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45 DTR G-2

Trusts

Leeway Urged on Including Capital Gains In Trust's First Year of Net Investment Tax

By Diane Freda

Tax regulators should consider taking the position that, in the first year that an existing trust or estate has capital gains and net investment income, fiduciaries be allowed to reconsider whether capital gains will be included in the trusts and estates distributable net income (DNI) under tax code Section 643.

Under net investment tax rules IRS proposed in December (REG-130507-11), the income of a trust or estate is taxed to that trust or estate unless its distributable net income is carried out to the beneficiaries (231 DTR G-6, 12/3/12).

Proposing the rules for which Treasury Regulations Section 1.469-5T(g) has been reserved since 1988 is the best way to provide guidance on determining whether an estate or trust 'materially participates' under Section 469 and 1411.

Michael Grace, attorney Milbank, Tweed, Hadley & McCloy

The proposed rules would subject trusts and estates to the net investment income (NII) tax if they have undistributed NII and also have adjusted gross income over the dollar amount at which the highest tax bracket for an estate or trust begins for the taxable year. For tax year 2013, the threshold amount is $11,950.

The IRS guidance does not address the treatment of capital gains for existing trusts or estates that may or may not have included capital gains in the determination of DNI, Melissa Willms of Davis & Willms in Houston and other members of the State Bar of Texas Section of Taxation said in a March 4 comment letter to IRS.

Capital gains are generally excluded from DNI, but they can be included under Section 643 under certain circumstances, the letter said.

Trusts and estates that do not include capital gains in DNI will find that component of NII trapped in the trust or estate, resulting in undistributed NII to the trust or estate, the Texas bar group said.

"The duty of a fiduciary to treat and report capital gains as part of an existing trust or estate's DNI consistently is particularly problematic with a new tax such as the one under Section 1411," the authors said, adding that "if the tax imposed by Section 1411 had existed in the year that an existing trust or estate had first incurred capital gains, the fiduciary may have exercised its discretion differently."

Thumbs Up, Down on Alternative Method for CRTs

Charitable remainder trusts have special rules under the IRS proposed guidance. Although a trust itself is not subject to Section 1411, annuity and unitrust distributions may be net investment income to the noncharitable recipient beneficiary, according to some analyses.

By taking the position that all net investment income is carried out to beneficiaries first, it is foreseeable that beneficiaries will be required to report NII from categories of trust distributions that they have not yet received, the authors of the Texas state bar letter said.

The proposed rules provide special rules to maintain the character and distribution of the ordering rules in Section 664 for purposes of Section 1411.

On the method for determining distributable amounts of NII for charitable remainder trusts, the Texas bar group recommended that charitable remainder trust trustees be allowed the option of determining the DNI under the current rules in Section 1411(c)(2), or under an alternative method now being considered by the Treasury Department and IRS.

The alternative method would allow a trustee to figure out whether income is NII under each class of income described in Section 664 and the related Treasury regulations. The amount of recordkeeping for a trustee would not be unduly burdensome under this method, they said.

The current classification and reporting of distributions for purposes of Section 1411 are not consistent with the ordering rules under Section 664 of the Internal Revenue Code and may result in overreporting of net investment income by beneficiaries, they said.

Meanwhile, Kaspick & Company took the completely opposite view. The company, which provides planned gift investment management and administrative services, urged Treasury and IRS to reconsider the proposed method used to determine DNI.

"We believe the method proposed is inconsistent with the existing four-tier structure, is less intuitive, and less beneficial in terms of the time and effort required of trustees of such instruments," Lindy Sherwood, Kaspick's president and managing director, said in a Feb. 28 letter.

"The method in the proposed rules seeks to avoid sub-accounting within each tier of income created under Section 664 and instead effectively creates a fifth tier of NII that must be tracked and reported separately by trustees," she said. Creating the fifth tier alongside the already well understood and applied categories of Section 664 will result in greater confusion for beneficiaries of Section 664 trusts, Sherwood said.

Material Participation Question More Important

Milbank, Tweed, Hadley & McCloy attorney Michael Grace said the enactment of Section 1411 has added a significant new dimension to the need to determine whether an estate or trust "materially participates" in an activity.

His March 5 letter said the proposed rules should provide guidance on determining whether an estate or trust materially participates under both tax code Sections 469 and 1411.

Many estates and trusts over the years have not incurred losses from passive activities as Section 469 defines them, he said, because the estates and trusts have not had to characterize either losses or income under that section. However, they will now have to concern themselves with passive activity limitations because they will now have to characterize income from trades or businesses in order to comply with Section 1411.

He said the best way to do that would be to propose the rules for which Treasury Regulations Section 1.469-5T(g) has been reserved since 1988.

Grace said the rules should propose that, in general, an estate or a trust "materially participates" in a trade or business activity, or a business conducted by the entity, if any fiduciary or any beneficiary would materially participate in the activity if the fiduciary or beneficiary directly owned the interest in the activity.

"However a beneficiary's share of distributable net income sourced from a trade or business activity or a business in which the beneficiary did not materially participate should be characterized as passive under both Section 469 and Section 1411," he said.

Furthermore, he said the capacity in which the person participates should not matter for determining whether a fiduciary or beneficiary materially participates.

Under the proposed rules, an estate or trust should materially participate in an activity or a business if either a fiduciary or a beneficiary materially participates, he said. However, any beneficiary who does not materially participate in a trade or business activity under Section 469 or a trade or business under Section 1411 would characterize as passive the beneficiary's distributable net income sourced from that activity or business.

Tax Should Not Apply to Foreign Trusts

Section 1411 should not apply to foreign trusts or estates that have little connection the United

States, according to the Florida Bar Tax Section. Imposing a tax on a foreign trust's NII could result in an effective tax on NII that might be distributed to people who are not otherwise subject to the Section 1411 tax, Steven Hadjilogiou, lead author of that letter, and an attorney with Baker & McKenzie, said.

Section 1411 should only apply to U.S. beneficiaries of foreign trusts to whom distributions of NII are made or required to be made, it said.

The Florida tax section said the fiduciary relationship of an estate operates even more restrictively, generally, than that of a trust. "With a trust, a trustee must follow the terms of the trust but may be granted much (and maybe complete) discretion with respect to who will receive distributions and when," that letter said. With an estate, a fiduciary might be more restricted due to the terms of a will or revocable trust in a testate estate.

The group further said if Treasury does issue final rules requiring the imposition of Section 1411 on foreign estates, the tax should not be imposed until distributions of NII are actually made.

For More Information

Texts of letters from State Bar of Texas Section of Taxation, Florida Bar Tax Section, Michael Grace, and Kaspick and Company are in TaxCore.

A comment letter from the American Council of Gift Annuities related to the Section 1411 net investment tax rules was published at 39 DTR TaxCore, 2/27/13.

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State Bar of Texas Tax Section Comments on Proposed Rules (REG-130507-11) on Net Investment Income Tax

SECTION OF TAXATION
State Bar of Texas

March 4, 2013

electronic mail: Comments@irscounsel.treas.gov

Via Federal eRulemaking portal at *www.regulations.gov*

(IRS REG-13057-11)

CC:PA:LPD:PR (REG-130507-11)

Room 5203

Internal Revenue Service

P. O. Box 7604

Ben Franklin Station

Washington, DC 20044

Re: Comments of the State Bar of Texas, Tax Section on Proposed Regulations Regarding Net Investment Income Tax under Section 1411 of the Internal Revenue Code

Dear Ladies and Gentlemen:

On December 5, 2012, the Department of Treasury and the Internal Revenue Service published proposed Treasury regulations under section 1411 of the Internal Revenue Code and requested comments on the proposed rules. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the following comments on the proposed procedures.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

/s/

Tina R. Green

Chair, Section of Taxation

The State Bar of Texas

RESPONSE TO REQUEST FOR COMMENTS ON PROPOSED REGULATIONS ISSUED TO PROVIDE GUIDANCE UNDER SECTION 1411 OF THE INTERNAL REVENUE CODE (IRS REG-13057-11)

This response to the request for comments with respect to proposed Treasury regulations issued to provide guidance under section 1411 of the Internal Revenue Code is presented on behalf of the Section of Taxation of the State Bar of Texas.

Principal responsibility for drafting these comments was exercised by Melissa Willms, Amanda Gyeszly, Lora Davis, and Celeste Lawton. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Tina R. Green, Chair of the Section of Taxation of the State Bar of Texas reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, the Chair of COGS, also reviewed the comments on behalf of COGS.

Although members of the Section of Taxation who participated in preparing, reviewing and approving these Comments have clients who would be affected by the federal tax law principles addressed by these Comments and have advised clients on the application of such principles, 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.

Contact Persons:

Melissa Willms

melissa@daviswillms.com

(281) 786-4500

Amanda Gyeszly

agyeszly@fizerbeck.com

(713) 840-7710

Lora Davis

ldavis@theblumfirm.com

(214) 751-2130

Celeste Lawton

clawton@fulbright.com

(713) 651-5278

Date: March 4, 2013

For tax years beginning January 1, 2013, section 1411 [1] of the Internal Revenue Code imposes a 3.8% tax on certain income of individuals, estates, and trusts. The Department of Treasury (the "*Treasury*") and the Internal Revenue Service (the "*IRS*") have recognized the need for guidance in the interpretation of this section and the calculation of the tax imposed thereby. The intention of these Comments is to specifically address certain issues under this section and the proposed Treasury regulations relating to trusts and estates.

[1] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "*Code*"), unless otherwise indicated.

1. Treatment of Capital Gains for Purposes of Determining a Trust's or an Estate's Distributable Net Income

We respectfully recommend that the Treasury and the IRS consider taking the position that in the first year that an existing trust or estate has capital gains and net investment income, the fiduciaries of those existing trusts and estates be allowed to reconsider whether capital gains will be included in the distributable net income of those trusts or estates pursuant to section 643 of the Code.

A review of the statute and proposed Treasury regulations raises a concern for existing trusts and estates with regard to the treatment of capital gains. The income of a trust or an estate is taxed to that trust or estate unless the trust's or estate's distributable net income ("DNI") is carried out to the beneficiaries of the trust or estate. I.R.C. §§651, 661. As a general rule, capital gains are not treated as part of DNI. This general rule applies as long as such gains are allocated to corpus and are not "paid, credited, or required to be distributed to any beneficiary during the taxable year." I.R.C. §643 (a)(3). However, pursuant to section 643 of the Code and the related Treasury regulations, capital gains may be included in DNI under certain conditions and if done pursuant to local law, the trust agreement, or "a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)." Treas. Reg. §1.643(a)-3. Two of the three conditions set forth in section 1.643(a)-3(b) of the Treasury regulations are relevant. According to these conditions, capital gains may be included as part of DNI: (i) if the capital gains are allocated to corpus and reported consistently by the fiduciary as part of a beneficiary's distributions, or (ii) if the capital gains are allocated to corpus but actually distributed to the beneficiary or used by the fiduciary in calculating the amount that is to be distributed to the beneficiary. Treas. Regs. §§1.643(a)-3(b)(2), (3). It is significant because of the consistency requirement set forth in the Treasury regulations. If as part of its discretionary authority, the fiduciary treats and reports capital gains as part of the trust's or estate's DNI, it must do so for all future years of the trust or estate.

The final Treasury regulations related to section 643 of the Code are effective for the taxable years of all trusts and estates ending after January 2, 2004. Section 1411 of the Code is effective for taxable years beginning after December 31, 2012, and except for certain charitable trusts, the proposed Treasury regulations related to trusts and estates are effective for taxable years beginning after December 31, 2013. Health Care and Education Reconciliation Act of 2010, P.L. 111-152 [H.R. 4872], Mar. 30, 2010; Prop. Treas. Reg. §1.1411-3(g). Pursuant to section 1411 of the Code, a trust or an estate must pay the tax imposed under that section on the trust's or estate's *undistributed* net investment income, and for purposes of determining net investment income, net gain must be calculated and included. I.R.C. §§1411(a)(2), (c)(1)(A)(iii). The proposed Treasury regulations provide guidance on the calculation of a trust's or an estate's undistributed net investment income, including certain deductions to be taken into account, but do not address the treatment of capital gains for existing trusts or estates that may or may not have included capital gains in the determination of DNI. Prop. Treas. Reg. §1.1411-3(e). Because section 1411 of the Code causes many capital gains to be included in net investment income, trusts and estates that do not include capital gains in DNI will have this component of net investment income trapped in the trust or estate. Therefore, it will remain as undistributed net investment income, taxable to the trust or estate. When exercising the fiduciary's discretion to determine whether capital gains will be included and treated as part of DNI pursuant to section 643 of the Code, as part of its duty to the trust or estate and its beneficiaries, the fiduciary would take into account any tax that would be imposed, including any tax imposed pursuant to section 1411 of the Code. The duty of a fiduciary to treat and report capital gains as part of an existing trust's or estate's DNI consistently is particularly problematic when a new tax such as that imposed by section 1411 of the Code is enacted. If the tax imposed by section 1411 of the Code had existed in the year that an existing trust or estate had first incurred capital gains, the fiduciary may have exercised its discretion differently.

Section 469 of the Code imposes a similar consistency requirement on taxpayers. Once a taxpayer has grouped particular activities to determine whether the taxpayer's trade or business is a passive activity, the taxpayer must then group those activities similarly in all future years. Treas. Reg. §1.469-4(e). However, when drafting the proposed Treasury regulations related to section 1411 of the Code, the IRS recognized that taxpayers might group their activities differently because of the imposition of the tax under section 1411 of the Code. Accordingly, the IRS has issued a proposed Treasury regulation that allows taxpayers (which includes individuals, estates and trusts) a fresh look at their groupings and allows each taxpayer to regroup its activities once in the first year in which section 1411 applies beginning after December 31, 2013, with the result that any regrouping must apply for all future years. Prop. Treas. Reg. §1.469-11(b)(3)(iv).

Like a taxpayer's reconsideration of its grouping under the regrouping rules, a fiduciary of an existing trust or estate might desire to make a different determination as to the treatment of capital gains as

part of DNI. Therefore, when a fiduciary is not otherwise prohibited from treating capital gains as part of DNI, it would be reasonable to allow a fiduciary a "fresh start" to determine whether capital gains will be treated as part of DNI.

2. Method of Determining Distributed Amount of Net Investment Income for Charitable Remainder Trusts

We respectfully recommend that the Treasury and the IRS allow trustees of charitable remainder trusts the option to determine the distributed amount of net investment income as set forth in the current section 1.1411-3(c)(2) of the proposed Treasury regulations or under the alternative method considered by the Treasury and the IRS.

Section 664 of the Code and the related Treasury regulations provide rules for determining the character of distributions to non-charitable beneficiaries of charitable remainder trusts to whom an annuity or unitrust payment is made. The character of the distributions will then determine the portion of the distribution that will be income taxable to each beneficiary. I.R.C. §664(b); Treas. Reg. §1.664-1(d). These ordering rules under section 664 of the Code require the trustee to examine and categorize its receipts in order to then determine whether distributions consist of ordinary income, capital gain, other income, or corpus. Trustees of such trusts must maintain records in this regard.

While section 1.1411-3(b)(3) of the proposed Treasury regulations makes it clear that a charitable remainder trust is not subject to the tax imposed pursuant to section 1411 of the Code, all or a portion of distributions to non-charitable beneficiaries of the trust may be subject to the additional tax. Specifically, if the trust's income consists of net investment income, any annuity or unitrust distributions to a beneficiary will also consist of net investment income. Prop. Treas. Reg. §1.1411-3 (c)(2). The annuity or unitrust distributions will consist of net investment income equal to the lesser of the total distributions for the year or the current and accumulated net investment income of the trust. Prop. Treas. Reg. §1.1411-3(c)(2)(i). Neither section 1411 of the Code nor the proposed Treasury regulations allows or requires the trustee to determine what portion of each section 664 category of receipts or distributions consists of net investment income. By taking the position that all net investment income is carried out to beneficiaries first, it is foreseeable that beneficiaries will be required to report net investment income from categories of trust distributions that they have not yet received. This classification and reporting of distributions for purposes of section 1411 of the Code is not consistent with the ordering rules under section 664 of the Code and may result in an over-reporting of net investment income by beneficiaries.

A trustee must maintain records regarding the character of distributions made to a non-charitable beneficiary of a charitable remainder trust. A trustee must also determine what portion of a trust's income is net investment income. The Treasury and the IRS have indicated that they considered an alternative method for determining the net investment income on a class-by-class basis within the categories of section 1.664-1(d)(1) of the Treasury regulations. This alternative method would allow the trustee to determine whether income is net investment income under each class of income described in section 664 and the related Treasury regulations. In light of the extensive recordkeeping that a trustee must maintain, the additional recordkeeping imposed on a trustee by this alternative method would not be unduly burdensome and would be consistent with the requirements of section 664 of the Code. Therefore, the trustee should be allowed the option to determine and report the distributed amount of net investment income as set forth in the current section 1.1411-3(c)(2) of the proposed Treasury regulations or under the alternative method considered by the Treasury and the IRS.

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