AFFORDABLE CARE ACT: A TRUST AND ESTATE PERSPECTIVE

Written By

MELISSA J. WILLMS
Davis & Willms, PLLC
3555 Timmons Lane, Suite 1250
Houston, Texas 77027
(281) 786-4500
melissa@daviswillms.com

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EDUCATION:
· LL.M., Tax Law, University of Houston Law Center, 1996
· J.D., Texas Tech University School of Law, 1992
· B.A., Psychology, B.A., Sociology, University of Texas at Austin, 1987

OTHER QUALIFICATIONS:
· Board Certified, Estate Planning and Probate Law, Texas Board of Legal Specialization
· Admitted to Practice: State Bar of Texas; Federal District Court for the Southern District of Texas; United States Tax Court

PROFESSIONAL ACTIVITIES:
· Real Estate, Probate and Trust Law Section, State Bar of Texas, (Member, Decedents’ Estates Committee, 2011-present)
· Tax Section, State Bar of Texas (Council Member, 2013-2015; Vice Chair, Estate and Gift Tax Committee, 2011-present)
· Best Lawyers in America, Trusts and Estates
· Fellow, Texas Bar Foundation
· Member, State Bar of Texas (Sections of Real Estate, Probate and Trust Law; Tax); Houston Bar Association (Section of Probate, Trusts and Estates); The College of the State Bar of Texas; Houston Estate and Financial Forum

SPEECHES AND PUBLICATIONS:
· Author/Speaker: Between Death and Probate: Practical Items of Esoterica, State Bar of Texas 37th Annual Advanced Estate Planning and Probate Course, 2013
· Testimony at public hearing before the United States Department of Treasury and Internal Revenue Service on proposed Section 1411 regulations concerning net investment income tax, Washington, D.C., April 2, 2013
· Comment letter to Department of Treasury on behalf of the Tax Section of the State Bar of Texas on proposed regulations regarding net investment income tax under Section 1411 of the Internal Revenue Code, March 4, 2013
· Author/Speaker: Living with the “New” Estate Tax, Houston Bar Association, Probate, Trusts and Estates Section, 2013
· Author: Decanting Irrevocable Trusts, Texas Tax Lawyer, Fall 2012
· Author/Speaker: Decanting Irrevocable Trusts, State Bar of Texas 36th Annual Advanced Estate Planning and Probate Course, 2012
· Comment letter to Department of Treasury on behalf of the Tax Section of the State Bar of Texas concerning transfers by a trustee from an irrevocable trust to another irrevocable trust (sometimes called “Decanting”), May 22, 2012
· Co-Author/Panelist: Planning for No Probate: Special Issues with Revocable Trusts and Nonprobate Assets, State Bar of Texas 18th Annual Advanced Estate Planning Strategies Course, 2012
· Panelist: Basic Estate Planning, State Bar of Texas Annual Building Blocks of Wills, Trusts and Estate Planning/Live Satellite Broadcast, 2012
· Co-Author/Speaker: Getting the Estate Plan Back on Track, The Houston TSCPA Foundation Personal Financial Planning Lunch & Learn Seminar, 2011
· Co-Author: Administration of Estates with Revocable Trusts: Drafting to Head Off Pre- and Post-Death Problems, State Bar of Texas 22nd Annual Advanced Estate Planning and Probate Drafting Course, 2011
· Co-Author/Panelist: 2011 and Beyond: Back to the Future, State Bar of Texas 17th Annual Advanced Estate Planning Strategies Course, 2011
· Co-Author/Panelist: 2010 and Beyond: Estate Planning and Administration Issues, South Texas College of Law Wills & Probate Institute, 2010
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AFFORDABLE CARE ACT:\ A TRUST AND ESTATE PERSPECTIVE

I. INTRODUCTION
The goal of this outline is to give insight as to how new Section 1411 of the Internal Revenue Code applies to trusts and estates. It is not meant to be an exhaustive analysis of every aspect of the Affordable Care Act or even every aspect of Section 1411 and the recently issued proposed Treasury regulations. After describing the statute and proposed regulations as they relate to trusts and estates, the outline examines unique issues and problem areas, as well as potential planning ideas for these entities.

II. ADDITIONAL INCOME TAX ON TRUSTS AND ESTATES

A. Health Care and Education Reconciliation Act of 2010, P.L. 111-152. The year 2013 brought a new income tax to estates and trusts. The Health Care and Education Reconciliation Act of 2010 ("HCA 2010") imposes an additional 3.8% income tax on individuals, trusts, and estates. Although the tax is similar between individuals on the one hand and trusts and estates on the other, there are some differences.

B. IRC § 1411. The new income tax is found in new Chapter 2A of the Internal Revenue Code entitled "Unearned Income Medicare Contribution." Chapter 2A is comprised only of Section 1411. Although commonly referred to as a Medicare tax (which is understandable based on the name of the Chapter), the funds will not be placed in the Medicare Fund but will go to the General Fund of the Treasury.

For individuals, the 3.8% tax applies to the lesser of net investment income or the excess of a taxpayer's modified adjusted gross income over certain defined thresholds. For estates and trusts, the 3.8% tax applies to the lesser of undistributed net investment income or the excess of adjusted gross income over a threshold determined based on the highest income tax bracket for estates and trusts ($11,950 for 2013). For ease of reference, for individuals who are married filing jointly, the threshold is $250,000 (for married filing separately, $125,000 each) and for single individuals, the filing threshold is $200,000.

The statute as it applies to estates and trusts is as follows:

§ 1411(a) In general. Except as provided in (e) –
(2) Application to estates and trusts. In the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by this subtitle) for each taxable year a tax of 3.8 percent of the lesser of –
(A) the undistributed net investment income for such taxable year, or
(B) the excess (if any) of –
   (i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over
   (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

Because the threshold for trusts and estates is based on the highest income tax bracket for each, the threshold is indexed each year to some extent for these entities, whereas there is no indexing for individuals.

C. Proposed Regulations. On December 5, 2012, the IRS issued a Notice of Proposed Rulemaking ("Notice") seeking comments to proposed Treasury regulations related to Section 1411 (77 FR 72611) which are expected to be finalized in 2013. As stated in the Notice, the purpose of Section 1411 is to impose a tax on "unearned income or investments." The Notice provides that for the most part, the principles of chapter 1 of subtitle A of the Internal Revenue Code are to be applied in determining the tax to be imposed. In addition, the statute introduces terms that are not defined and makes cross references to various other sections of the Internal Revenue Code; however, as pointed out in the Notice, nothing in the legislative history indicates that a term used in the statute is meant to have the same meaning as it would for other income tax purposes. The proposed regulations are intended to provide additional definitions of terms and guidance for the imposition of the tax. The proposed regulations are "designed to promote the fair administration of section 1411 while preventing circumvention of the purposes of the statute."

D. Net Investment Income vs. Undistributed Net Investment Income. Individuals, trusts, and estates now have to calculate their net investment income. Net investment income consists of the sum of three categories of income. IRC § 1411(c)(1). The first category includes gross income from interest,
dividends, annuities, royalties, and rents, other than those that are derived in the ordinary course of a trade or business. Note that each of these types of income may be included even though they may be earned through an activity that may otherwise be thought of as a trade or business because to be excluded, the income must meet the specific ordinary course of a trade or business exception as set out in the proposed regulations. To meet the exception, the trade or business must be one to which the tax will not apply. In each of these categories, when the term "trade or business" is used, it is in reference to that term as defined in Section 1411(c)(2). A further discussion of what is included as a trade or business follows, but a classic example of how a business ends up not meeting the exception involves rental real estate activities of a real estate professional as described in section 6.B.i.(b)(2) of the Notice. The second category includes other gross income derived from a trade or business. The third category includes net gain from the disposition of property held in a trade or business. From the total of these categories, deductions that are properly allowed are taken. IRC § 1411(c)(1)(B).

Exhibit A sets forth a preliminary attempt to diagram the calculation of net investment income.

For estates and trusts, the first component of income taken into account is "undistributed" net investment income, a term that is unique to Section 1411. Although the statute does not define what is meant by "undistributed," the proposed regulations apply rules similar to those in Sections 651 and 661 regarding the carry out of distributable net income ("DNI") to beneficiaries. Prop. Treas. Reg. § 1.1411-3(e).

Whereas for other income, DNI carries out to beneficiaries to the extent of a trust or estate's taxable income, for purposes of Section 1411, net investment income will carry out to beneficiaries (and the trust will receive a deduction) in an amount equal to the lesser of the trust's DNI or its net investment income. In other words, if a trust has both net investment income and other income, distributions will carry out each class of income pro rata to the beneficiaries. In turn, each beneficiary will pick up the respective classes of income for purposes of computing their income, including net investment income, and the trust will receive corresponding deductions. With the vast difference between the threshold for estates and trusts and individuals, the distribution of net investment income will frequently impact the overall amount of the tax paid.

The interrelation between taxable income, fiduciary accounting income, and DNI can be difficult to understand. DNI not only determines how much taxable income will be income taxed to a beneficiary. It also determines the amount that will be taxed to a trust or a beneficiary for purposes of Section 1411. Therefore, it is important that these concepts be understood. Although the examples in Proposed Treasury Regulation Section 1.1411-3(f) propose to illustrate the calculation of undistributed net investment income, the examples contain a fundamental mistake. Examples 1 and 2 of the proposed Treasury regulation describe a trust that has various receipts, including a distribution from an individual retirement account ("IRA"). The trust also makes distributions to one or more beneficiaries. In calculating DNI, the examples exclude a portion of the IRA distribution that is allocated to principal for purposes of calculating fiduciary accounting income. However, when determining a trust's DNI, any amounts that the fiduciary allocates to principal or income for purposes of fiduciary accounting income are irrelevant. Rather, when determining a trust's DNI, the taxable income of the trust is what is important. Therefore, when reviewing Examples 1 and 2 of the proposed Treasury regulations, keep in mind that this fundamental assumption is misstated and no portion of the IRA distribution should be excluded from DNI. Therefore, the trust's DNI should be $85,000, causing the need for an adjustment to the rest of the calculations in the examples. Presumably, because this mistake has been pointed out to the IRS and Treasury Department, these calculations will be corrected prior to the issuance of final regulations.

E. Trade or Business. The phrase "trade or business" is part of each of the categories of net investment income. Therefore, a fiduciary must evaluate this phrase to determine whether items of income or gain constitute net investment income. Section 1411(c)(2) defines "trade or business" as (i) a passive activity or (ii) a trade or business of trading in financial instruments or commodities. IRC § 1411(c)(2). Note that trading in financial instruments or commodities is included regardless of whether or not it is a passive activity. Because income from passive activities comprise the largest portion of what constitutes net investment income, determining what activities are passive is key.

F. Trusts. Although the statute indicates that the tax applies to "trusts," it does not specify which trusts are included. Proposed Treasury Regulation Section 1.1411-3(a)(1)(i) specifies that the statute applies to trusts that are subject to part I of subchapter J of chapter I of subtitle A of the Internal Revenue Code unless otherwise exempted – in other words, the statute applies to ordinary trusts as defined in Treasury
Regulation Section 301.7701-4(a), but not to certain other trusts, including charitable trusts, grantor trusts, foreign trusts, and business trusts. In addition, because subtitle A does not include tax exempt trusts, the statute does not apply to tax exempt trusts.

G. Grantor Trusts. The grantor trust rules for income tax purposes are to be applied for purposes of Section 1411. Therefore, the 3.8% tax is not imposed on a grantor trust, but items of income or deductions that are attributable to the grantor (or to someone treated as the grantor) are to be treated as if the items had been paid or received by the grantor for calculating his or her own net investment income. Prop. Treas. Reg. § 1.1411-3(b)(5).

H. Special Problem Areas. Although the statute uses terms such as "net investment income," "adjusted gross income," "ordinary course of a trade or business," "passive activity" and "disposition," the terms do not necessarily correspond to the same terms as used in other parts of the Internal Revenue Code. Following is a discussion of some net investment income problem areas, but this is in no way meant to be an exhaustive list. The Notice also asked for comments related to foreign estates and foreign trusts but as noted above, a discussion of those issues is beyond the scope of this paper.

1. Capital Gains. A review of the statute and proposed regulations raises a concern for existing trusts and estates with regard to the treatment of capital gains. As mentioned above, trust and estate income is taxed to the trust or estate unless the income (or more specifically unless the trust's or estate's DNI) is carried out to the beneficiaries. As a general rule, capital gains are not treated as part of DNI. This general rule applies as long as those gains are allocated to corpus and are not "paid, credited, or required to be distributed to any beneficiary during the taxable year." IRC § 643(a)(3). However, pursuant to Section 643 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(b).

Two of the three conditions which allow a fiduciary to allocate capital gains to DNI can invoke a consistency requirement by the fiduciary for all future years. Id. Most commentators and practitioners believe that in the first year that a trust or estate incurs capital gains, once a fiduciary decides to allocate the capital gains to DNI or not to do so, the fiduciary has in effect made an election that remains in place for all future years of the trust or estate. Unfortunately, there is no authority or guidance in this area to suggest otherwise. A trust or an estate may have the ability to allocate capital gains to corpus on a case-by-case basis under a narrow condition provided by Treasury Regulation Section 1.643(a)-3(b)(3), but there is no clear guidance for fiduciaries as to how to meet the condition under this so-called "deeming rule." Since many capital gains are included in net investment income under Section 1411, trusts and estates that do not include capital gains in DNI (which are most trusts and estates), or cannot "deem" capital gains to be part of DNI under the narrow condition provided in the regulations, will have this component of net investment income trapped as undistributed net investment income, taxable to the trust or estate. Section 1411 and the related proposed Treasury regulations do not address this issue for existing trusts or estates, although for other similar elections, an entity is given a fresh start to make a new election. It seems that it would be fair to allow existing trusts and estates that incur capital gains after December 31, 2012 the option to reconsider how capital gains are to be allocated since it is possible 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 election may have been different. The Tax Section of the State Bar of Texas, in their comments on the proposed regulations, has asked for just such a fresh look. We will have to wait for the final regulations to see whether this option will be granted.

2. Passive Activities, Passive Income, and the Passive Loss Rules. The statute does not define to what extent the passive loss rules for "ordinary" income taxes will apply. For purposes of Section 1411, passive activities are those that are included within the meaning of Section 469. IRC § 1411(c)(2)(A). According to the proposed regulations, a two-step determination is needed to determine if an activity is a passive activity. First, the activity must be a trade or business within Section 162. Second, the activity must be passive within the meaning of Section 469, which means the taxpayer must not materially participate in the trade or business. Prop. Treas. Reg. § 1.1411-5(b). Section 469 further provides that in order for a taxpayer to materially participate in an activity, the taxpayer must be involved in the operations of the activity on a regular, continuous and substantial basis. IRC § 469(h)(1). It appears that for the most part, the majority of passive income will be included in the calculation of the tax under Section 1411. However, there are certain
exceptions where items that are generally thought of as passive are not included and vice versa, such as in the case of actively managed real estate investments. As a result, practitioners will need to not only have a good understanding of Section 469 and its related Treasury regulations to know what constitutes a passive activity but will also need to master the exceptions under Section 1411 when computing net investment income.

a. Material Participation. Because Section 1411 defers to Section 469 to define a passive activity, we must look to Section 469. For determining the disallowance of passive activity losses and credits, Section 469 applies to individuals, trusts, estates, closely held C corporations, and personal service corporations. IRC § 469(a). Although Section 469 applies to trusts and estates, what amounts to material participation by a trust or estate has not been defined beyond the requirement that the taxpayer's involvement in the operations of the business must be regular, continuous and substantial. The temporary regulations outline seven separate tests that an individual may satisfy in order to meet the definition of material participation and avoid the passive loss disallowance rules. Since the statute was enacted in 1986, however, no such regulations have been issued for trusts and estates. Temp. Treas. Reg. § 1.469-5T(a), 1.469-5T(g), 1.469-8.

From Section 469 we can glean that the taxpayer's involvement in the operations is what is important. However, for trusts and estates, who the taxpayer is continues to be an issue. Only one federal case has addressed this issue. In Mattie K. Carter Trust v. U.S., 256 F.Supp.2d 536 (N.D. Tex. 2003), a testamentary trust owned a cattle ranching operation. In addition to work done by the trustee himself, the trust employed a ranch manager and other employees. The work done by the trustee, the ranch manager, and the other employees was performed on behalf of the trust. The IRS argued that the trustee is the taxpayer and only his activities should be considered to determine whether the trust materially participated in the operations. The trust argued that the trust, as a legal entity, is the taxpayer and the activities of the fiduciaries, employees and agents of the trust should be considered. The court looked to the plain language of Section 469 which states that a trust is the taxpayer, and in agreeing with the trust, held that the material participation of the trust should be determined by looking at the activities of all persons acting on behalf of the trust, not solely the trustee. The court noted that common sense says that in order to determine material participation by a trust, one must look to the activities of all of those who work on behalf of the trust.3

In the decade since the holding in the Mattie K. Carter Trust case, and with no regulations having being issued, the IRS has continued to maintain its position that only the activities of the trustee should be considered. See, PLR 201029014; TAM 201317010; TAM 200733023. The only source that the IRS cites for its position is language in the legislative history of Section 469 that states that "an estate or trust is treated as materially participating in an activity . . . if an executor or fiduciary, in his capacity as such, is so participating." S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986). It is important to note, however, that nothing in the legislative history indicates that looking to the actions of an executor or trustee is the exclusive way to determine material participation by a trust or an estate. In the most recent Technical Advice Memorandum, the IRS again found that the language in the legislative history is the standard to apply to trusts for determining material participation. In so finding, the IRS inexplicably comes to the conclusion that the sole means for making such determination is to find that in the operation of the activity, the activities of fiduciaries, in their capacities as fiduciaries, are conducted on a regular, continuous, and substantial basis. TAM 201317010.

In relying on limited language in legislative history for its reasoning in these decisions, the IRS appears to ignore the ability to consider activities of employees when determining material participation by other categories of taxpayers in Section 469. See, Temp. Treas. Reg. § 1.469-1T(g) (allowing activities of employees of corporation to be taken into account by virtue of the rules of Section 465(c)(7)) and Temp. Treas. Reg. § 1.469-1T(k) (Examples 1 and 2 where activity as employee by owner of entity counts toward whether entity materially participates in a business). Although it may be understandable to disregard the activities of employees of the underlying operation who are not trustees, employees of the trust itself are not the same, and their activities should be taken into account. Unless and until the IRS reverses its narrow view of these rules, commentators suggest for trusts that own an interest in an entity such as a limited liability company, the entity might be structured to be member-managed so that the activities of the trustee

2 Like with Section 469, the trusts at issue are non grantor trusts, since the passive activity loss rules do not apply to grantor trusts and instead are applied at the grantor level. Temp. Treas. Reg. § 1.469-1T(b)(2).

3 In criticizing the IRS, the court went as far as to say that the IRS's position that only the activities of the trustee himself should be considered is "arbitrary, subverts common sense, and attempts to create an ambiguity where there is none." Id. Zowie!
(owner) count toward material participation. Of course, in this case, the trustee would owe fiduciary obligations to the company as well as to the trust beneficiaries and would need to explore how best to deal with any potential division of loyalties in exercising its fiduciary duties. For other thoughts and potential planning alternatives when a trust owns an interest in a business entity, see Gorin, Structuring Ownership of Privately-Owned Business: Tax and Estate Planning Implications (available by emailing the author at sgoran@thompsoncoburn.com to request a copy or request to subscribe to his newsletter "Gorin's Business Succession Solutions").

One case currently before the Tax Court involves an issue of whether a trustee qualifies for a certain exception under Section 469 for real estate activities. Frank Aragona Trust v. Comm'r., Tax Court Docket No. 015392-11. Because this exception involves a determination of material participation by a taxpayer, the court’s ruling may have an impact on a trustee's material participation for other purposes of Section 469. The case was tried before the judge in May 2012 and briefs were submitted in October 2012. Hopefully we will receive some guidance in the near future.

Section 1411 and the related proposed Treasury regulations require taxpayers to look to Section 469 for the passive activity loss rules. It seems evident that the Treasury Department did not want to add anything new to the passive activity loss rules through Section 1411. With no regulations being issued for Section 469 to deal with passive activities and material participation for trust and estates, it seems unlikely that final regulations will be issued for Section 1411 to address these issues.

3. Qualified Subchapter S Trusts ("QSSTs"). In most cases, when a trust owns stock in an S corporation and the income beneficiary makes an election to have the trust treated as a QSST, because the beneficiary is treated as the owner of the stock for income tax purposes, all income from the S corporation which is attributable to the QSST will be taxed to the beneficiary. Treas. Reg. § 1.1361-1(j)(7). An exception to this rule is when a disposition of the S stock occurs. In that case, the beneficiary is not treated as the owner and any resulting gain or loss that is recognized will be reported by the trust. Treas. Reg. § 1.1361-1(j)(8). For Section 1411 purposes, neither the statute nor the proposed regulations provide any special rules that would change these results. In the Notice, the IRS has asked for comments to determine if any special rules are needed. However, as things currently stand, presumably, these same rules will apply with regard to allocating income and gain for QSSTs. As a result, a QSST’s share of an S corporation’s net investment income will be taxed to the beneficiary, but net investment income arising from a sale of S corporation stock will be taxed to the trust. In determining the amount of net investment income that results from a sale of S corporation stock, a four-step adjustment process may be required. See, Prop. Treas. Reg. § 1.1411-7(c).

As a reminder, income for trust and estate purposes is not always the same as income for income tax purposes. Section 643(b) provides that for trusts and estates, if the general term "income" is used, it means fiduciary accounting income as determined pursuant to the governing instrument and local law, and not taxable income. IRC § 643(b). Because a beneficiary will have to report taxable income as part of DNI but will receive only a distribution of fiduciary accounting income (if any), the distinction between fiduciary accounting income and taxable income is important when considering a QSST election. Accordingly, it raises the question as to whether a beneficiary should try to obtain some assurance or guarantee from the trustee regarding sufficient cash distributions, whether of income or principal, in order to pay any income tax liability that arises from the QSST election. For additional discussion regarding the income characterization issues, see Davis, Funding Testamentary Trusts: Tax and Non-Tax Issues, State Bar of Texas Adv. Est. Planning Strategies Course, 2013.

4. Electing Small Business Trusts ("ESBTs"). In contrast to a QSST, when a trust holds S corporation stock and the trustee makes an election to have the trust treated as an ESBT, all income from the S corporation is taxed to the trust at the highest income tax bracket, regardless of whether any income is distributed to a beneficiary and without regard to any threshold. IRC § 641(c). The portion of the trust that holds the S corporation stock is treated as if it were a separate trust. Id. If all or any portion of an ESBT is a grantor trust, the income attributable to such portion is taxable to the grantor. Treas. Reg. § 1.641(c)-1(c). As with other S corporation shareholders, in making an ESBT election, a trustee would want some assurance from the S corporation that sufficient cash distributions will be made from the corporation to allow the trustee to pay any income tax liability. An ESBT will have to pay income tax on its share of S corporation income at the highest marginal rate. The trustee of an ESBT, therefore, must make careful consideration before making any distributions to beneficiaries, since the trust will need to retain sufficient funds to pay any income tax liability and will not have the advantage of...
reducing the trust’s taxable income since it will not receive a distribution deduction for these distributions.

Also in contrast to QSSTs, Section 1411 provides special rules for ESBTs. In Proposed Treasury Regulation Section 1.1411-3(c)(1), two separate computations are made to determine whether income of an ESBT is subject to the net investment income tax. In line with the proposed Treasury regulations stated attempt to preserve as much Chapter 1 treatment as possible, the first calculation requires that the amount of the undistributed net investment income be calculated for each of the separate S and non-S portions of the trust. The separate treatment is disregarded, however, for the second calculation because the proposed Treasury regulations require the ESBT to then calculate its adjusted gross income by combining the adjusted gross income of the non-S portion of the trust with the net income or net loss of the S portion of the trust. Id. In other words, the trust is treated as a single trust for determining whether the trust’s adjusted gross income exceeds the Section 1411 threshold. The trust is then to pay tax on the lesser of the trust’s total undistributed net investment income or the excess of the trust’s adjusted gross income over the trust’s threshold. Prop. Treas. Reg. § 1.1411-3(c)(1)(ii)(C). Example 3 in Proposed Treasury Regulation 1.1411-3(f) provides a detailed example of the calculation. Again, as discussed above, these calculations can be avoided if the trustee’s involvement in the S corporation constitutes material participation which would prevent treatment as a passive activity and imposition of the net investment income tax.

5. Charitable Remainder Trusts. Although charitable remainder trusts are not themselves subject to Section 1411, distributions that are made to non-charitable beneficiaries may be. The proposed regulations provide that the net investment income of a non-charitable beneficiary will include an amount equal to the lesser of the distributions made for the year or the trust’s current and accumulated net investment income. Prop. Treas. Reg. § 1.1411-3(c)(2). The trust’s accumulated net investment income is measured beginning with years after December 31, 2012. Prop. Treas. Reg. § 1.1411-3(c)(2)(iii). In addition, the proposed regulations impose certain character and ordering rules in order to first distribute net investment income proportionately among the non-charitable beneficiaries before any amounts of non-net investment income. Id. It appears at this point that for non-charitable beneficiaries of charitable remainder trusts, there is a WIFO (“worst in – first out”) approach, thereby imposing another layer of tax on these beneficiaries. The IRS and Treasury Department have received comments requesting a different approach.

6. Properly Allocable Deductions. The only deductions allowed in computing net investment income are those that are allowed by subtitle A of the Internal Revenue Code and are properly allocated to the gross income or net gain which is part of net investment income. IRC § 1411(c)(1)(B). The key is that the deductions must be allocated to the related gross income or net gain. Proposed Treasury Regulation Section 1.1411-4(f) places further limitations on the amount and timing of these deductions. In the Notice, the IRS asked for comments regarding the treatment of certain deductions, such as suspended passive losses and net operating losses.

1. Special Notes. A few additional items of note:

1. Estates of Decedents Dying in 2012. Section 1411 is effective for taxable years beginning after December 31, 2012. The consensus among commentators is that for estates of decedent’s dying in 2012 before December 31, 2012, Section 1411 will not apply until the second year of the estate since the first taxable year of the estate began in 2012. Therefore, it is important to consider the application of Section 1411 when choosing the year end for these estates.

2. Tax Does Not Apply to Distributions from Qualified Plans. You will recall that there are two components of income used to measure whether the tax will apply. One type of income is net investment income and the other is adjusted gross income (modified adjusted gross income for individuals and adjusted gross income as defined in Section 67(e) of the Code for trusts and estates). Section 1411(c)(5) provides that net investment income does not include distributions from qualified plans. However, there is no exception for distributions from qualified plans for purposes of computing adjusted gross income. As a result, distributions from qualified plans may push the trust or estate into the top income tax bracket, exposing its net investment income to the 3.8% tax.

3. Nonresident Aliens. The tax does not apply to nonresident aliens. IRC § 1411(e)(1).

J. Planning for the Tax. The additional 3.8% income tax on trusts and estates can be considered an additional cost of forming a trust or administering an estate. Items to consider include:

- Planners will need to advise clients that certain investments may subject estates and trusts to additional income tax. For example, when funding testamentary trusts, it may be more desirable to
transfer the homestead to the surviving spouse and make a non pro rata distribution of other assets to fund the trust so that if the homestead is later sold, any appreciation will not be subject to the tax imposed under Section 1411.

· There may be even more reason for clients to take a team approach with the attorney, accountant and financial planner to adequately plan to minimize the additional tax burden.

· Fiduciaries have a greater burden with the additional recordkeeping necessary to track assets that may be subject to the 3.8% tax, and most likely will need even more assistance than before from accountants.

· When evaluating whether to make a distribution, fiduciaries may desire additional cooperation between themselves and beneficiaries in order to better evaluate the tax brackets of each as they relate not only to income taxes, but also the tax on net investment income.

· There may be more incentive to speed up the administration of estates to minimize the potential of the additional tax that may not apply once the assets which produce net investment income are transferred to beneficiaries.

· Fiduciaries will need to weigh whether it is better to invest more in assets that are not subject to the tax, such as those that produce tax-exempt income vs. those assets that may produce a higher after-tax return regardless of this additional tax.

· There may be more incentive to take a buy-and-hold approach to investing in order to put off the additional tax burden that may arise from recognizing capital gains.

III. CONCLUSION

The enactment of Section 1411 brings a new facet to estate and trust planning and administration. Advisors need to be familiar with these rules in order to appropriately counsel testators, grantors, executors, trustees, and beneficiaries regarding how these rules impact estates, trusts, and their beneficiaries. It is hoped that this outline can provide some assistance to advisors until the IRS, Treasury Department, and case law provide clearer guidance as to how these murky rules effect trusts and estates.
EXHIBIT A

IRC 1411 Net Investment Income (Preliminary)

Gross Income from Int., Divs., Annuities, Royalties, Rents

- Derived in the ord. course of a trade/bus.?
  - NO
    - LESS Allowable Deductions
  - YES
    - Gross Income from Trade or Business

Gross Income from Trade or Business

- Passive Activity?
  - NO
    - NO Net Investment Income
  - YES
    - Trading Fin. Instruments or Commodities?
      - NO
        - LESS Allowable Deductions
      - YES
        - NOT Net Investment Income

Net Taxable Gain From Disposition of Property

- Property held in a trade or business?
  - NO
    - LESS Allowable Deductions
  - YES
    - LESS Allowable Deductions