as if such amount were realized directly by such corporation from the source from which it is realized by the controlled foreign corporation.” Similarly, Regulation section 4.954-2(b)(6) provides that subpart F income that is “attributable to . . . tax-exempt interest shall be treated as tax-exempt interest in the hands of the U.S. shareholders.”143 Prior to the elimination of the CFC/PFIC overlap, Regulations under section 904 also provided for lookthrough for income from a QEF.144 Given these longstanding precedents, we believe the Treasury and the Service have the general regulatory authority to provide for lookthrough for purposes of section 1411.

In addition, at least two provisions in the Code provide for lookthrough of income earned by a CFC. Section 904(d)(3)(B) provides that subpart F inclusions are passive category income for foreign tax credit purposes “to the extent the amount so included is attributable to passive category income” earned by the CFC.145 Section 512(b)(17)(A) provides that a U.S. shareholder

143 This regulation still applies by virtue of Regulation § 1.954-0(a)(2) (“[T]he provisions of § 4.954-2(b)(6) of this chapter continue to apply.”). But see Reg. § 1.952-2(c)(1) (suggesting the opposite rule).
144 Reg. § 1.904-5(j).
145 See also Reg. § 1.904-5(j) (similar rule for certain PFICs).
that a tax-exempt organization earns unrelated business taxable income (UBTI) if it includes subpart F income “attributable to insurance income . . . , which, if derived directly by the organization, would be treated as” UBTI. These examples in the Code and Regulations demonstrate that U.S. shareholders and QEF shareholders have already applied lookthrough rules in other contexts, and a lookthrough approach for section 1411 would not be breaking new ground.

Under a lookthrough approach, the final Regulations could provide that section 1411(c) would be applied to a subpart F or section 1293 inclusion “as if such amount were realized directly by such individual, estate, or trust from the source from which it is realized by the controlled foreign corporation or qualified electing fund.” Only subpart F or section 1293 inclusions are considered—other non-subpart F income is not. Under a lookthrough rule, distributions of previously taxed earnings would be ignored and, therefore, would not be subject to section 1411. This would allow for consistent treatment of these amounts for purposes of chapters 1 and 2A.

For most QEF shareholders (particularly in respect of PFICs that satisfy the “income test” under section 1297), most section 1293 inclusions will constitute Category 1 or Category 3 NII, which generally encompass passive income within the meaning of section 1297(b). Similarly, for U.S. shareholders of CFCs, most subpart F inclusions attributable to foreign personal holding company income will be Category 1 or Category 3 NII.

Whether other types of subpart F or section 1293 inclusions are captured under section 1411 would depend on whether the income was Category 2 NII. This would require applying section 1411(c)(2)(B) and the passive activity rules under section 469 to determine whether the U.S. shareholder or QEF shareholder materially participated in the trade or business conducted by the CFC or PFIC (if any). We recognize that this would entail a novel application of the rules under section 469, which do not generally attribute the trade or business conducted by a C corporation to its shareholder. However, we believe the application of section 469 to a CFC treated as a lookthrough would be consistent with the approach applied to S corporations or partnerships.

Moreover, we believe that in practice, very few QEF shareholders or U.S. shareholders materially participate in any trade or business of the PFIC or CFC. Therefore, most shareholders of QEFs or CFCs will treat inclusions that do not come under Category 1 or Category 3 NII as Category 2 NII, with the end result that most of the shareholder’s subpart F or section 1293 inclusion will constitute NII. Although subpart F inclusions attributable to section 956 property would likely not be captured under any of the section 1411 categories, we do not think this presents significant opportunities for tax avoidance in the context of individuals, estates, and trusts, who are the only persons subject to section 1411.146

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146 Under a lookthrough approach that did not tax inclusions attributable to I.R.C. § 956, CFCs seeking to repatriate foreign income would have an incentive to first repatriate in the form of an investment in U.S. property rather than as a distribution subject to I.R.C. § 1411. However, we believe that most individual U.S. shareholders will ultimately prefer to pay the 3.8% tax and receive cash directly as opposed to in the form of an obligation (which would require a loan agreement and payment of interest) or an indirect interest in other U.S. property (which the U.S. shareholders would not necessarily be able to control).
A lookthrough rule would require taxpayers to obtain information about the character of the income earned by the CFC or PFIC. We do not think this presents significant compliance burdens for U.S. shareholders of those entities, who are by definition significant shareholders and must already obtain detailed information for the purpose of filing Form 5471. In the case of PFIC shareholders, Regulation section 1.1411-10 only affects shareholders that have made a QEF election. For QEFs, section 1295 already imposes significant reporting requirements on PFICs to provide a PFIC Annual Information Statement to electing shareholders describing the PFIC’s ordinary earnings and net capital gain or allowing shareholders to examine its books.147 These rules could be modified to require QEFs to provide sufficient information for taxpayers to determine their section 1411 obligations. While we recognize that this creates additional burdens on PFIC shareholders who already face difficulties in obtaining information, we believe these additional costs are modest compared to the burdens imposed upon owners of both CFC and QEF stock under the Proposed Regulations. In addition, we believe that because most taxpayers do not materially participate in any trade or business conducted by a PFIC, in most of cases, all of a taxpayer’s section 1293 inclusion will be NII under one of the three section 1411 categories and taxpayers will not need to obtain detailed information from the PFIC.

In summary, we recommend that the final Regulations treat subpart F and section 1293 inclusions as dividends. In the alternative, we recommend the final Regulations adopt a lookthrough approach to allow for consistent treatment of subpart F and section 1293 inclusions under chapter 1 and 2A, and avoid the administrability problem associated with the Proposed Regulations.

B. Application of Portfolio Income Rule under Regulation Section 1.469-2T(c)(3) to Subpart F Inclusions for Purposes of Section 1411

1. Summary

Section 469(e)(1) provides that certain types of income are not taken into account as income from a passive activity under section 469. Temporary Regulation section 1.469-2T(c)(3)(i) clarifies that this exception applies to “portfolio income,” which specifically includes subpart F and section 1293 inclusions.148

Under Proposed Regulation section 1.1411-10(b), if a taxpayer owns CFC or QEF stock as part of that taxpayer’s trade or business described in section 1411(c)(2) (which includes passive activities described under section 469), then any subpart F or section 1293 inclusions are taken into account as Category 2 NII.149

2. Recommendation

We recommend that the final Regulations clarify whether the portfolio income rules under Temporary Regulation section 1.469-2T(c)(3)(ii) apply for purposes of Proposed Regulation section 1.411-10(b). To the extent that a taxpayer has subpart F or section 1293

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147 Reg. § 1.1295-1(g)(1).
148 An exception applies for certain income “derived in the ordinary course of a trade or business.” Temp. Reg. § 1.469-2T(c)(3)(ii).
149 Prop. Reg. § 1.1411-10(b), 77 Fed. Reg. 72,611, 72,648 (2012); see also 77 Fed. Reg. 72,611, 72,629 (2012).
inclusions as part of a passive activity, we recommend that income be included as Category 2 NII and not subject to paragraphs (c) through (g) of Proposed Regulation section 1.1411-10, in spite of the portfolio income exception.

3. **Explanation**

Proposed Regulation section 1.1411-10(b) covers both trading activity under section 1411(c)(2)(B) as well as passive activities under section 1411(c)(2)(A). We understand that Proposed Regulation section 1.1411-10(b) is intended to allow taxpayers who earn subpart F or section 1293 inclusions as part of activities described in section 1411(c)(2) to avoid the rules described in Proposed Regulation section 1.1411-10(c) through (g). In the case of passive activities described in section 1411(c)(2)(A), the Proposed Regulations appear to contemplate a situation in which a taxpayer owns CFC or QEF stock as part of that taxpayer’s passive activity. Proposed Regulation section 1.1411-10(b) states that subpart F or section 1293 inclusions from such passive activity are treated as Category 2 NII.

However, we do not think that the Proposed Regulations achieve the intended result due to the portfolio income exception for subpart F and section 1293 inclusions. Proposed Regulation section 1.1411-10(b) applies generally to “income derived from a trade or business” described in section 469, but portfolio income is not “income derived from a trade or business” described in section 469. Subpart F and section 1293 inclusions are both portfolio income and, under the Proposed Regulations, are not Category 1 NII because they are not interest, dividends, annuities, royalties, or rents. Therefore, taxpayers who have subpart F or section 1293 inclusions as part of a trade or business described in section 1411(c)(2)(A) will not be subject to Proposed Regulation section 1.1411-10(b) but would instead be subject to the rules in Proposed Regulation section 1.1411-10(c) through (g). In other words, Proposed Regulation section 1.1411-10(b) would in practice only apply to income from trading activities under section 1411(c)(2)(B). We do not believe that Treasury or the Service intended the rule under Proposed Regulation section 1.1411-10(b) to be so narrow.

Although one could interpret Proposed Regulation 1.1411-10(b) as applying without incorporation of the portfolio income rules, this interpretation is not apparent from the overall structure of the Proposed Regulations. To the contrary, the Preamble suggests that the portfolio income exception does generally apply in the context of section 1411. For example, the Preamble refers to “Coordination With Portfolio Income Rules in Section 469” in explaining that the “ordinary course of a trade or business” exception in Category 1 NII does not apply.

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150 See 77 Fed. Reg. 72,611, 72,629 (2012).
151 See Reg. § 1.469-2T(c)(3).
152 Reg. § 1.469-2T(c)(3)(i) specifically identifies income from a controlled foreign corporation (within the meaning of I.R.C. § 957) and from a qualified electing fund (within the meaning of I.R.C. § 1295(a)) as portfolio-type income that is specifically excluded from the characterization as passive or non-passive under I.R.C. § 469.
153 Under certain narrow circumstances, one of the exceptions in Temp. Reg. § 1.469-2T(c)(3)(ii) could apply.
Similarly, the Preamble suggests that net gain from the sale of certain property as part of a passive activity can be portfolio income that is not Category 2 NII.\textsuperscript{155}

Because the underlying purpose of the portfolio income exception (to prevent taxpayers from shielding passive losses with portfolio income) does not exist in the context of section 1411, we do not believe that the Proposed Regulations should take into account the portfolio income exception. Alternatively, if the portfolio income exception does apply for purposes of section 1411, then Proposed Regulation section 1.1411-10(b) would in practice apply mainly to trading activity and not passive activities (which would be carved out due to the portfolio income exception rule), and we recommend that the final Regulations state so specifically.

Regardless of which approach is adopted, we recommend the final Regulations clarify the interaction between the portfolio income exception and Proposed Regulation section 1.1411-10(b).

C. Ability to Make Election under Proposed Regulation Section 1.1411-10(g) on an Amended Return

1. Summary

If a taxpayer makes 10(g) Election, which applies to all interests in CFCs or QEFs held by the taxpayer in the year of the election or acquired in subsequent years, the taxpayer would include subpart F and section 1293 inclusions as NII under Category 1 in the same manner and in the same taxable year as such amounts are included in income for chapter 1 purposes. Moreover, distributions out of previously taxed earnings would not be treated as dividends for section 1411 purposes, and thus would not be included as NII. Furthermore, the various conforming adjustments for section 1411 purposes would not be required.

Proposed Regulation section 1.1411-10(g)(3)\textsuperscript{156} provides that the 10(g) Election must be made:

for the first taxable year beginning after December 31, 2013, during which the [taxpayer] directly or indirectly holds stock of a controlled foreign corporation or qualified electing fund and the [taxpayer] is subject to tax under section 1411 or would be subject to tax under section 1411 if the election were made with respect to the stock of the controlled foreign corporation or qualified electing fund.

The election must be made in a manner prescribed by the Secretary on or before the due date for filing the taxpayer’s income tax return for the taxable year for which the election is made. The Proposed Regulations do not specify whether a taxpayer is permitted to make a 10(g) Election on an amended return.

\textsuperscript{155} See 77 Fed. Reg. 72,611, 72,624 (2012) (suggesting that “gain described in section 469(e)(1)(A)(ii) will be net investment income” only under two narrow circumstances).

\textsuperscript{156} 77 Fed. Reg. 72,611, 72,650 (2012).
2. **Recommendation**

We recommend that the final Regulations clarify that a taxpayer is permitted to make a 10(g) Election on its original or an amended return for the first taxable year beginning after December 13, 2013, during which the taxpayer holds stock of a CFC or QEF and the taxpayer is subject to tax under section 1411.

3. **Explanation**

The rules set forth in the Proposed Regulations that apply to taxpayers with investments in CFCs or QEFs are complicated in nature. Thus, it may take a considerable amount of time for taxpayers with substantial investments in CFCs or QEFs to determine whether (and the extent to which) they are subject to tax under section 1411. Furthermore, taxpayers that make a 10(g) Election must make the election with respect to all of their interests in CFCs or QEFs held in the taxable year of the election or subsequently acquired. Given the broad ramifications of making a 10(g) Election, we recommend that taxpayers be afforded a sufficient amount of time to ascertain whether making the election would be beneficial, taking into account numerous factors such as tax consequences and compliance burdens. Permitting taxpayers to make the election on an amended return would help address this concern.

Additionally, taxpayers that want to make a 10(g) Election, but that fail to meet the timing requirement of Proposed Regulation section 1.1411-10(g)(3), would be faced with the unduly burdensome task of keeping separate books and computations for purposes of chapters 1 and 2A. Permitting taxpayers to make the election on an amended return would help mitigate this result.

The Proposed Regulations permit taxpayers to make certain other elections for purposes of section 1411 on an amended return. For example, Proposed Regulation section 1.1411-7(b)(1)(ii) provides taxpayers with an election to apply special computational rules for section 1411 purposes with respect to certain installment sales made prior to the effective date of section 1411. This election is made by filing a computational statement “with the taxpayer’s original or amended return for the first taxable year beginning after December 31, 2013 in which the taxpayer is subject to tax under section 1411.”\(^\text{157}\) Permitting taxpayers to make a 10(g) Election on an amended return would help create consistent filing procedures with respect to the various elective regimes provided by the final Regulations thereby mitigating unnecessary taxpayer confusion and increasing the likelihood of taxpayer compliance.

For all of the foregoing reasons, we recommend that taxpayers be allowed to make a 10(g) Election on an amended return.

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D. Ability to File Protective Election under Proposed Regulation Section 1.1411-10(g)

1. Summary

Under Proposed Regulation section 1.1411-10(g)(3), a taxpayer that wishes to make a 10(g) Election must make the election for the first taxable year beginning after December 31, 2013, during which the taxpayer holds stock of a CFC or QEF and the taxpayer “is subject to tax under section 1411 or would be subject to tax under section 1411 if the election were made with respect to the stock of the controlled foreign corporation or qualified electing fund.” (Emphasis added). A taxpayer that does not make a 10(g) Election in such year would presumably be barred from making the election in a subsequent year.

2. Recommendation

We recommend that the final Regulations permit taxpayers who reasonably believe they are not subject to tax under section 1411, or would not be subject to such tax in a taxable year had they made a 10(g) Election, to file a protective 10(g) Election preserving their right to treatment under Proposed Regulation section 1.1411-10(g) if it is later determined that they were (or would have been) subject to tax under section 1411 in such taxable year.

3. Explanation

A taxpayer that intends to make a 10(g) Election may inadvertently believe that he or she is not required to do so. For example, a taxpayer that includes in gross income for his or her 2014 taxable year $199,000 of income derived from a section 162 trade or business and $2,000 of subpart F income would not, absent a 10(g) Election, be subject to tax under section 1411 because subpart F income is not treated as NII under the default rule. If a 10(g) Election were made, however, the taxpayer would be subject to tax under section 1411 because the $2,000 subpart F income would be includible as NII, and the MAGI threshold would be surpassed. If the taxpayer does not make the 10(g) Election on its 2014 income tax return, he or she may be barred from making the election in a subsequent year. Likewise, where a taxpayer has NII that includes amounts that might be subject to a 10(g) Election, but does not believe he is subject to the tax on NII because the MAGI threshold is not met, and a later adjustment increases MAGI to an amount exceeding the threshold, resulting in liability for the tax, the taxpayer would be out of luck, having lost forever the ability to make a 10(g) Election. This result seems unduly harsh, especially considering the significant amount of time and effort that taxpayers would need to expend in investigating whether they are subject to tax under section 1411 and, if so, whether a 10(g) Election should be made. Permitting taxpayers to file a protective 10(g) Election would help address this concern.
E. Section 743 Basis Adjustments Where Partnership Holds Stock of CFC or PFIC

1. Summary

The Preamble requested comments on the determination of a partner’s basis adjustment under section 743 for purposes of section 1411 when the partnership holds stock in a CFC or a QEF.

2. Recommendation

If the final Regulations retain the rule that provides that a holder has a different basis for income and NII purposes, we recommend the following:

First, we recommend that any rules regarding adjustments to basis under section 743 for purposes of section 1411 provide that the basis adjustment is solely for purpose of the transferee partner and the transferee partner should have the same basis adjustment under section 743 for NII and other income tax purposes.

Second, although section 743 permits adjustments to basis only if a section 754 election is in effect or there is a substantial built-in loss, we recommend that the Treasury and the Service give consideration to permitting transferee partners to adjust the basis of partnership property for purposes of section 1411, notwithstanding that these conditions may not be satisfied.

Third, in light of the foregoing and the uncertainty of current law under chapter 1, we recommend that the Service issue guidance regarding basis adjustments for purposes of section 1411 as a new proposed regulation package rather than including the rules in these final Regulations.

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159 I.R.C. § 743 provides that the basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by I.R.C. § 754 is in effect with respect to such partnership or unless the partnership has a substantial built-in loss immediately after such transfer.
160 As one commentator has noted, it is not clear under current law that adjustments are made to a partner’s basis in its partnership interest as a result of subpart F inclusions (or the receipt of previously taxed income) by the partner with respect stock held indirectly by the partner through the partnership. Jackel, Proposed Regulation on Net Investment Income Tax, 2012 TAX NOTES TODAY 242-10 (December 17, 2012). This commentator also noted that the treatment of subpart F inclusions by a domestic partnership in the hands of its partners may not itself represent a subpart F inclusion by the partners, and, therefore, it is not clear if the special rules of Prop. Reg. § 1.1411-10 will apply in this circumstance. We recognize guidance in this area is outside the scope of the final Regulations; however, we agree with this commentator that the ability of taxpayers to comply with the rules of the Proposed Regulations and the ability of the Service to administer these provisions will be greatly enhanced if the rules of chapter 1 are clarified.
161 This is consistent with current law. See Reg. § 1.743-1(j)(1) (basis adjustment constitutes an adjustment to the basis of partnership property with respect to the transferee only).
162 As noted above, in light of the absence of guidance regarding the changes to I.R.C. §§ 734 and 743 following the American Jobs Creation Act of 2004, Pub. L. 108-357, 118 Stat. 1418, compliance and administration of I.R.C. § 1411 would be enhanced if the rules of chapter 1 are clarified.
3. **Explanation.**

First, the determination of whether income (including CFC or QEF inclusions, assuming a taxpayer has made a 10(g) Election or one of the alternatives discussed previously in these Comments is adopted) constitutes NII is likely to be determined on a partner-by-partner basis. For example, a subpart F inclusion of a U.S. taxpayer with respect to CFC stock held by a partnership may constitute NII if the activity is a passive activity, whereas the same subpart F inclusion may not constitute NII pursuant to section 1411(c)(1)(A)(ii) if the activity is not a passive activity or if the U.S. taxpayer is a C corporation. The fact that the transferor may not have been subject to the NII tax on the appreciation in the CFC stock is not relevant to the transferee under section 1411. Thus, we recommend that any basis adjustment under section 743(b) apply for both NII and Chapter 1 income tax purposes because such basis adjustments reflect the transferee’s investment in the assets held by the partnership, including its CFC and QEF stock.

Second, current law under chapter 1 causes a transferee partner to recognize income and gain already recognized by the transferor partner if basis adjustments are not made in connection with the transfer, but the transferee ultimately recognizes a loss (or reduced gain) in an equal and offsetting amount when the partnership interest is sold. Thus, lack of a section 754 election generally does not cause the transferee to recognize more or less income or gain in total than would be the case with a section 754 election. The difference is timing and potentially character of income. However, for purposes of the NII Tax, the lack of a section 754 election may significantly change the total amount of NII Tax that the transferee will ultimately owe because, for example, the fact that no net loss is allowed under section 1411(c)(1)(A)(iii) may preclude an offsetting loss when the partnership interest is sold. Moreover, the deemed sale approach of Proposed Regulation section 1.1411-7 may preclude recognition of an offsetting loss for NII purposes. Accordingly, consideration should be given to permitting transferee partners to adjust the basis of partnership property for purposes of section 1411, notwithstanding that the partnership may not have a section 754 election in effect. Alternatively, if basis adjustments are not permitted in the absence of a section 754 election, then, consistent with the approach of Proposed Regulation section 1.1411-10(c)(2) (which limits dividend recognition of previously taxed income attributable taxable years beginning after December 31, 2012), we recommend that the Service consider adopting a rule that limits recognition for transferee partners of previously taxed income to amounts that were excluded by (i) the transferee partner (ii) on or after the date on which the transferee partner acquired its interest in the partnership.

Finally, in light of the foregoing and the uncertainty of current law, we recommend that the Service issue guidance regarding basis adjustments for purposes of section 1411 as a new proposed regulation package, rather than including those rules in these final Regulations.

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163 This assumes that Prop. Reg. § 1.1411-10(b) applies without the application of the portfolio income exception as discussed in Comment X. B., and the partnership holding the stock conducts a passive activity with respect to the partner, or that the look-through approach of Comment X. A. is adopted and the activity of the CFC is a passive activity with respect to the partner.

164 The character of the loss (or reduced gain), however, may be different.