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

June 16, 2014

The Honorable John Koskinen
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-130843-13 relating to guidance under section 1411, as added by the Health Care and Education Reconciliation Act of 2010, regarding net investment income tax (11/26/2013)

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

The American Institute of Certified Public Accountants (AICPA) submits the comments below in response to the proposed regulations under section[1] 1411 of the Internal Revenue Code, regarding the new section 1411 net investment income (NII) tax. 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 more than 394,000 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.

We have identified a number of issues in the application of proposed regulations under section 1411 surrounding the optional simplified reporting method, retirement payments to partners, and tiered passthrough dispositions. We respectfully request that the Internal

[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

Revenue Service (IRS) and Department of the Treasury ("Treasury") modify the proposed regulations to address these issues with our detailed suggestions below to provide additional clarity in this area.

Executive Summary

The AICPA commends the IRS and Treasury for issuing proposed regulations, which provide clarity for taxpayers and tax practitioners regarding the new NII tax. We especially laud the inclusion of an optional simplified method for calculating the gain or loss on disposition of certain active interests in partnerships and S corporations in the proposed regulations. We are particularly pleased with the IRS's decision to incorporate several of the concepts we had recommended in our previous comments submitted on June 17, 2013.[2]

To further the Treasury's objective underlying the proposed regulations under section 1411, we offer the following recommendations:

1. The final regulations should periodically adjust the qualification threshold figures under Prop. Reg. § 1.1411-7(c)(2) to reflect inflation (optional simplified reporting method) for purposes of section 1411.

2. The final regulations should modify the nonavailability of the optional simplified reporting method exceptions under Prop. Reg. § 1.1411-7(c)(3)(iv) to eliminate uncertainty. Specifically, the final regulations should clarify the following items:

    I. Definition of the phrase of "transferor knows or has reason to know";

    II. Definition of the term "gross assets";

    III. Definition of the term "Section 1411 Property" with respect to "cash or cash equivalents"; and

    IV. Definition of the phrase "during the transferor's Section 1411 Holding Period."

[2]See
http://www.aicpa.org/Advocacy/Tax/Individuals/DownloadableDocuments/AICPA%20Section%201411%20Comment%20Letter%20FINAL%20DATED%2006%2017%202013.pdf.

3. The final regulations should provide a taxpayer with an option to include their entire chapter 1 gain or exclude their entire chapter 1 loss from the disposition of certain active interests in passthrough entities (as defined in Prop. Reg. § 1.1411-7) in calculating their NII for the year to further reduce administrative burden.

4. The final regulations should simplify the rules for retirement payments to partners and the nonapplicability of section 1411.

5. The final regulations should include a simplified safe-harbor method to allow taxpayers who have elected to regroup their real estate activities under Treas. Reg. § 1.469-9 to apply the optional simplified reporting method under Prop. Reg. § 1.1411-7(c) in the event of a tiered passthrough disposition based upon current year information that is readily available to the taxpayer within the Schedule K-1 issued by the upper-tiered passthrough entity.

6. The final regulations should provide that when a qualified subchapter S trust ("QSST") disposes of S corporation stock, the disposition is treated as a disposition of the stock by the current income beneficiary of the QSST for purposes of determining the amount of gain or loss resulting from the sale of S corporation stock included in the NII of the trust under section 1411(c)(4). Thus, if the current income beneficiary materially participates in the activities of the S corporation, the exception under section 1411(c)(4) should apply to the trust.

A more detailed discussion of the above recommendations is included below.

<u>Specific Comments</u>

The AICPA recommends that the IRS and Treasury modify the proposed regulations to address the following issues:

1. Modification to qualifications under optional simplified reporting method

The proposed regulations provide an optional simplified reporting method that qualified taxpayers may use in lieu of the calculation described in Prop. Reg. § 1.1411-7(b). According to the proposed regulations, qualifying taxpayers must meet at least one of two requirements. Under the first requirement, the sum of the taxpayer's allocable share of separately stated items of income, gain, loss, and deduction during the Section 1411 Holding Period, of a type that the taxpayer would take into account in calculating NII, cannot exceed 5% of the sum of all separately stated items of income, gain, loss, and deduction allocated to the taxpayer during the holding period. The Section 1411 Holding Period is described as being generally the year of the disposition and the preceding two years. Additionally, chapter 1 gain recognized by the taxpayer from the disposition of the passthrough entity cannot exceed $5,000,000. Under the second requirement, taxpayer's total chapter 1 gain or loss recognized from the disposition of interest in the passthrough entity cannot exceed $250,000 (including gains and losses from multiple dispositions as part of a plan).

We believe the proposed optional simplified reporting method will significantly reduce administrative burden for many taxpayers and equally benefit IRS examining agents during an audit. However, we are concerned that the proposed qualifications and eligibility rules of the optional simplified reporting method could still exclude certain small taxpayers.

If the Federal Reserve Bank's target inflation rate of 2% is achieved, nominal dividend distributions from investments and rental income will rise. As a result, an increased number of taxpayers might be unable to use the optional simplified reporting method. Maintaining (even expanding) the number of taxpayers who can qualify for the optional simplified reporting method should promote higher compliance from taxpayers and further the underlying objective of the rule.

In order to make the optional simplified reporting method available to more taxpayers, we recommend the following refinements to the qualifications under Prop. Reg. § 1.1411-7(c)(2):

I. Under Prop. Reg. § 1.1411-7(c)(2)(i), we propose that the final regulations raise the 5% threshold to 10% under the first requirement and periodically review and adjust this percentage threshold in the future.

II. Under Prop. Reg. § 1.1411-7(c)(2)(i), we propose that the final regulations include a future adjustment of the $5,000,000 gain or loss threshold for inflation when the accumulated adjustment exceeds $250,000.

III. Under Prop. Reg. § 1.1411-7(c)(2)(ii), we propose that the final regulations include a future adjustment of the $250,000 gain or loss threshold for inflation when the accumulated adjustment exceeds $25,000.

2. Clarification of the nonavailability of optional simplified reporting method rules under Prop. Reg. § 1.1411-7(c)(3)(iv)

Proposed Reg. § 1.1411-7(c)(3) prohibit certain taxpayers from using the optional simplified reporting method if certain conditions are met. According to Prop. Reg. § 1.1411-7(c)(3)(iv), "a transferor is not eligible to use the simplified reporting method" if "the transferor knows or has reason to know that the percentage of the Passthrough Entity's gross assets that consist of Section 1411 Property has increased or decreased by 25 percentage points or more during the transferor's Section 1411 Holding Period due to contributions, distributions, or asset acquisitions or dispositions in taxable or nonrecognition transactions."

We note that certain terms and phrases in this nonapplicability rule are not defined further in the proposed regulations. Therefore, the AICPA is concerned that the lack of clarity in this nonapplicability rule would create confusion for both taxpayers and IRS agents. To eliminate this confusion, we request that the IRS provide additional guidance in the following areas:

I. Definition of the phrase "transferor knows or has reason to know"

According to the proposed regulations, the phrase "knows or has reason to know" is not currently defined. We are concerned that a broad interpretation of such phrase could result in unnecessary controversy between taxpayers and the IRS. A modest refinement to this rule would eliminate such ambiguity.

For example, we recommend that the final regulations modify this rule as follows:

"The transferor knows or has reason to know that the percentage of the Passthrough Entity's gross assets that consist of Section 1411 Property has increased or decreased by at least 25 percentage points during the transferor's Section 1411 Holding Period due to contributions, distributions, or asset acquisitions or dispositions in taxable or nonrecognition transactions***, as part of a plan that includes the transfer of the transferor's interest in the Passthrough Entity.***"

Furthermore, we recommend that the IRS illustrate, through examples, a number of circumstances where this rule would apply.

II. Definition of the term "gross assets"

We note that term "gross assets" is not currently defined in the proposed regulations. We are concerned that a broad interpretation of the term "gross assets" may trigger a controversy between taxpayers and the IRS.

Therefore, we recommend using "adjusted basis" when defining the term "gross assets." "Adjusted basis" provides an indisputable evidence of cost over other value such as fair market value. Fair market value injects subjectivity into the equation. Differences in opinion as to value could inadvertently trigger the nonapplicability rule. In addition, fair market value is not an appropriate measure of gross assets when it is not independently determined by transactions, made at arm's length. Finally, we suggest adding a reference (e.g., adjusted basis) in the final regulations. Such reference would provide clarity and reduce uncertainty.

Furthermore, taxpayers are likely to determine their qualification based on the assets on the entity's balance sheet. Thus, we suggest that the IRS include examples based on Schedule L (Balance Sheet per Books) in the entity tax return in the final regulations.

III. Definition of "Section 1411 Property" with respect to "cash or cash equivalents"

According to Prop. Reg. § 1.1411-7(a)(2)(iv), "the term *Section 1411 Property* means property owned by or held through the passthrough entity that, if disposed of by the entity, would result in net gain or loss allocable to the transferor of a type that is includable in determining net investment income of the transferor under § 1.1411-4(a)(1)(iii)." This definition does not explicitly exclude cash or cash equivalents.

However, Prop. Reg. § 1.1411-7(c)(3)(ii) states "Section 1411 Property (other than cash or cash equivalents)" which clearly excludes cash or cash equivalents from Section 1411 Property.

We are concerned that the inconsistent use of the term "cash or cash equivalents" in defining the term Section 1411 Property creates an ambiguity between taxpayers and the IRS. The sale of cash clearly does not produce a gain or loss. Therefore, we suggest that the term "Section 1411 Property" specifically exclude cash or cash equivalents.

If the Section 1411 Property is intended to include cash, we suggest that the final regulations include a parenthetical such as "(including cash or cash equivalents)" added after the term "Section 1411 Property."

IV. Definition of the phrase "during the transferor's Section 1411 Holding Period"

As noted above, the rule under Prop. Reg. § 1.1411-7(c)(3)(iv) is triggered if the amount of Section 1411 Property contained in gross assets is increased or decreased by at least 25 percentage points during the period. However, it is unclear if this test compares the amounts of Section 1411 Property at the beginning and the end of the period or if this test is triggered by the amount of Section 1411 property increasing or decreasing by the requisite amount at any time during the period.

For purposes of discussion of IV above, we offer the following situation:

ABC, Inc. is an S corporation operating a drive-through coffee stand. The business was started for $100,000, debt-free, by two former college roommates with gifts from parents. The business has been in operation for five years. The stand is currently profitable and makes $100,000 per year after taking reasonable salaries for the owners. The S corporation continually makes distribution of its earning throughout the year, mostly to pay taxes and repay student loans. Consequently, the company maintains a minimal amount of working capital. The business plans to acquire a second stand; therefore, no distributions were made for one year to accumulate the funds needed to acquire the new stand. The new stand was acquired using the accumulated cash, and working capital was once again minimal.

A year later, one of the owners decides to go back to school and sells out to the other owner for $100,000. For purpose of this example, assume the seller knows everything about the business.

Based on the facts above and depending on one's own interpretation, two different results are attainable.

<u>Interpretation #1</u>

At the beginning of the Section 1411 Holding Period three years ago, the assets consisted of minimal Section 1411 Property. The coffee stand was formed for $100,000 five years ago and depreciated down to $60,000. At the end of the Section 1411 Holding Period, the assets consisted of minimal Section 1411 Property: one fully depreciated coffee stand and the new coffee stand with a cost of $100,000, and an adjusted basis of $80,000. Since the Section 1411 Properties are minimal at the beginning and end of the Section

1411 Holding Period, we could conclude that the Section 1411 Property did not increase or decrease by at least 25 percentage points during this period. Thus, the nonapplicability test is passed and the sale is eligible for the optional simplified reporting method.

Interpretation #2

During the year of accumulation (Year 2 of the Section 1411 Holding Period), cash or cash equivalents were increased to $100,000 and then decreased to zero as part of an asset acquisition. Thus, the portion of gross assets represented by the Section 1411 Property increased by at least 25 percentage points. Since such change in the Section 1411 Property was not due to contributions or distributions, or asset acquisitions or dispositions, a taxpayer could reasonably conclude that the increase is not a violation of the nonapplicability rule. However, the Section 1411 Property was then decreased to zero, due solely to an asset acquisition, which represents a clear decline, as a portion of gross assets, of at least 25 percentage points during the Section 1411 Holding Period. Thus, a taxpayer could also interpret these facts to conclude the 25-percentage point test has failed; as a result, the nonapplicability rule applies and the optional simplified reporting method is unavailable.

In our view, interpretation #1 is a more feasible interpretation due to the tremendous complexity implicit in the second interpretation.

Under interpretation #2, a contribution of cash used to purchase a trade or business asset could cause, however briefly, Section 1411 Property to both increase and decrease by 25 percentage points.

Similarly, a loan from which proceeds are deposited in the cash account and then used to buy a trade or business asset would, if large enough, trigger a violation of the rule while disbursement of the loan directly to the vendor of the trade or business asset would not violate the rule.

In a common situation, such as a typical professional services business, the accumulation of cash from profits, followed by a distribution of cash to pay taxes could, depending on the make-up of the other gross assets of the business, trigger the nonapplicability rule.

As illustrated above, the lack of clarity existing in this rule creates confusion and misunderstanding by taxpayers. Therefore, we recommend that the IRS and Treasury provide clarity through specific examples.

3. Election to treat entire chapter 1 gain subject to section 1411

Proposed Reg. § 1.1411-7 provides rules to calculate the net passive investment income for the disposition of certain active interests in partnerships and S Corporations. According to preamble (part 9.C.i) of the proposed regulations:

> Proposed § 1.1411-7(b) provides the calculation for determining the amount of the transferor's gain or loss under section 1411(c)(1)(A)(iii) from the disposition of an interest in a Passthrough Entity. For dispositions resulting in chapter 1 gain, the transferor's gain equals the lesser of: (i) the amount of gain the transferor recognizes for chapter 1 purposes, or (ii) the transferor's allocable share of net gain from a deemed sale of the Passthrough Entity's Section 1411 Property (in other words, property which, if sold, would give rise to gain or loss that is includable in determining the transferor's net investment income under § 1.1411-4(a)(1)(iii)). The proposed regulations contain a similar rule when a transferor recognizes a loss for chapter 1 purposes.

This section provides a primary method for determining the gain or loss subject to the NII tax under section 1411(c)(4), which postulates a deemed sale of the assets of the passthrough entity.

Proposed Reg. § 1.1411-7(c) provides an optional simplified reporting method for determining the gain or loss subject to the NII tax under section 1411(c)(4), which eliminates the complicated computation under the primary method.

Currently the proposed regulations do not provide a provision for opting out of the calculations required by section 1411(c)(4).

While the simplified reporting method is much simpler than the primary method, the cost of preparing even these simplified calculations may exceed the benefit incurred from excluding some gain or including some loss received by the taxpayer. For example, the cost of preparing even these simplified calculations for taxpayers with a small amount of NII may exceed the NII tax. As a result, such taxpayers may prefer treating all gains resulting from the sale of a passthrough entity in which the taxpayer materially participated as subject to the NII tax rather than prepare calculations allocating the gain or loss between trade or business and investment assets. Additionally, taxpayers choosing this option would treat all losses as <u>not</u> subject to the NII tax. Although the simplified reporting method provides much-needed simplification, this option would provide further simplification and reduce administrative burden. As noted above, the gain subject to NII tax is the lesser of the chapter 1 gain or the section 1411(c)(4) calculation. Thus, taxpayers would forgo complex calculations that can only reduce the amount of income subject to NII tax.

Therefore, the AICPA recommends allowing the taxpayer to annually elect forgoing allocation computations on an entity by entity basis. This election would apply to all transactions in regards to that entity; therefore, the taxpayer is unable to select such treatment on a transaction-by-transaction basis. If the taxpayer chooses to elect out of the calculation, an election is attached to the return in lieu of the statement required by Prop. Reg. § 1.1411-7(g)(2) with the following statement:

"The Taxpayer elects out of the calculations required by §1.1411-7 as they relate to ABC, LLC to determine the share of trade or business gain or loss inherent in each transaction and hereby treats all gains from the sale of ABC, LLC as subject to the Net Investment Income Tax and all losses as not subject to the Net Investment Income Tax. The Taxpayer understands this is an irrevocable election for this year for this entity and applies to all transactions in the current year. If the amount of chapter 1 gain or loss is subsequently adjusted due to IRS examination, the Taxpayer may choose to make a new election or recalculate the Net Investment Income based on the primary or optional simplified reporting method."

As indicated by the proposed statement above, this annual election is irrevocable. However, if the reported total chapter 1 gain or loss, which is the subject of such an election, is subsequently changed because of an IRS examination, the election is void. Thus, the taxpayer should have the ability to make a new election relating to the adjusted amount of chapter 1 gain or loss or recalculate based on the primary or optional simplified reporting method.

Choosing to elect out of the calculations should not recharacterize prior classifications of income or loss as trade or business, passive or investment. Additionally, this treatment will only affect the amount of NII from gains and losses from entity disposition transactions, thereby excluding other items of investment income and investment deductions.

We recommend that the IRS and Treasury allow taxpayers to decide annually whether to include their entire chapter 1 gain or exclude their entire chapter 1 loss from the disposition of certain active interests in passthrough entities (as defined in Prop. Reg.

§ 1.1411-7) in calculating their NII for the year to avoid the administrative burden and expense of the section 1411(c)(4) calculations.

4. Retirement payments to partners

Partners do not qualify for the general rule under section 1411(c)(5) that excludes most employee retirement payments from the NII tax. For partners retiring from partnerships, section 736 provides a complicated set of rules to determine the nature of partner retirement payments. Partner retirement payments under section 736 are generally treated as payments in exchange for partnership property (both capital and ordinary), guaranteed payments, or a distributive share. Alternatively, the partners receive special treatment for general partners in non-capital intensive partnerships to the extent of unrealized receivables or goodwill. The proposed regulations adopt this labyrinth and layer additional rules on top of the complicated section 469 and burdensome section 1411(c)(4) rules.

Currently, retiring partners are faced with complicated rules to determine the treatment of their retirement payments for purposes of chapter 1 of the Code. The proposed regulations apply those existing rules without giving partners a simple rule for the NII tax.

In the AICPA comment on REG-130507-11, dated June 17, 2013, relating to guidance under section 1411, we stated that the AICPA does not believe that the potentially inconsistent treatment among retired partners and employees was the intent of Congress in drafting the statute.[3] The AICPA continues to believe that for purposes of the NII tax, the final regulations should exempt payments made to retiring partners who have materially participated in the partnership for a certain period of years from NII tax. The fact that section 736 may characterize some portion of the payments as in exchange for property should not change the NII tax result. Therefore, we recommend a simple bright-line rule for the non-application of the NII tax to retirement payments for partners who have materially participated. The IRS and Treasury should consider applying this rule to service partnerships such as those partnerships described in section 1202(e)(3)(A).

5. Tiered passthrough dispositions

According to the preamble of the proposed regulations, the IRS and Treasury "have reserved proposed § 1.1411-7(e) to further consider a simplified method for determining

[3] See http://www.aicpa.org/Advocacy/Tax/Individuals/DownloadableDocuments/AICPA%20Section%201411%20Comment%20Letter%20FINAL%20DATED%2006%2017%202013.pdf.

the section 1411(c)(4) gain resulting from the disposition by a Passthrough Entity of an interest in a Subsidiary Passthrough Entity." Accordingly, the IRS and Treasury have requested comments regarding a simplified method for determining gain in such cases.

Proposed Reg. § 1.1411-7(b) provides a method to determine the gain or loss recognized for chapter 1 purposes that is attributable to property owned, directly or indirectly, by the passthrough entity that, if sold, would give rise to net gain within the meaning of section 1411(c)(1)(A)(iii). For dispositions resulting in chapter 1 gain, the proposed regulations note that the taxpayer's gain equals the lesser of (1) the amount of gain the taxpayer recognizes for chapter 1 purposes, or (2) the taxpayer's allocable share of net gain from a deemed sale of the passthrough entity's section 1411 property.

The proposed regulations also provide an optional simplified reporting method that qualifying taxpayers may use in lieu of the calculation described in Prop. Reg. § 1.1411-7(b). According to the regulations, qualifying taxpayers must meet at least one of two requirements. Under the first requirement, the sum of the taxpayer's allocable share of separately stated items of income, gain, loss, and deduction during the Section 1411 Holding Period, of a type that the taxpayer would take into account in calculating NII, cannot exceed 5% of the sum of all separately stated items of income, gain, loss, and deduction allocated to the taxpayer during the holding period. The Section 1411 Holding Period is described as being generally the year of the disposition and the preceding two years. Also, chapter 1 gain recognized by the taxpayer from the disposition of the passthrough entity cannot exceed $5,000,000. Under the second requirement, "the total amount of chapter 1 gain or loss recognized by the transferor from the disposition of interests in the Passthrough Entity does not exceed $250,000 (including gains or losses from multiple dispositions as part of a plan.)" In the example provided in the proposed regulations, the taxpayer in question does not have adequate information or the necessary access to the books and records to complete either of these calculations.

The proposed regulations do not provide guidance in determining the section 1411(c)(4) gain resulting from the disposition by a passthrough entity of an interest in a subsidiary passthrough entity when the taxpayer has elected to group his/her real estate activities under Treas. Reg. § 1.469-9. This shortfall becomes apparent when the taxpayer lacks access to the books and records of the lower-tier passthrough entity and receives insufficient information from the upper-tier passthrough entity. As a result, the taxpayer cannot perform the necessary calculations required by the general rule provided under Prop. Reg. § 1.1411-7(b). In addition, the lack of information prohibits the taxpayer from being able to determine eligibility for the optional simplified reporting method under Prop. Reg. § 1.1411-7(c).

The AICPA recommends adding a simplified safe-harbor method to the applicable regulations as they relate to tiered passthrough dispositions that utilize current year information made available to taxpayers on their Schedule K-1. Such a provision would allow affected taxpayers to avoid performing calculations required under Prop. Reg. § 1.1411-7(b) and the optional simplified reporting method qualification test provided under Prop. Reg. § 1.1411-7(c), both of which involve information that may not be readily available or obtainable by the taxpayer.

We further recommend that the IRS allow taxpayers who have elected to regroup their real estate activities under Treas. Reg. § 1.469-9 to apply the optional simplified reporting method under Prop. Reg. § 1.1411-7(c) in the event of a tiered passthrough disposition if the taxpayer owned an interest that was less than a 25% limited interest in the applicable upper-tier passthrough for the entire taxable year or the total amount of the applicable gain on the disposition does not exceed $250,000.

In conclusion, if the taxpayer owns at least a 25% interest in aggregate at any point during the entity's taxable year or holds a general or managing interest at any ownership interest level or whose applicable gain exceeds $250,000, such taxpayer is unable to use the optional simplified reporting method under the safe-harbor method provided under Prop. Reg. § 1.1411-7(e). Accordingly, the taxpayer must apply the calculations provided by Prop. Reg. § 1.1411-7(b) and the optional simplified reporting method qualification test provided under Prop. Reg. § 1.1411-7(c).

To illustrate our simplified safe-harbor method, we offer the following examples:

Example 1:

Partner A holds a 20% limited interest in XYZ, a passthrough entity that owns a 50% interest in LTP, a subsidiary passthrough entity that is a real estate development company. Partner A is a real estate developer and elected to group his real estate activities under Treas. Reg. § 1.469-9. XYZ sells its interest in LTP, the gain from the sale of that interest allocable to Partner A was $300,000 and XYZ may qualify under Prop. Reg. § 1.1411-7(a)(2). However, Partner A lacks access to the books of LTP that would allow Partner A to compute the section 1411(c)(4) inclusion under the general rule of Prop. Reg. § 1.1411-7(b). Additionally, Partner A receives insufficient information from XYZ to allow Partner A to determine whether he qualifies to apply the optional simplified reporting method under Prop. Reg. § 1.1411-7(c) or to undertake the computation of Prop. Reg. § 1.14117-(b).

Our proposed simplified safe-harbor method within Prop. Reg. § 1.1411-7(e) would allow Partner A to apply the optional simplified reporting method under Prop. Reg. § 1.1411-7(c) since his ownership percentage in XYZ is a limited partner/member interest and is less than 25% even though his allocated gain exceeds $250,000.

Example 2:

The same facts from Example 1 apply, but Partner A's 20% interest is a general partner/member interest.

Under these circumstances, Partner A would not qualify for our safe-harbor method within Prop. Reg. § 1.1411-7(e), since he owns general partner/limited interest and his allocated gain exceeds $250,000. Partner A would either need to compute his section 1411(c)(4) inclusion under the general rule of Prop. Reg. § 1.1411-7(b) or determine whether he qualifies to apply the optional simplified reporting method of Prop. Reg. § 1.1411-7(c) by employing the applicable tests.

Example 3:

The same facts apply from Example 1, however Partner A acquired an additional 10% interest in XYZ during the year. After Partner A's acquisition of the additional 10% ownership, Partner A would cumulatively own a 30% limited partner/member interest in XYZ.

Under these circumstances, Partner A would not qualify under our proposed safe-harbor method within Prop. Reg. § 1.1411-7(e), since he owns at least 25% of limited partner/member interests any point during the tax year and his allocated gain exceeds $250,000. Partner A would either need to compute his section 1411(c)(4) inclusion under the general rule of Prop. Reg. § 1.1411-7(b) or determine whether he qualifies to apply the optional simplified reporting method of Prop. Reg. § 1.1411-7(c) by employing the applicable tests.

Example 4:

The same facts apply from Example 1, but Partner A also owns a 50% interest in XYZ-B, a passthrough entity that owns a 30% interest in XYZ. By aggregation of Partner A's ownership interests, Partner A owns a total interest of 35% in XYZ (20% interest held personally plus the 15% interest (50% interest in XYZ-B of the 30% interest in XYZ) held through XYZ-B).

Under these circumstances, Partner A would not qualify under our proposed safe-harbor method within Prop. Reg. § 1.1411-7(e), since his aggregate ownership is at least 25%. Partner A would either need to compute his section 1411(c)(4) inclusion under the general rule of Prop. Reg. § 1.1411-7(b) or determine whether he qualifies to apply the optional simplified reporting method of Prop. Reg. § 1.1411-7(c) by employing the applicable tests.

Example 5:

The same facts apply from Example 1, but Partner A owns a 30% general partner/member interest and Partner A's allocated gain from the sale of XYZ's interest in LTP was $200,000.

The proposed safe-harbor method within Prop. Reg. § 1.1411-7(e) would allow Partner A to apply the optional simplified reporting method of Prop. Reg. § 1.1411-7(c) since the total amount of the allocated gain on the disposition does not exceed $250,000.

We believe the taxpayers that satisfy this criteria pose little to no risk to the underlying calculations under Prop. Reg. § 1.1411-7(b) and the optional simplified reporting method qualification test proposed by Prop. Reg. § 1.1411-7(c). Therefore, the final regulations should exclude taxpayers that satisfy the safe-harbor method illustrated above from the complex calculations under Prop. Reg. § 1.1411-7(b).

6. Dispositions of Stock in an S Corporation Held by a QSST

When an election is made to treat a qualifying trust as a QSST, the current income beneficiary of the trust is treated as the deemed owner of the S corporation stock held by the trust.[4] Accordingly, the current income beneficiary includes, in computing his or her taxable income, the S corporation items allocated to the shares of S corporation stock held by the QSST. However, Treas. Reg. § 1.1361-1(j)(8) provides that the trust, and not the current income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST. While the trust is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by a QSST, for purposes of applying sections 465 and 469 to the beneficiary of the trust, the disposition of the S corporation by the trust shall be treated as a disposition by such beneficiary.[5]

We recommend that the final regulations recognize section 1361(d)(1)(C) and Treas. Reg. § 1.1361-1(j)(8) with respect to the section 469 treatment available for the beneficiary. The last sentence of Treas. Reg. § 1.1361-1(j)(8) provides:

[4] See section 1361(d)(1)(B).
[5] See section 1361(d)(1)(C) and Treas. Reg. § 1.1361-1(j)(8).

> "However, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST shall be treated as a disposition by the income beneficiary."

The disposition of the stock at a gain, therefore, provides passive income to allow the beneficiary to deduct previously suspended passive losses and deductions. Further, the entire disposition of the S corporation stock allows the beneficiary to deduct the suspended loss if the activity nets to an overall loss, due to section 469(g). The beneficiary, therefore, receives the benefit of the trust's treatment of the disposition.

Similarly, the trust should receive the benefit of the history of the beneficiary's participation status for purposes of determining the character of the trust's gain for section 469 purposes. For example, if the beneficiary materially participated in at least five of the previous ten years in the activity of the S corporation (meeting the test of Treas. Reg. § 1.469-5T(a)(5)), the trust should be deemed to have materially participated in the activities of the S corporation for purposes of determining the amount of gain or loss resulting from the sale of S corporation stock included in the trust's NIIT under section 1411(c)(4).

In conclusion, the final regulations should provide that when a QSST disposes of S corporation stock, the disposition is treated as a disposition of the stock by the current income beneficiary of the QSST for purposes of determining the amount of gain or loss resulting from the sale of S corporation stock included in the NII of the trust under section 1411(c)(4). Thus, if the current income beneficiary materially participates in the activities of the S corporation, the exception under section 1411(c)(4) should apply to the trust.

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We welcome the opportunity to discuss these comments. If you have any questions regarding this submission, please contact me at (304) 522-2553 or jporter@portercpa.com; Jonathan Horn, Chair of the AICPA Individual and Self-Employed Tax Technical Resource Panel, at (212) 744-1447 or jmhcpa@verizon.net; or Jason Cha, AICPA Technical Manager, at (202) 434-9231, or jcha@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, Department of the Treasury
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
Ms. Adrienne Mikolashek, IRS Office of the Chief Counsel for Passthroughs and Special Industries, Internal Revenue Service