



American Institute of CPAs
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

May 8, 2013

Mr. Steven T. Miller
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Ms. Lisa Zarlenga
Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mr. Curtis G. Wilson
Associate Chief Counsel for
Passthroughs and Special Industries
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on [REG-130507-11](#) relating to guidance under section 1411, as added by the Health Care and Education Reconciliation Act of 2010, regarding net investment income tax as relevant to estates and trusts (12/5/2012)

Dear Messrs. Miller, Wilkins, and Wilson, and Ms. Zarlenga:

The American Institute of Certified Public Accountants (AICPA) submits the comments below in response to the above mentioned proposed regulations published on December 5, 2012, regarding guidance on the new section 1411 net investment income (NII) tax as relevant to trusts and estates. Section 1411 imposes a tax on unearned income on investments of certain individuals, estates, and trusts, whose income is above the statutory threshold amounts.

The AICPA is the world's largest member association representing the accounting profession, with nearly 386,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Executive Summary

The AICPA recommends that with respect to trusts and estates, the final section 1411 regulations:

1. Exempt pooled income funds, cemetery perpetual care funds, qualified funeral trusts, and Alaska Native Settlement Trusts from the section 1411 tax.

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2. Correct the calculation of distributable net income (DNI) in Examples 1 and 2 of section 1.1411-3(f).
3. Provide that for an electing small business trust (ESBT), taxpayers have the option to compute NII and adjusted gross income separately for the S and non-S portions and then add them together, or to elect to compute them for the entire trust using the rules applicable to normal trusts. Also, we suggest the final regulations contain the appropriate corrections to Example 3 of section 1.1411-3(f).
4. Provide that NII of a charitable remainder trust is treated in accordance with section 664(b) and section 1.664-1(d)(1)(ii)(b) and not treated as distributed first to the annuity or unitrust recipient unless so required under the current statutory and regulatory provisions.
5. Provide that the state income tax payable per the state income tax return, rather than the actual state income tax payments made during the year, be used in calculating the trust or estate's NII.
6. Provide that in computing a trust or estate's NII, deductions are permitted for an allocable portion of administration expenses, including fiduciaries' and attorneys' fees, and for the estate tax attributable to income in respect of a decedent (IRD) under section 691(c)(1) if the IRD is investment income.
7. Provide that existing trusts and estates may make a new determination about whether to treat capital gains as part of a distribution to beneficiaries under section 1.643(a)-3(b)(3) in light of the application of the section 1411 tax.
8. Provide that the section 1411 tax is not applicable to foreign trusts or estates on non-U.S. source income until such income is distributed to a U.S. beneficiary, and provide that the section 1411 tax applies to accumulation distributions of NII from foreign trusts to a U.S. beneficiary only to the extent the distributions are of income accumulated after December 31, 2012.

Background

Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 added new section 1411 to the Internal Revenue Code (IRC or "Code") effective for taxable years beginning after December 31, 2012. Section 1411(a)(2) provides that in the case of an estate or trust, there is hereby imposed (in addition to any other tax imposed by the subtitle) for each taxable year a tax of 3.8 percent of the lesser of —

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- (A) the undistributed NII for such taxable year, or
- (B) the excess (if any) of the adjusted gross income (as defined in section 67(e)) for such taxable year, over the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

On December 5, 2012, proposed regulations were published that address various aspects of section 1411, including the section's application to trusts and estates. The following comments are provided with respect to the provisions of the regulations that affect trusts and estates.

General Comments

The AICPA recognizes the effort that was devoted by Internal Revenue Service (IRS) and Treasury officials to provide clarity for taxpayers and practitioners regarding this new tax on NII. The guidance is appreciated as it generally provides a reasonable approach to interpreting, implementing, and complying with the new NII tax rules as applicable to trusts and estates.

Specific Comments

The AICPA recommends that the final regulations address the following issues.

A. Domestic Trusts and Estates

1. Exemption from Section 1411 Tax for Certain Types of Trusts

Section 4.A. of the Preamble to the proposed regulations requests comments as to whether there may be administrative reasons to exclude pooled income funds, cemetery perpetual care funds, qualified funeral trusts, and Alaska Native Settlement Trusts from the application of section 1411. The AICPA suggests that the final regulations exclude all of these trusts from taxation under section 1411.

Pooled Income Funds: A pooled income fund is a trust maintained by a public charity. Donors make contributions to the trust and reserve an income interest for life. Upon the donor's death, the portion of the trust attributable to the donor's contribution is distributed to the charity. A pooled income fund is a taxable trust. It receives a distribution deduction under section 661 for the income distributed to the income beneficiaries. It receives a charitable deduction under section 642(c)(3) for long-term capital gain that is permanently set aside for charitable purposes. If short-term capital gains are allocated to income under the terms of the governing instrument, then they are distributed to the income beneficiaries currently and would become part of the

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beneficiaries' NII. If short-term capital gains are not allocated to income under the terms of the governing instrument, then they are taxable to the pooled income fund. The amount of the short-term capital gain will be accumulated by the pooled income fund and ultimately will be payable to the charity even though there is no charitable deduction available for this gain.

In general, the section 1411 tax is not applicable to wholly charitable trusts. In addition, the tax is not applicable to charitable remainder trusts because these trusts' income, to the extent it is not distributed to the annuity or unitrust recipient, will be held and ultimately payable to charity. We suggest that the treatment of pooled income funds be similar to other types of split-interest trusts sanctioned by the Code. Even though a pooled income fund pays income tax on its short-term capital gain that is not distributed as part of the income payable to the income beneficiaries, that income is being held for charitable purposes and should not be subject to the section 1411 tax.

Cemetery Perpetual Care Funds: A cemetery perpetual care fund described in section 642(i) is a trust established for the perpetual care of gravesites. While the trust's earnings are generally distributed to a for-profit cemetery corporation, they are used for care and maintenance expenses of the individual gravesites in the cemetery. The funds do not benefit individuals directly, but rather help to defray the expenses of maintaining gravesites at a for-profit cemetery. These funds are not an investment vehicle for wealthy individuals, who we presume are the targets of the section 1411 tax.

Qualified Funeral Trusts: A qualified funeral trust is a domestic trust that arises when a person prepays his or her funeral by transferring cash to a funeral home that will invest it and hold it in trust until the person dies. Such a trust is a grantor trust unless the election is made to treat it as a qualified funeral trust under section 685. A qualified funeral trust is taxed on its income each year. Under section 685(c), each beneficiary's share of the trust is treated as a separate trust for purposes of the tax rates under section 1(e). We believe that qualified funeral trusts will not have sufficient income for each beneficiary's share to be at the highest tax rate so the tax under section 1411(a) would not be applicable to the qualified funeral trust. Therefore, we suggest that qualified funeral trusts be exempted from the application of the tax under section 1411(a) so that the trustee is not required to even consider the possible application of the tax.

Alaska Native Settlement Trusts: Alaska Native Settlement Trusts were established to hold assets for Alaska natives that were received under the Alaska Native Claims Settlement Act. The settlement trusts may not operate as a business and may not make a subsequent transfer of land or interests therein except for a reconveyance to the transferor (a corporation). These trusts may elect to be treated under section 646 so that they pay tax on income at the lowest rate specified for ordinary income of an individual

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rather than the higher tax rates applicable to estates and trusts. Trust beneficiaries generally are not taxed on distributions from the trust, and contributions by an Alaska Native Corporation to the trust are not deemed distributions to the corporation's shareholders. In enacting section 646, Congress allows these trusts to be taxed at the lowest rate applicable to individuals. It would be inconsistent with the purposes of section 646 to require these trusts to pay the section 1411 tax because that tax is not applicable to any individual in the lowest tax bracket.

The above-listed types of trusts are special trusts set up for particular situations and none of them should be subject to the tax under section 1411.

2. Computation of DNI in Examples 1 and 2

Examples 1 and 2 in section 1.1411-3(f) of the proposed regulations provide that DNI does not include the portion of the individual retirement account (IRA) distribution that is allocated by the trust to principal. This is an incorrect assumption because whether an item of income (other than capital gain) is allocated to income or principal for fiduciary accounting purposes is irrelevant in determining the trust's DNI.

Section 643(a) provides that DNI is the taxable income of the estate or trust generally reduced by capital gains under section 643(a)(3). Thus, in the examples, the taxable income of the trust is \$90,000 (the total of dividend income of \$15,000, interest income of \$10,000, capital gain of \$5,000, and IRA income of \$60,000). The taxable income is reduced by the capital gain of \$5,000 to arrive at DNI of \$85,000. The fact that a portion of the IRA distribution is allocated to principal for fiduciary accounting purposes has no effect on the computation of the DNI. Because the DNI is \$85,000, rather than \$50,000 as stated in the examples, all the numbers in examples 1 and 2 need to be adjusted.

3. Computation of Tax for Electing Small Business Trusts

Even though section 1411 is located Chapter 2A, the rules contained in Chapter 1 are generally used to determine the NII and the adjusted gross income for purposes of computing the section 1411 tax. With respect to ESBTs, the question arises as to how to determine those amounts. Section 641(c) provides that for purposes of Chapter 1 the S portion and the non-S portion are treated as separate trusts and the tax is computed separately for each portion. Some special rules under section 641(c) (such as limitations on certain deductions) are applicable in determining the amount on which the S portion is taxed. An ESBT may also have a grantor portion, defined in section 1.641(c)-1(b)(1) as the portion of the trust that is treated as owned by the grantor or another person under

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subpart E. Any items of income of the ESBT that are attributable to the grantor portion will be includible by the deemed owner in computing his or her section 1411 tax.

With respect to the rest of the ESBT (or all the ESBT if it does not have a grantor portion), there are three options for determining NII and adjusted gross income: (1) determine the amounts for the entire trust using the special rules applicable to ESBTs; (2) determine the amounts separately for the S portion and the non-S portion and then combine the amounts to compute the section 1411 tax; or (3) determine the amounts for the entire trust using the rules applicable to normal trusts.

Because we believe the income from the non-S portion should not be subject to the more restrictive rules, the first option is not viable.

The second option is consistent with how the ESBT is taxed for Chapter 1 purposes and may be the easiest method for taxpayers and practitioners to apply. The NII and adjusted gross income of the S and the non-S portion would be readily determinable from the current year's tax return. Those amounts could then be combined for purposes of computing the section 1411 tax. The downside of this option is that the separate treatment of the portions of the ESBT is required only for purposes of Chapter 1 and is not required for purposes of Chapter 2A. In addition, in some situations, the second option would require payment of the section 1411 tax sooner than the third option.

If the second option is used, the rules applicable in section 641(c) to the S portion need to be followed. The S portion is not entitled to reduce its income by the capital loss carryover under section 641(c)(2)(D). That section provides that the amount of tax imposed on the S portion is determined with certain modifications. For example, the S portion's adjusted gross income would not be reduced by the capital loss carryover.

The third option is based on the fact that the separate treatment of the S and non-S portions is not required by Chapter 2A. It may be the most favorable to taxpayers in certain situations. For example, the special restrictions normally applicable to the S portion would not be applicable to the combined trust, and losses from one portion could be used to offset losses from the other portion (which is not generally permitted). If this option is used, it has to be used exclusively because taxpayers will not be able to rely on the information on the current year's tax return to determine NII and adjusted gross income.

The facts in Example 3 in section 1.1411-3(f) may be used to illustrate the difference between the second and third options. With the second option, the adjusted gross income for the S portion is \$20,600 (net rental income of \$21,000, less its share of the annual trustee fee of \$400). The S portion is not allowed to reduce its income by the

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\$3,000 capital loss carryover. In this example, the NII of the S portion is the same as the adjusted gross income of the S portion, \$20,600. The adjusted gross income for the non-S portion is \$20,400 (dividend income of \$15,000, plus interest income of \$10,000, plus capital gain of \$5,000, less its share of the annual trustee fee of \$600, less the distribution deduction of \$9,000). The NII of the non-S portion is the same as the adjusted gross income of the non-S portion, \$20,400. The NII of the ESBT is \$41,000 (the sum of the NII of the S portion \$20,600 and the NII of the non-S portion \$20,400). The adjusted gross income of the ESBT is also \$41,000.

With the third option, the NII of the ESBT is \$36,000 (net rental income of \$21,000, plus dividend income of \$15,000, plus interest income of \$10,000, less annual trustee fee of \$1,000, less the distribution deduction of \$9,000). The \$5,000 capital gain of the non-S portion is offset by \$5,000 of the capital loss from the S portion so there is zero capital gain for purposes of the ESBT's NII. The ESBT's adjusted gross income is \$34,000 after taking into account the remaining \$2,000 capital loss allowed under section 1211(b)(1).

In this example, the third option allows taxpayers to defer the section 1411 tax that they would otherwise currently pay under the second option. By utilizing the S portion capital loss during the current year, it will not be available in the future when the S portion has capital gain. That is the year that the ESBT would be able use the capital loss under the second option.

The second option is the easiest for taxpayers to use because the information is available on the current year's tax return. We believe that this option should be the general rule applicable to ESBTs. However, because separate treatment of the S and non-S portions is not required for purposes of Chapter 2A, we believe that taxpayers should be able to elect to use the third option. An ESBT should be able to make this election at any time, but once made, it must continue to use the third option for all future years. Taxpayers who make this election will need to track capital losses separately for section 1411 purposes than they do for regular tax purposes. As illustrated in Example 3, when applying the third option, the S portion for regular tax purposes will still have a \$7,000 capital loss that it can use in the future when the S portion has a capital gain. However, for section 1411 purposes, that capital loss is used in the current year and thus not available in the future.

Appropriate adjustments must be made to Example 3 depending on which option the taxpayer chooses to adopt. Even if the final regulations continue to require the initial separate computation of NII and adjusted gross income for the S and non-S portions, Example 3 needs to be corrected to show that the adjusted gross income of the S portion is not reduced by the \$3,000 capital loss in accordance with section 641(c)(2)(D).

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Therefore, we suggest that the final regulations provide that for an electing small business trust (ESBT), taxpayers have the option to compute NII and adjusted gross income separately for the S and non-S portions and then add them together, or to elect to compute them for the entire trust using the rules applicable to normal trusts. We also suggest the final regulations contain the appropriate corrections to Example 3 of section 1.1411-3(f).

4. Charitable Remainder Trusts

Section 1.1411-3(c)(2) of the proposed regulations provides that the NII of the beneficiary attributable to the beneficiary's annuity or unitrust distribution from a charitable remainder trust (CRT) is the amount equal to the lesser of the total amount of the distributions or the current and accumulated NII of the charitable remainder trust. The Preamble to the proposed regulations states that this rule reduces the compliance and recordkeeping burden that would be imposed if the trust were required to track the NII consistent with section 1.664-1(d)(1).

NII could consist of qualified dividend income, other ordinary income, short-term capital gain, or various types of long-term capital gain as long as the items of income are earned by the CRT after December 31, 2012. The proposed regulations require that a distribution be considered NII to the extent the CRT has undistributed NII, irrespective of whether the NII is ordinary income or capital gain, a position contrary to the categories set forth in section 664(b), and irrespective of what type of income it is within the categories, a position contrary to the classes set forth in section 1.664-1(d)(1)(i)(b) and the current ordering rules of section 1.664-1(d)(1)(ii).

Section 664(b) requires that ordinary income be treated as distributed prior to capital gains. A CRT's income must first be assigned to a category, namely ordinary income, capital gains, or other income. Distributions are then considered made first from the ordinary income category, then from the capital gain category, and then from the other income category. Any remaining distributions are treated as a return of capital. "The general principle of section 664(b) is that income subject to the highest Federal income tax rate is deemed distributed prior to income subject to a lower (or no) Federal income tax rate." Preamble to the proposed section 1.664-1(d) regulations (REG 110896-98, 2003-2 C.B. 1226).

Beginning in 1997, various types of long-term capital gains were subject to different tax rates, and beginning after 2002, different types of dividends were subject to different tax rates. Section 1.664-1(d)(1) of the regulations was amended to take into account the different tax rates applicable to income within the same category. The Preamble to the proposed regulations (REG 110896-98, 2003-2 C.B. 1226) states:

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The proposed regulations will amend § 1.664-1(d)(1) to revise the rules for characterizing a CRT distribution to take into account differences in the Federal income tax rates applicable to items of income that are assigned to the same category under section 664(b). The trust's income is assigned, in the year it is required to be taken into account by the trust, to one of three categories: the ordinary income category, the capital gains category, or the other income category. Further, within the ordinary income and capital gains categories, items are also assigned to different classes based on the Federal income tax rate applicable to each type of income in the category. In accordance with section 664(b), a CRT distribution is treated as being made from the categories in the following order: ordinary income, capital gain, other income, and trust corpus. Within the ordinary income and capital gains categories, income is treated as distributed from the classes of income in that category beginning with the class subject to the highest Federal income tax rate and ending with the class subject to the lowest Federal income tax rate.

The amendments to section 1.664-1(d)(1) of the regulations were finalized in 2005 in T.D. 9190.

One of the goals of the amendments to section 1.664-1(d)(1) was to provide rules that would be applicable currently and in the future, irrespective of what changes were made to the tax rates applicable to the types of income earned by a CRT. For example, the amendments did not specifically provide that qualified dividends are distributed after other types of ordinary income. They provided rules to determine what order qualified dividends would be distributed. Providing general ordering rules that could be applied each year irrespective of changes to the tax rates allows the regulations to be timeless so that they would not have to be amended each time a change is made to the tax rate applicable to a particular type of income. Now, when a new tax rate is potentially applicable to NII, the existing provisions of section 1.664-1(d) should be allowed to determine the order in which the NII is treated as distributed. Instead, the section 1411 proposed regulations seek to override both the statute and the existing regulations without modifying the section 664 regulations. Taxpayers looking to determine the character of a distribution from a CRT will look to section 664 and the regulations thereunder. As a practical matter, taxpayers likely will not know that those provisions are overruled elsewhere, buried in the section 1411 regulations.

We believe that NII should first be assigned to either the ordinary income category or the capital gain category, as required by section 664(b). Then, NII within each category should be assigned to an appropriate class in accordance with section 1.664-1(d)(1)(i)(b)

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– for ordinary income, NII that is either qualified dividend or other ordinary income and for capital gain, NII that is short-term capital gain or one of the various long-term capital gain classes. Section 1.664-1(d)(1)(ii) will then apply to determine the order of the distributions.

We do not understand why the statutory rules and the current regulatory rules are not followed with respect to NII in the proposed regulations. The rule in the proposed section 1411 regulations overrides the statutory provision of section 664(b) because NII that is capital gain will be distributed prior to accumulated ordinary income earned before 2013. While this would be beneficial to taxpayers, we believe it is contrary to the requirements of section 664(b). We believe that the various types of NII should be treated as separate classes of income within each category, and the normal rules should apply to determine which category of income and which class of income within that category is being distributed to the annuity or unitrust recipient.

5. Allocation of State and Local Taxes

The AICPA agrees with the allocation of a portion of state and local tax deductions in determining NII by using any reasonable method, an example of which is allocating the deduction based on the ratio of investment income to total gross income.

However, additional guidance is needed as to the treatment of refunds of state and local taxes in the current or subsequent year. A trust or estate may receive a refund in a subsequent year for which a deduction against NII was taken in a previous year.

Trusts generally are taxed in accordance with the rules applicable to individuals. One of the most significant differences is that trusts are allowed a distribution deduction for distributions made to beneficiaries that are authorized by the governing instrument. Distributions cannot be made only to reduce a trust's income taxes. The distribution deduction is limited to the trust's DNI. The amount of the distribution deduction is calculated differently for a simple trust versus for a complex trust.

A simple trust is required to distribute all of its fiduciary accounting income to the beneficiaries. However, in most cases capital gains and losses are retained and taxed at the trust level. A complex trust is generally not required to distribute all of its fiduciary accounting income; thus, the income retained and taxed at the trust level is more likely to be a combination of both ordinary income and capital gain.

A simple trust might have a large capital gain in the current year for which state and local taxes are due, but those taxes are not paid until the following year. A complex trust may have significant income in the current year and little or no income in the

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subsequent year. There also may be significant differences in the percentage of investment income compared to other types of income from year to year. Unless the state tax is paid in the current year, the ratio will be skewed, sometimes significantly.

The AICPA recommends that for estates and trusts, the state income tax payable per the state income tax return, rather than the actual state income tax payments made during the year, be allocated in calculating NII. This would more accurately reflect the deduction that should be used in calculating NII under section 1411.

6. Other Appropriate Deductions

The AICPA believes that in determining the NII of a trust or estate, an allocable share of administration expenses incurred by the trust or estate should reduce the trust or estate's investment income in arriving at NII. These administrative expenses should include fiduciaries' and attorneys' fees.

In addition, if investment income is also income in respect of a decedent, any deduction for estate taxes attributable to that income under section 691(c)(1) should also reduce investment income to arrive at NII. The purpose of section 691(c)(1) is to provide a deduction against income that was previously subject to estate tax in an attempt to partially alleviate subjecting the same income to two taxes. The deduction for estate taxes on income in respect of a decedent should be just as applicable to the section 1411 tax as it is to the regular income tax.

7. Treatment of Capital Gains as Part of Trust Distribution

Generally, capital gains of a trust are allocated to corpus for fiduciary accounting purposes and are deducted in computing the trust's DNI. As a result, the trust, rather than the beneficiaries, is generally taxed on the capital gains. Section 1.643(a)-3(b) provides the rules for situations in which capital gains are included in DNI. Under section 1.643(a)-3(b)(3), capital gains are included in DNI to the extent they are, pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of discretion by the fiduciary, allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary.

The tax under section 1411 applies to a trust or estate with an adjusted gross income in excess of \$11,950 for 2013. The tax applies to individuals whose modified adjusted gross income is in excess of \$250,000. At the time the fiduciary of an existing trust made the decision as to whether to treat capital gains as part of the distributions to beneficiaries, that decision was tax-neutral since generally long-term capital gains are

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taxed at the same rate whether taxed to the trust or the beneficiaries. The section 1411 tax with the wide discrepancy in thresholds between trusts and individuals changes the landscape dramatically. Capital gains most likely will be subject to the 3.8% tax if retained by the trust but also most likely will not be subject to the 3.8% tax if distributed to the trust's beneficiaries. This new tax will certainly affect the decision of fiduciaries in newly created trusts as to whether they plan to treat capital gains as part of distributions to the beneficiaries. Fiduciaries of existing trusts should have the ability to reconsider their prior practice and make a new decision going forward based on the imposition of the section 1411 tax.

B. Foreign Trusts and Estates

Section 4.C. of the Preamble to the proposed regulations requests comments on how section 1411 should apply to United States persons that receive accumulation distributions from foreign trusts and estates, including the means by which to identify such distributions as NII.

Subchapter J of the Code provides for the income tax treatment of estates, trusts, beneficiaries and decedents. In determining taxable income subject to tax, a domestic trust or estate is entitled to an income tax deduction for distributions made (or required to be made) to beneficiaries, not to exceed the estate or trust's DNI.¹ The recipient beneficiary is taxed on amounts distributed (or required to be distributed).² The character of amounts distributed to the beneficiary retains the same character as that determined at the estate or trust level.³ Taxable income remaining after any income distribution deduction is taxed at the entity level.

A foreign nongrantor trust is subject to U.S. income tax on undistributed U.S. source income.

A U.S. beneficiary of a foreign nongrantor trust is taxed on distributions of the trust's DNI in a manner similar to that applicable to domestic trusts, although DNI is calculated somewhat differently for a foreign trust.⁴ If DNI exceeds distributions for a given year, the excess becomes undistributed net income (UNI). If, on the other hand, distributions to a U.S. beneficiary exceed DNI for a given year, such excess is an accumulation distribution to the extent of the trust's UNI.⁵ The trust must track its UNI by year.

¹ IRC §§ 651 and 661.

² IRC §§ 652(a) and 662(a).

³ IRC §§ 652(b) and 662(b).

⁴ IRC § 643(a)(6) provides that DNI of a foreign trust includes income from sources outside the U.S., income otherwise excluded by treaty, and net capital gains.

⁵ Repealed for domestic trusts, effective for distributions in tax years beginning after August 5, 1997.

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Assuming the trustee provides the beneficiary with a Foreign Nongrantor Trust Beneficiary Statement,⁶ the beneficiary will be advised as to the components of the current year distribution, including the tax character of DNI, as well as the amount, if any, of UNI.

A complicated series of calculations is necessary to determine the additional tax that the beneficiary must pay on the accumulation distribution.⁷ Simplistically, when a trust beneficiary receives an accumulation distribution, the distribution is attributed to the earliest year(s) of the trust for which there is remaining UNI. Distributions of income accumulated before the beneficiary was born or reached age 21 are disregarded, and adjustments are made for U.S. income taxes paid by the trust. The character of income at the trust level is disregarded, with the exception of tax-exempt income. The beneficiary calculates an average accumulation that is added to the beneficiary's taxable income for three of the last five preceding years. The beneficiary's federal income tax for those years is then recomputed to determine the additional income tax resulting from the accumulation distribution. The resulting tax is subject to an interest charge.⁸ Although the additional tax and interest charge are determined with reference to prior years, the tax and interest resulting from the accumulation distribution are paid by the beneficiary in the year of such distribution.

Distributions from estates are not subject to the accumulation distribution tax regime.

Section 1411 provides for a tax of 3.8% of the lesser of NII, or the excess of modified adjusted gross income over a threshold amount. The tax applies to individuals, estates and trusts. Proposed regulations sections 1.1411-3(d)(2)(ii) and 1.1411-3(c)(3) reserve on the application of section 1411 to foreign estates and foreign trusts with United States beneficiaries. Further, in the Preamble to the regulations, the Treasury Department and the IRS request comments on several issues, including how the tax should be applied to U.S. persons that receive accumulation distributions from foreign trusts and the method to be used to determine which of those distributions is NII.

The AICPA believes that the section 1411 tax is not applicable to a foreign trust with non-U.S. source income until such income is distributed to a U.S. beneficiary and taxable under the provisions of Chapter 1 of the Code. If a foreign trust or estate makes a distribution of current DNI to a U.S. beneficiary, the AICPA agrees that it is appropriate that the NII derived from the foreign trust or estate is subject to the section 1411 tax. Since the character of the income earned by the foreign entity is retained at

⁶ Format for this statement is included in the instructions to IRS Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts.

⁷ IRC §667.

⁸ IRC §668.

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the beneficiary level, the beneficiary should be able to determine the amount of distributed income subject to the tax.

A U.S. beneficiary is taxable on an accumulation distribution from a foreign nongrantor trust, and it is appropriate that the distribution should be subject to tax under section 1411 to the extent that the distribution consists of NII of the trust earned after December 31, 2012. However, this approach presents both an administrative burden on the trustee as well as unfairness to the beneficiary to the extent that the accumulation distribution consists of income earned prior to January 1, 2013.

In the past, it has not been necessary for trustees to maintain records of the character components of UNI (with the exception of the tax-exempt portion). It has only been necessary to determine in which year the UNI was accumulated. It would be an undue burden for trustees to be required to reconstruct prior year accounting records to determine the character of income and determine the NII for those years.

Further, since the section 1411 tax is not applicable to years prior to January 1, 2013, it would be unfair to beneficiaries to subject them to this tax to the extent that an accumulation distribution consists of income earned prior to that time. The AICPA, therefore, believes that the application of section 1411 should be applied only to distributions of UNI accumulated after December 31, 2012. A prospective application is included for distributions from controlled foreign corporations and passive foreign investment at section 1.1411-10(c)(2)(i) of the proposed regulations. We believe that the proposed regulations should adopt a similar rule for accumulation distributions from foreign trusts.

NII as defined in section 1411(c) includes income from interest, dividends, annuities, royalties, rents, and gains reduced by allocable expenses. It is reasonable to believe that many foreign trusts will earn only income defined by section 1411(c) and that no additional recordkeeping will be required by the trustee (other than the year of accumulation and the amount of tax-exempt income, if any) since the entire accumulation distribution will consist of NII. For those trusts with income excluded from the definition of NII, it will be necessary for the trustee to compute the excludable income in order to provide complete information to the beneficiary.

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We welcome the opportunity to discuss these comments or to answer any questions that you may have.

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Mr. Curtis G. Wilson
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I can be reached at (304) 522-2553, or jporter@portercpa.com; or you may contact Frances Schafer, Chair, AICPA Trust, Estate, and Gift Tax Technical Resource Panel, at fwswcs3@comcast.net; Donita Joseph, Chair, AICPA Trust Impact of Medicare Surtax Task Force, at (562) 304-1242 or djoseph@windes.com; Peggy Ugent, Member, AICPA Foreign Trust Task Force, at (512) 370-2756 or pugent@psrp.com; or Eileen Sherr, AICPA Senior Technical Manager, at 202-434-9256, or esherr@aicpa.org.

Sincerely,



Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

cc: Ms. Catherine Veihmeyer Hughes, Estate and Gift Tax Attorney Advisor, Office of Tax Policy, Treasury Department
Ms. Melissa Liquerman, Chief Branch 2, Office of the Associate Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service
Mr. James Hogan, Chief Branch 4, Office of the Associate Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service
Mr. David Kirk, Attorney, Office of the Associate Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service
Ms. Adrienne Mikolasheck, IRS Office of Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service