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APRIL 3, 2013

Speakers Say NII Tax Regs Could Be Simplified and Recommend Exemptions

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Summary by taxanalysts

As the IRS and Treasury attempt to finalize regulations under the section 1411 net investment income tax, speakers representing a variety of industries testified at the IRS headquarters in Washington on April 2 as to how the final rules could be simplified and why the government should exempt their interests from the tax.

Full Text Published by taxanalysts

As the IRS and Treasury attempt to finalize regulations under the section 1411 net investment income (NII) tax, speakers representing a variety of industries testified at the IRS headquarters in Washington on April 2 on how the final rules could be simplified and why the government should exempt their interests from the tax.

Given that the proposed regulations (REG-130507-11) issued in November 2012 were developed with the help of nearly every IRS associate chief counsel's office, it comes as no surprise that the speakers, who represented industries as dissimilar as the business aviation lobby and Alaska native settlement trusts, came prepared with their own interpretation of how the tax, and its final regulations, should operate.

Most speakers testified that the complexity of the proposed regs risks creating unnecessary confusion for taxpayers and their representatives. The final regulations should be user friendly, said Michael J. Grace of Whiteford Taylor Preston LLP. (Unofficial hearing transcript.)

While the NII tax is designed to affect individuals with higher incomes, the threshold for the tax applying to trusts is considerably lower, and many of those entities are not represented by large, savvy law firms, Grace said. "I would urge you in drafting, to err on the side of explaining things simply, clearly, and completely, even if a more elegant drafting approach may suggest a different way to go," he said.

The section 1411 tax is 3.8 percent on the lesser of NII or the amount by which an individual's modified adjusted gross income exceeds $200,000 ($250,000 for joint filers and surviving spouses). For covered trusts and estates, the 3.8 percent tax is imposed on the lesser of undistributed NII or the excess, if any, of adjusted gross income, as defined under section 67, over the dollar amount at which the highest tax bracket in section 1(e) begins. Brackets under section 1(e) are indexed for inflation, unlike the threshold amounts under the NII tax that apply to individuals.

Grace recommended that the government incorporate into the final regulations the "salient recommendations" included in the preamble to the proposed regs. Preambles are excluded from the Code of Federal Regulations, Grace noted, and he said most practitioners don't have time to reconcile final rules with the preamble. "I think you also want to fend off challenges by some who claim that preambles aren't technically or legally included in the rules themselves," he added.

Grace also suggested that the government provide more examples in the final regs.

Material Participation and Rents

For Grace and several other speakers, the intersection of sections 1411 and 469 appeared to be of particular importance, especially regarding real estate. The treatment of rents, for example, has confused many taxpayers, Grace said. One way of reducing confusion would be to dedicate a separate subsection of the final regulations to address that issue exclusively, he said.

The IRS also should consistently apply the grouping rules under sections 1411 and 469, Grace said. "If two separate things are properly grouped under [section] 469, I urge you that those groupings also be respected under [section] 1411 without inquiring further," he said, adding that the relevant language in the proposed regs' preamble is "troublesome" because it says a proper grouping under reg. section 1.469-4(d)(1) will not convert gross income from rents into gross income derived from a trade or business described in proposed reg. section 1.411-5(a)(1).

Consistent application of the grouping rules would make administering the NII tax easier and would "far outweigh" the risks of some rents escaping the tax, Grace said.

Robert Conner of the accounting firm BKD LLP agreed, saying, "The final regulations should conclude that an appropriate economic unit, pursuant to a grouping election, is respected for purposes of section 1411." Material participation and trade or business requirements should be tested on a grouped activity as a whole rather than on a component basis, he said. Assuming those criteria are met, the income should be excluded from NII, Conner argued.

Conner pointed to section 6.B. of the proposed regs' preamble, which says that the grouping rules "will apply in determining the scope of a taxpayer's trade or business in order to determine whether such trade or business is a passive activity for purposes of section 1411(c)(2)(A)." Once a grouping election determines the scope of the trade or business, as long as the taxpayer is active in that trade or business, the combined ordinary and rental income will escape the NII tax, assuming the trade or business is not involved in trading in financial instruments or commodities, he said.

As an example, Conner described self-rented property in which a materially participating owner of a manufacturing business also owns rental real estate held in a limited liability company. The business leases the real estate from the LLC, and the individual owner has a valid grouping election and materially participates in the grouped economic unit as a whole. Because the individual materially participates, the rental income earned by the LLC should be excluded from the NII calculation, Conner said.

David Kirk, branch 2 attorney-adviser, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), asked whether the separate "brother-sister" entities could obtain a tax benefit by engaging in that structure, thereby "eroding" the Self-Employment Contributions Act (SECA) tax base for the operating company. If the rent paid out is not subject to the SECA tax and is also exempt for section 1411 purposes, "we are perpetuating the base erosion for Medicare," Kirk said.

Conner replied that the S corporation would still have to pay a reasonable compensation to the owner.

Kirk said that while an eroding SECA base is sometimes a problem with S corporations, the same could be said for other businesses that are similarly situated but are limited partnerships or limited liability partnerships. (Prior analysis ⧉.)

Properly Allocable Deductions

Under section 1411(c)(1)(A), NII is broken up into three buckets. Under the first two buckets, the amount of income is determined on a gross income basis, while under the third, it is determined on a net basis. Once the sum of those buckets is calculated, taxpayers are allowed deductions that are "properly allocable to such gross income or net gain."

Don Susswein of McGladrey LLP noted that the proposed regulations prohibit section 165 losses from being used to compute NII, but he said there is nothing in the statute to exclude those losses from the list of properly allocable deductions. Section 165 losses are not just capital losses incurred on the sale of stock but include many other types of losses, including mark-to-market losses, foreign currency losses, and section 1231 losses, he said.

Susswein said double counting should be avoided, so that a loss used against bucket 1 should not also be used against bucket 2. Nonetheless, a loss that is not used in one bucket should be allowed to be used in another, he said.

As an example, Susswein pointed to a "bucket 2 business," or one that is involved in trading financial instruments or commodities. If that business earns a gain on the sale of one stock but a loss on the sale of another, "I don't think Congress thought that [the business] would be subject to the net investment income tax on the gross income," Susswein said. But that trading activity is not a bucket 3 business, for which netting is allowed, he said.

"This notion that you go through the buckets for [section] 165 losses is useful," Susswein said.

Scott Dinwiddie, special counsel/associate chief counsel, IRS Office of Associate Chief Counsel (Income Tax and Accounting), asked whether specific language applying deductions to bucket 2 income would be a straightforward fix for avoiding "the whipsaw of a trader being subject to [section] 1411 on gross income."

Susswein said that would solve "half the problem" but would still leave problems for bucket 1 taxpayers. "This tax, as you know, is not indexed to inflation," he said. Susswein said the question could be asked why the drafters of the legislation used the term "net gain" in bucket 3. He said he researched the issue and is confident the drafters pulled that part out of section 163. "I think they were so concerned that losses be allowed that they stuck it into bucket 3."

Dinwiddie said the government could specify which losses apply to bucket 2 gains, or, as Susswein urged, it could "essentially disregard bucket 3 as its own bucket and allow those losses to offset bucket 2 and offset bucket 1."

"If you approach the statute as if it came from Mount Sinai and no word could be redundant, I would agree: The word 'net' is probably unnecessary," Susswein said. "If you're going to make that leap to bucket 2, then it's clearly not a statutory problem, and so why not get it right?"

Foreign Pensions

Roy A. Berg of Moodys Gartner Tax Law LLP said beneficiaries of Canadian retirement plans could be subject to the NII tax. Because the tax is subject to estimated tax payments and because foreign retirement plans are not exempt from the tax, thousands of affected individuals could be subject to underpayment penalties for the 2013 tax year, Berg said.

The preamble to the proposed regulations acknowledges that U.S. persons who are the beneficiaries of foreign retirement plans "may require special treatment," Berg said, adding that without special treatment, income that is otherwise protected by the Canada-U.S. tax treaty could be caught up by the tax. "Our recommendation is that the final regs exclude from the NII calculation both accrued income and distributions from Canadian retirement plans that receive beneficial treatment under the treaty."

Berg said his recommendation is consistent with the preamble, specifically part 5.A.vii., which states that income from employment, including income and gains from nonqualified deferred compensation plans, is not NII because it arises from the trade or business of being an employee.

James Gifford, also of Moodys, argued that the proposed regs are ambiguous regarding how foreign tax credits under section 901 are addressed for purposes of offsetting the NII tax. The IRS said in January that its "current thinking" was that FTCs could not offset NII, because under the statute, the credits can offset only a chapter 1 tax liability. (Prior coverage 🗎.)

According to Gifford, there's still room to argue that the strict interpretation may not reflect Congress's intent. Things get more difficult in the treaty context, he said, especially if the tax is at odds with a treaty that provides a credit against a U.S. tax. "Whether or not a regulation is the correct place to answer that, I'm not sure, but I think that's an important policy question for Treasury and the IRS to answer," he said.

Kirk said one camp argues that the IRS should allow FTCs generally, while another says the IRS should allow them as properly allocable deductions under section 164(a)(3). But section 164 says that if a foreign income tax is taken as a credit, it ceases to be a deduction, he said.

Trade or Business Definition

The proposed regulations do not define trade or business, something the IRS has been reluctant to do. Instead, taxpayers must undertake the same facts and circumstances test to determine whether their activity is a trade or business. Income earned in the ordinary course of a trade or business, as long as it is not the trade or business of trading financial instruments or commodities, is exempt from the tax. (Prior coverage 🗎.)

John Hoover, representing the National Business Aviation Association, said that based on the proposed regs' preamble as well as public comments by IRS and Treasury officials, the ordinary course of a trade or business is defined by reference to section 162 and its case law. "This is an important test, and it needs to be clearly set forth in the text of the regulations," he said. "I suggest the regulations include a specific reference to the definition of a trade or business under section 162 and the case law thereunder."

Trusts, Estates, and Fiduciaries

Several speakers urged the IRS to modify the proposed regulations as they apply to trusts and estates. Under the proposed regs, trusts, funds, and special accounts exempt from taxation under subtitle A of Title 26 are also exempt from the NII tax. However, the NII tax applies to trusts subject to the provisions of Part I of subchapter J, even if those trusts have special computational rules within those provisions. As applied to trusts and estates, the NII tax attempts to rely on the distributable net income (DNI) rules as much as possible.

Charitable remainder trusts (CRTs), described under section 664, are excluded from the NII tax, but all or a portion of distributions to a non-charitable beneficiary of the trust may be subject to the tax. Speaking on behalf of the State Bar of Texas Section of Taxation, Lora Davis said the proposed regulations require CRTs to make two calculations: one for regular tax purposes and one for NII purposes.

The NII calculations won't be completely parallel to the typical distribution calculations made under the section 664 regulations, Davis said. A trustee must maintain records on the character of distributions made to a non-charitable beneficiary of a CRT and must also determine what portion of that income is NII, she said.

Davis noted that Treasury and the IRS rejected an alternative method for reporting by a CRT, which was on a class-by-class basis within the categories of reg. section 1.664-1(d)(1), because it was seen as too burdensome for CRT fiduciaries, but she said that isn't always the case. The alternative method "would actually result in more accurate reporting to the beneficiaries to the CRTs," Davis said, citing past adjustments that CRTs have had to make in their reporting.

Catherine Hughes, attorney-adviser in Treasury's Office of Tax Legislative Counsel, said that traditionally, giving fiduciaries a choice can create problems for them. "Then, in every situation, as I understand fiduciary obligation, they have to go through both ways of doing it and then figure out which is the best," Hughes said. "Are we better off not giving them a choice?"

Davis replied that while the issue is complicated, given the fiduciary's responsibility, she does not know how many CRTs would actually be affected. "It's only going to apply to CRTs who are going to have accumulated income from prior years," she said.

Melissa Williams, also representing the State Bar of Texas Section of Taxation, said that when determining a trust or estate's DNI for purposes of calculating any potential NII, capital gains are an "outlier." Capital gains are subject to NII but are not always a part of fiduciary accounting income, which is "pivotal in determining the DNI of a trust or estate," she said. She argued that fiduciaries should be allowed to reconsider whether capital gains will be included in the DNI of a trust or estate under section 643.

Although capital gains are generally excluded from DNI, they can be included in limited circumstances under reg. section 1.643(a)-3(b), one of which requires consistency, Williams said. Because capital gains are subject to the section 1411 tax, trusts and estates that do not include capital gains in DNI must recognize the capital gains as undistributed NII, taxable to the trust or estate, she said.

Williams added that when the section 643 regulations were issued in 2004, fiduciaries had little reason to be concerned about a potential section 1411 tax. Although newly established trusts and estates can better account for the treatment of capital gains, previously established trusts and estates would have to comply with the consistency requirement, and the section 1411 proposed regs are silent on the treatment of capital gains for existing trusts and estates that may not have included capital gains in the DNI calculation, she said.

"If we were to adopt your recommendation, are there other situations where people should be allowed a fresh start under [section] 643 that would not be inconsistent with the requirement of consistency?" Hughes asked.

"I don't believe so, because this is going to the issue of it being a new tax," Williams replied.

Settlement Trusts

IRS officials have said that they are open to hearing from the trusts and funds community regarding whether those trusts should be subject to the NII tax. The government's decision to include those trusts was based on Congress's intention to cover trusts within the common understanding of the word "trust" under reg. section 301.7701-4(a). In January an IRS official said the government would consider exempting some trusts or funds based on policy or administrative reasons, if it is able to do so under the regulatory framework. (Prior coverage.)

The section 646 Alaska native settlement trust is one type of trust to which the NII tax applies. Tatitlek Corp., the sponsoring native corporation of the Tatitlek, Alaska, settlement trust, argued in a comment letter that the inclusion of that type of trust by the IRS was inappropriate. Section 646 provides generally that Alaska native settlement trusts are taxed at the lowest individual rates for both capital gains and ordinary income and that the trust is taxed at the trust level and not the individual level, the group said. The legislative history of the section 1411 tax and the electing settlement trusts provides that the trusts were not meant to fall under the tax, the letter argues.

Dustin Stamper of Grant Thornton LLP, who represented Tatitlek at the hearing, argued that section 1411 exempts section 646 trusts from the NII tax. Most settlement trusts distribute all their income each year, and "if the normal trust rules apply, you wouldn't have any tax at the entity level -- all the tax would be at the individual level," he said. Alaska native settlement trusts were designed to be taxed on the entity level, not the individual level, he said.

Section 646 taxes a settlement trust differently, Stamper said. Because settlement trust taxes are intended to be imposed at the entity level to avoid taxation of the beneficiary, the trust is not allowed to take deductions under sections 651 or 661, he said. "All the trust income is subject to the Medicare tax," which is not what Congress intended because it "subverts" section 646, he said.

Adrienne Mikolashek, branch 2 attorney-adviser, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), asked if non-income benefits were being paid to beneficiaries by the trusts. Stamper responded that each trust operates differently but that the trusts' predominant goal is to fight poverty and that distributions are mostly made as income to the beneficiaries. However, some do provide community benefits such as healthcare, he said.

Bruce Edwards, representing Shee Atika Inc., another Alaska native settlement trust, said the social benefits provided to beneficiaries tend to complicate things. In addition to more common pro rata distributions, Alaska native settlement trusts provide education and funeral benefits, land preservation benefits, and elderly benefits, he said. Electing settlement trusts are different from normal trusts given their social purpose, their creation by Congress, and their structure, Edwards said. The trusts shouldn't be subject to the section 1411 tax, he said.

Additional documents

- Comment letter from Michael J. Grace of Whiteford Taylor Preston LLP.
- Comment letter from BKD LLP.
- Comment letter from Don Susswein of McGladrey LLP.
- Comment letter from Roy A. Berg of Moodys Gartner Tax Law LLP.
- Comment letter from the State Bar of Texas Section of Taxation.
- Comment letter from Shee Atika Inc.

Correction, April 3, 2013: This article originally reported the Internal Revenue Code applicable section as 163, rather than 164.

Tax Analysts Information

Code Sections: Section 1411 -- Medicare Contribution Tax
Section 469 -- Passive Loss Limitations
Section 901 -- Foreign Tax Credit
Section 646 -- Alaska Native Settlement Trusts
Section 165 -- Losses
Section 163 -- Interest
Section 162 -- Business Expenses
Section 664 -- Charitable Remainder Trusts

Section 643 -- Estate and Trust Definitions
Jurisdiction: United States
Subject Areas: Limited liability companies
Partnership taxation
Individual income taxation
Trusts and estates taxation
Financial instruments tax issues
Financial institution tax issues
Author: Trivedi, Shamik
Institutional Author: Tax Analysts
Tax Analysts Document Number: Doc 2013-7871
Tax Analysts Electronic Citation: 2013 TNT 64-1