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June 17, 2013

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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 (12/5/2012)

Dear Messrs. Werfel, 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. 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 submits the following recommendations with respect to the final section 1411 regulations:

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1. The final regulations should provide additional and clear guidance on when income is derived “in the ordinary course of a trade or business” for purposes of section 1411.
2. The final regulations should clarify when a rental real estate activity is considered to have risen to the level of a section 162 trade or business for purposes of section 1411.
3. The final regulations should clarify that regrouping activities under section 469 only affects whether a specific activity is treated as passive or non-passive under section 469, and should additionally include clear guidance on whether the rules of Treas. Reg. § 1.469-4, or other rules, apply to the regrouping of activities under section 469. Furthermore, the final regulations should provide a method for S Corporations and Partnerships which have elected to group activities the same one-time opportunity to regroup under section 469.
4. The final regulations should provide additional rules that allow mark-to-market losses of traders to reduce NII.
5. The final regulations should clearly provide that distributions to retired partners which qualify under section 1402(a)(10) as not subject to self-employment tax are excluded from gross income subject to the section 1411 tax.
6. The final regulations should provide that dividends received from Alaska Permanent Funds are excluded from gross income subject to the section 1411 tax.
7. The final regulations should provide additional guidance on whether or not the gain or loss from the repayment of reduced basis debt held by an S corporation shareholder is excluded from gross income subject to the section 1411 tax. For any portion of this income subject to the section 1411 tax, the final regulations should allow the use of either our proposed simplified method or safe harbor method of calculation.
8. The final regulations should provide for a simplified method and a safe harbor, such as those proposed below to comply with the requirements of section 1411(c)(4) regarding the gain recognized on a distribution in excess of basis for either an S corporation shareholder or a partner in a partnership.
9. The final regulations should clearly provide that income received by Indian tribal members is excluded from gross income subject to the section 1411 tax.

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10. The final regulations should provide that income from a covenant not to compete is excluded from gross income subject to the section 1411 tax.
11. The final regulations should provide additional guidance on the treatment of state and local tax refunds in the current or a subsequent year.
12. The final regulations should provide that losses, including section 165 losses, and deductions recognized in connection with taxable business and investment activities, the income of which is subject to the section 1411 tax, should be considered “properly allocable deductions” for the section 1411 tax.
13. The final regulations should provide clear guidance that suspended passive losses will be considered properly allocable deductions under section 1411(c)(1)(B) in the year allowed under Chapter 1.
14. The final regulations should replace the proposed “property by property deemed sale” method with a methodology more consistent with the statutory language of section 1411. In addition, a simplified method calculation and an alternate safe harbor method that would significantly reduce the compliance burdens for taxpayers when applying the requirements of section 1411(c)(4) to the disposition of an interest in a partnership or S corporation should be included.
15. The final regulations should include an amendment to the adjustment rules under Prop. Reg. § 1.1411-7 to adjust the gain or loss from a deemed sale of all assets of a partnership or S corporation to include the liquidation gain/loss caused by inside/outside basis differentials.
16. The final regulations should utilize either the simplified method or the safe harbor method mentioned above when the trustee (transferor) computes the gain or loss from the sale or disposition of an S corporation owned by a qualifying subchapter S trust (QSST) and taken into account for purposes of section 1411.

Background

Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 added section 1411 to the Internal Revenue Code (IRC or “Code”) effective for taxable years beginning after December 31, 2012. Section 1411 imposes a 3.8% tax on certain individuals, estates, and trusts.

In the case of an individual, section 1411(a)(1) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8% of the lesser of (A) the

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individual's net investment income for such taxable year, or (B) the excess (if any) of (i) the individual's modified adjusted gross income (MAGI) for such taxable year, over (ii) the threshold amount. Section 1411(b) provides that the threshold amount is: (1) in the case of a taxpayer filing a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), \$250,000; (2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, \$125,000; and (3) in any other case, \$200,000.

As defined in section 1411(c)(1), the NII is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business ("Bucket 1"), (ii) other gross income derived from a passive activity and a trade or business of trading in financial instruments or commodities ("Bucket 2") and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business in which the taxpayer materially participates ("Bucket 3"), minus the deductions allowed by this subtitle which are properly allocable to such gross income or net gain.

Section 1411(d) defines MAGI as adjusted gross income increased by the excess of (1) the amount excluded from gross income under section 911(a)(1), over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amount excluded from gross income under section 911(a)(1).

On December 5, 2012, proposed regulations were published that address various aspects of section 1411. The following comments are provided with respect to the provisions of the regulations.

General Comments

The AICPA recognizes the effort that was devoted by Internal Revenue Service (IRS) and Department of Treasury (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.

Specific Comments

The AICPA recommends that the regulations be revised to address the following issues:

1. The Meaning of "ordinary course of a trade of business" Under Section 1411(c)(1)(A)(i)

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The AICPA requests that final regulations further clarify the meaning of “ordinary course of a trade or business” for purposes of section 1411(c)(1)(A)(i).

According to section 1411(c)(1), NII is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, *other than such income which is derived in the ordinary course of a trade or business* [emphasis added], (ii) other gross income derived from a passive activity and a trade or business of trading in financial instruments or commodities and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business in which the taxpayer materially participates, minus the deductions allowed by this subtitle which are properly allocable to such gross income or net gain.

As noted above, the section 1411 tax is not imposed on income which is derived in the ordinary course of a trade or business in which the taxpayer materially participates unless such income is from passive activities. Accordingly, determining whether income is derived from the ordinary course of a trade or business is critical to comply with the provision of section 1411. Yet, current law provides no clear guidance on whether an activity is considered conducted in the “ordinary course of a trade or business.”

The AICPA requests that taxpayers be permitted to apply the rules that are currently available under Chapter 1 of the IRC to determine whether the types of income specified under section 1411(c)(1)(A)(i) are derived in the ordinary course of a trade or business. The AICPA offers the guidance available under section 32 as an example. Section 32(i) denies the earned income credit to individuals who have “excessive investment income.” An individual may not claim the earned income credit if the aggregate amount of the taxpayer’s disqualified income for the year exceeds \$2,200. Under section 32(i)(2)(C), “disqualified income” includes any excess of gross income from rents or royalties not derived in the ordinary course of a trade or business, over the sum of the deductions (other than interest) that are clearly and directly allocable to the gross income, plus interest deductions properly allocable to the gross income.

In an effort to provide some guidance with respect to section 32, the IRS issued Field Service Advice 200120036 dated March 28, 2001. According to the advice, whether a taxpayer is engaged in a trade or business is highly factual.¹ To be engaged in a trade or business, the IRS notes that the taxpayer must be involved in the activity with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not

¹ *Higgins v. Commissioner*, 312, U.S. 212 (1914).

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qualify.² Where it is clear from the facts that real estate is devoted to rental purposes, the courts have repeatedly held that “such use constitutes use of property in a trade or business, regardless of whether or not it is the only property so used.”

The AICPA believes a taxpayer derives income from a trade or business, if the taxpayer has a profit motive for the activity and the taxpayer is engaged in the activity on a regular and continuous basis. Consequently, we request that the final regulations provide additional and clear guidance on what constitutes the “ordinary course of a trade or business” for purposes of sections 1411 and 469.

2. Application of the Special Rental Real Estate Activity Rule under Section 469 for Purposes of Section 1411

The AICPA further requests clear guidance on when a rental real estate activity is considered conducted in the course of a trade or business under Temp. Reg. §1.469-1T(e)(3)(vi) for purposes of section 1411.

According to section 469, the term “passive activity” generally includes any rental activity. There is an exception for taxpayers in real property businesses (i.e., the real estate professional exception). Under these special rules, the “per-se” passive activity classification of rental real estate does not apply, under section 469(c)(7)(A), to taxpayers in real property business for a taxable year if:

- (i) “more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
- (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.”

The AICPA notes that Example 1 of Prop. Reg. § 1.1411-5(b)(2) implies that a rental activity of a single commercial building cannot involve the conduct of a trade or business under section 162. This position is not supported by case law which holds that the rental of a single property may constitute a trade or business under various provisions of the Code.³ We specifically note that the Board of Tax Appeals and the Tax Court have

² *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

³ See PLR 9804026, citing *Hazard v. Comr*, 7 T.C. 372 (1946), acq., 1946-2 C.B. 3 (section 117 of the 1939 Code); *Post v. Comr*, 26 T.C. 1055 (1956), acq., 1958-2 C.B. 7 (same); *Gilford v. Comr*, 201 F.2d 735 (2d Cir. 1953) (same); *Szwarcz v. Comr*, 24 T.C. 733 (1955), acq., 1956-1 C.B. 5 (section 122 of the

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generally held that the rental of a single real property is sufficient to classify the property as used in a trade or business.⁴ The IRS has agreed in a 2001 Field Service Advice⁵ that, where the facts indicate that a property is devoted to rental purposes, its use will constitute use in a trade or business even if it is the only property so used. Furthermore, several circuit courts merely required taxpayers to be engaged in continuous and recurring activities to be engaged in a trade or business.⁶

The AICPA recommends that the final regulations clarify when a rental real estate activity is considered *not* to have risen to the level of a section 162 trade or business for purposes of section 1411. Since a rental activity is a trade or business, the assumption should be that a rental activity properly grouped with a pass-through non-rental trade or business in which the owner materially participates is not subject to section 1411. We also request that the final regulations include additional examples that illustrate when a rental activity is or is not considered a trade or business.

3. Regrouping Activities under Sections 469 and 1411

The AICPA recommends additional guidance on how the regrouping will be accomplished between activities where a taxpayer materially participates and those where a taxpayer does not materially participate for purposes of section 1411.

The proposed regulations allow taxpayers an opportunity to review their existing activity groupings and make a one-time regrouping to reflect the impact of the new section 1411 and implementing regulations.

The AICPA requests that the IRS clarify that regrouping activities will affect solely whether or not a specific activity is treated as passive or non-passive for purposes of the section 469 loss limitations. Furthermore, the proposed regulations, consistent with several public statements from employees of the Treasury, should indicate that grouping activities will not change the character of income from each individual activity (and subject it to the section 1411 tax) under section 1411 (a)(1)(A)(i).

1939 Code); *Pinchot v. Comr.*, 113 F.2d 718 (2d Cir. 1940) section 302 of 1926 Act); *Flint v. Stone Tracy Co.* 220 U.S. 107, 171 (1911) (Corporation Tax).

⁴ *Fackler v. Comr.*, 45 B.T.A. 708, 714 (1941), *Fegan v. Comr.*, 71 T.C. 791, 814 (1979); *Elek v. Comr.*, 30 T.C. 731 (1968); *O'Madigan v. Comr.*, 19 T.C.M. 1178 (1960); *Lagreide v. Comr.*, 23 T.C. 508 (1954), and *Hazard v. Comr.*, 7 T.C. 372 (1946).

⁵ See FSA 200120036, citing, *Curphey v. Comr.*, 73 T.C. 766 (1980); *Fegan v. Comr.*, 71 T.C. 791, 814 (1979); *Elek v. Comr.*, 30 T.C. 731 (1968); *O'Madigan v. Comr.*, 19 T.C.M. 1178 (1960); *Lagreide v. Comr.*, 23 T.C. 508 (1954); *Leland Hazard v. Comr.*, 7 T.C. 372 (1946).

⁶ See *Gilford v. Comr.*, 201 F.2d 735 (2d Cir. 1953); *Fackler v. Comr.*, 133 F.2d 509 (6th Cir. 1943); and *Bauer v. U.S.*, 168 F. Supp. 539 (Ct. Cl. 1958).

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In addition, the AICPA requests further guidance on allocating any suspended deductions, credits, or losses between endeavors that are being removed from, or retained in, an existing activity grouping. In particular, guidance on whether Treas. Reg. § 1.469-4(g) must be followed or whether any reasonable method of allocation is allowed would be appreciated.

The AICPA recommends that the final regulations include clear guidance on the applicability of Treas. Reg. § 1.469-4(g), or other appropriate rules, regarding the proper allocation of deductions and credits derived from the activities being regrouped for purposes of section 1411.

Lastly, the proposed regulations are silent on the possibility that certain passthrough entities (S corporations and partnerships) might want to elect to regroup activities due to the imposition of section 1411 on their owners/partners. We believe that fairness and equity dictate that these passthrough entities also be allowed a one-time opportunity to regroup their activities, after they have considered the effect of their current and proposed groupings on the tax liability under section 1411 of their individual owners/partners.

The AICPA recommends that S corporations and partnerships that have elected to group activities under section 469 be allowed to make a one-time election to regroup these activities during their tax year which begins in either 2013 or 2014.

4. Treatment of Mark-to-Market Losses of Traders

The AICPA requests additional guidance that allows the mark-to-market losses of Traders to reduce NII.

The proposed regulations do not allow a taxpayer that is engaged in the trade or business of trading in financial instruments or commodities (a “Trader”) to reduce NII by the mark-to-market losses derived in its trading activities.

The proposed regulations provide that any gross income described in Prop. Reg. § 1.1411-4(a)(1)(i) (e.g., interest, dividends, annuities, royalties, rents, substitute interest, and substitute dividends) is taken into account under that provision unless such income is derived in the ordinary course of a trade or business not described in Prop. Reg. § 1.1411-5 and section 1411(c)(2) (e.g., a passive activity with respect to such taxpayer or a trade or business of trading financing instruments or commodities). Therefore, any such portfolio-type gross income derived by a Trader in its trading business is NII under Prop. Reg. § 1.1411-4(a)(1)(i) and section 1411(c)(1)(A)(i) (Bucket 1).

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Prop. Reg. § 1.1411-4(c)(2) further provides that all other gross income derived by a Trader in its trading business is taken into account under Prop. Reg. § 1.1411-4(a)(1)(ii) and section 1411(c)(1)(A)(ii) (Bucket 2). This proposed regulation specifically provides that any gain from marking to market under section 475(f) or section 1256, and any realized gain from the disposition of property held in the trade or business is classified as other gross income subject to Prop. Reg. § 1.1411-4(a)(1)(ii) (Bucket 2), and is not classified as net gain under Prop. Reg. § 1.1411-4(a)(1)(iii) and section 1411(c)(1)(A)(iii) (Bucket 3) [emphasis added].

In addition, Prop. Reg. § 1.1411-4(f)(4) provides that section 165 losses can only offset net gain in Prop. Reg. § 1.1411-4(a)(1)(iii) (Bucket 3), and may not be treated as “allocable deductions” for purposes of Prop. Reg. § 1.411-4(a)(2) and section 1411(c)(1)(B). Prop. Reg. § 1.1411-4(d)(3) provides that a net gain under Prop. Reg. § 1.1411-4(c)(1)(A)(iii) cannot be less than zero. Prop. Reg. § 1.1411-4(d)(3) further provides that net gain attributable to the disposition of property is reduced, but not below zero, by losses deductible under section 165.

The interaction of these proposed regulations results in the elimination of most, if not all, of a Trader’s section 475(f) or section 1256 losses, and any losses from the disposition of property held in the trade or business of trading – leaving the Trader effectively taxed on gross income for purposes of the section 1411 tax because the Trader will have little to no gains included in Prop. Reg. § 1.1411-4(c)(1)(A)(iii) against which to offset the losses. Net gain cannot be negative; thus the Trader gets no reduction in NII for such losses.

We believe that sections 1411(c)(1)(A)(ii) and (iii) were not written with an intent to tax Traders on their gross trading gains.

The AICPA recommends that the final regulations be modified to allow mark-to-market losses under sections 475(f) and 1256, and losses from the disposition of property used in the trading business be treated as allocable deductions for purposes of section 1411(c)(1)(B). Alternatively, we recommend that the final regulations classify mark-to-market gains and gains from the disposition of property as Bucket 3 items, which would allow a Trader to determine net gains for purposes of section 1411.

5. Retirement Distributions to Retired Partners

The AICPA recommends that the final regulations provide that retirement payments to retired partners are not included in “net investment income” under section 1411.

Payments described under section 1402(a)(10) that are made to retired partners in many

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cases do not appear to be excluded from NII by either the section 1411(c)(5) exemption for distributions from a qualified plan, or the section 1411(c)(6) exclusion for income included in self-employment income under section 1401(b).

In order to qualify as a payment under section 1402(a)(10), the retired partner may render “no service with respect to any trade or business carried on by the partnership (or its successors)”⁷ during the year such payment is received. As such, for many partners the income may be classified as income from a passive activity within the meaning of section 469 and thus presumably included in NII. The AICPA notes that this treatment can vary among retired partners, and is inconsistent with distributions made from a qualified plan to a retired employee.

Some retired partners may be able to exclude such income from the calculation of NII for the first six years of retirement in circumstances where the “nickel and dime” material participation test of Temp. Reg. § 1.469-5T(a)(5) is satisfied; however, in the seventh and subsequent years of retirement this option would not be available. For other retired partners, if the activity from which the retired partner receives payment is a personal service activity within the meaning of Temp. Reg. § 1.469-5T(d), and the retired partner materially participated for any three taxable years preceding the taxable year, then the partner is considered to materially participate under Temp. Reg. § 1.469-5T(a)(6), rendering such income as excluded from NII subject to section 1411.

The AICPA does not believe that the potentially inconsistent treatment among retired partners and employees was the intent of Congress in drafting the statute. Under Treas. Reg. § 1.1402(a)-17(b)(1), payments which qualify under section 1402(a)(10) “constitute bona fide retirement income.” As such, we believe the final regulations should specifically state that payments to retired partners under section 1402(a)(10) are treated the same for purposes of section 1411 as distributions from qualified plans, as described in section 1411(c)(5) and Prop. Reg. § 1.1411-8, or such payment should be considered associated with a materially participating business under the “facts and circumstances” test of Temp. Reg. § 1.469-5T(a)(7) solely for purposes of section 1411.

The AICPA recommends that the final regulations exclude retirement distributions to retired partners from gross income subject to the section 1411 tax.

6. Alaska Permanent Funds Dividends

The AICPA recommends that the IRS exclude payments from the Alaska Permanent Fund from the section 1411 tax.

⁷ Treas. Reg. § 1.1402(a)-17(c)(1)(i).

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Citizens of the State of Alaska who meet certain residency requirements receive an annual payment from the State of Alaska Permanent Fund. The IRS, in Rev. Rul. 85-39, held that these payments were gross income under section 61. It also held that these payments were not gifts under section 102. In Rev. Rul. 90-56, the IRS expanded on Rev. Rul. 85-39 and held that these payments do not meet the definition of investment income under section 163(d)(4)(B). Inclusion as investment income would increase the amount of investment interest expense that could be deducted. In making this finding, the IRS concluded that the payments made by the State of Alaska did not constitute “gross income from interest, dividends, annuities, or royalties” under section 163(d)(5)(A)(i), which references section 469(e)(1)(A)(i)(1). Further, the IRS also ruled that these payments did not constitute passive income under section 469 and Temp. Reg. § 1.469-2T(c). Inclusion as passive income would increase the amount of passive losses that could be deducted.

The AICPA notes that the IRS has held that the Alaska Permanent Fund payments do not constitute any type of income that is included in the definition of NII under either section 1411(c)(1)(A)(i) (which taxes “gross income from interest, dividends, annuities, royalties”) or section 1411(c)(2)(A) (which taxes income from passive activities).

The AICPA recommends that the final regulations clearly exclude any dividends received from Alaska Permanent Funds from gross income subject to the section 1411 tax.

7. Repayment of Reduced Basis Debt Held by S Corporation Shareholder

The AICPA requests additional guidance on whether or not the capital gain on the repayment of reduced basis debt held by an S corporation shareholder is subject to the section 1411 tax.

Under section 1367(b)(2), S corporation shareholders can loan money to the corporation and the basis of this debt can be used for the deduction of losses described in section 1366. When this type of transaction occurs, the basis of the debt is reduced appropriately, according to section 1367(b)(2)(A) (“reduced basis debt”). When a written reduced basis debt is repaid prior to the basis of that debt being restored through recognition of income under section 1367(b)(2)(B), the repayment is treated as the sale or exchange under section 1271(a)(1).⁸ Because a note to a corporation in which the individual holds stock is generally a capital asset,⁹ the gain or loss from sale or exchange of such a note is generally capital gain or loss. Such capital gain or loss, if not considered

⁸ See Rev. Rul. 64-162.

⁹ *Whipple v. CIR* 373 US 193 (1963).

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attributable to the disposition of property held in a trade or business in which the taxpayer materially participates, is subject to the NII computation of net gain under section 1411(c)(1)(A)(iii) and thus potentially subject to the section 1411 tax. It is unclear whether this is the appropriate result in the case of reduced basis debt in an S corporation in which the shareholder materially participates. Application of other Code provisions may provide a different outcome.

Section 1411(c)(4)(A) provides that gain from the disposition of “an interest in a partnership or S corporation” is included in section 1411(c)(1)(A)(iii) to the extent attributable to property not used in a trade or business in which the taxpayer materially participates. This provision could apply to gain from repayment of reduced basis debt.

If a shareholder of an S corporation with an activity in which the shareholder materially participates holds a reduced basis loan, and a portion of that loan is repaid in a year when basis has not been fully restored, we believe section 1411(c)(4) should apply. We think that such reduced basis debt can and should be considered in “an interest in a S corporation” for section 1411(c)(4) purposes since the mechanics of operation peculiar to this debt under section 1367, including serving as basis for losses and the restoration of basis upon recognition of income, are available only when the debt instrument is held by an S corporation shareholder. That is to say, this type of debt, with its unique characteristics, exists only when a taxpayer holds both a stock and debt “interest in a corporation.” A note receivable from an individual, partnership, trust or government does not have these characteristics.

Section 385(a) provides that “the Secretary is authorized to prescribe such regulations as may be necessary or appropriate to determine whether *an interest in a corporation* is to be treated for purposes of *this title* as stock or indebtedness.” [emphasis added]. We note the phrase “an interest in a corporation” is identical to section 1411(c)(4). We further note that when the quoted section refers to “this title” the reference is understood to mean Title 26 of the United States Code. Thus, the characterization given an instrument is applicable for all sections of the IRC, which obviously includes section 1411. The phrase “an interest in a corporation” may apply to either debt or stock. Both types of instruments represent “an interest in a corporation.” Section 385 gives the Secretary the power, thus far unexercised in regulations, to determine whether “an interest in a corporation” is debt or stock. However, it does not give the Secretary the authority to exclude either from the definition of “an interest in a corporation” altogether.

Additionally, the IRS, in its annual no-rule revenue procedure, refers to “an interest in a corporation” as being either debt or equity.¹⁰ In Rev. Proc. 2013-3, the no-rule policy

¹⁰ Rev. Proc. 2013-3, Sec. 4.02(1).

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refers to whether a particular interest in a corporation is debt versus equity; that is to say, which of two subsets, both defined as part of the larger set encompassing all interests in a corporation, a particular interest may lie within.

Due consideration of the above authorities provides very significant support for the position that gain from the disposition of reduced basis debt should cause the interest to fall within section 1411(c)(4) if the stockholder holding the debt materially participates in an activity within the corporation. The AICPA urges the IRS to provide for this outcome in the final regulations.

If the debt from the S corporation has not been reduced to writing, often referred to as “open account” debt, the gain upon repayment of such a reduced basis debt generates ordinary income.¹¹ This type of debt shares the same unique characteristics of written notes under section 1367. The same argument made above, relative to written indebtedness, should uphold the position that “open account” debt also represents an interest in an S corporation for purposes of section 1411. The final regulations should reflect this result.

The AICPA requests that the final regulations clarify that reduced basis debt constitutes an interest in the S corporation for purposes of section 1411.

The AICPA recommends that the use of the simplified method described below regarding the disposition of an interest in a partnership or S corporation be allowed when the requirements under section 1411(c)(4) are applied to repayment of reduced basis loans. We further propose that gain from repayment of reduced basis debt of \$250,000 or less in a given year from an entity holding an activity in which the taxpayer materially participates be allowed to use our proposed safe harbor method described below.

The AICPA requests that the IRS provide additional guidance on the application of section 1411 with respect to gains recognized on repayment of reduced basis debt and consider our simplified method and safe harbor recommendations in the final regulations.

8. Distribution in Excess of Basis

The AICPA recommends that the final regulations contain a simplified and a safe harbor method to determine the portion of the gain recognized on a distribution in excess of basis that is attributable to a trade or business activity of the entity in which the distributee materially participates.

¹¹ See Rev. Rul. 68-537, 1968-2 C.B. 372, citing *Smith v. Comr*, 48 T.C. 872 (1967).

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Section 1368(b)(2) provides that a distribution in excess of basis “shall be treated as gain from the sale or exchange of property.” Section 731 provides similar rules in the case of a distribution from a partnership. It is unclear if the term “disposition” under section 1411(c)(4) would equate to “sale or exchange” as used in section 1368(b)(2) or section 731. Assuming it does so equate, a distribution in excess of basis would require an analysis of the unrealized gain within the entity to determine if the gain is attributable to property held in a trade or business which is not a passive activity or a section 475(e)(2) activity to the distributee owner. To the extent all or a portion of the gain can reasonably be allocable to the property held in a trade or business in which the taxpayer materially participates, the gain would be excluded from the computation of NII. All other gain recognized in excess of this amount is subject to the section 1411 tax. The AICPA recommends that the IRS establish an easy to apply, simplified method and/or safe harbor method for determining the percentage of gain allocable to each of the S corporation or partnership’s activities.

The AICPA notes that the treatment of distribution gain creates additional ambiguity as to when and how to value the business (e.g., at the year-end or at each of the various dates the taxpayer received distributions). Basis in an S corporation is generally determined at the end of the year, or, if earlier, the last day the stockholder held stock.¹²

Basis in a partnership is generally determined when necessary, but distributions may be subject to an advance rule that deems them made at year-end.¹³ We believe the valuation date for section 1411(c)(4) should be the same (the end of the year or, if earlier, the last day the interest is held).

The AICPA recommends that the use of the simplified method described below regarding the disposition of an interest in a partnership or S corporation be allowed when the requirements under section 1411(c)(4) are applied to distributions in excess of basis. We further propose that distributions in excess of basis of \$250,000 or less in a given year from an entity holding an activity in which the taxpayer materially participates be allowed to use our safe harbor method described below.

The AICPA requests that the IRS provide additional guidance on the application of section 1411 with respect to distributions in excess of basis and consider our simplified method and safe harbor recommendations in the final regulations.

¹² Treas. Reg. § 1.1367-1(d)(1).

¹³ Treas. Reg. § 1.1367-1(d)(1); Treas. Reg. § 1.731-1(a)(1)(ii).

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9. Income Received by Indian Tribal Members

The AICPA believes that income received by Indian tribal members should not be subject to the section 1411 tax.

According to income tax statutes, an Indian tribe is not a taxable entity. Tribal income not otherwise exempt from Federal income tax, however, is includible in the gross income of the Indian tribal member when distributed or constructively received.¹⁴ Absent a provision in a treaty or statute to the contrary, income directly derived by a member of an Indian tribe from unallotted Indian tribal lands is subject to Federal income tax.¹⁵

Native Americans may receive per capita payments, which are equal payments not based on the recipient's financial status, health, educational background or employment status. Such payments received under the Indian Gaming Regulatory Act (IGRA) are includible in gross income according to 25 USC 2710(b)(3)(D).

Similar to the rulings with respect to Alaska Permanent Fund dividends, such income is not "gross income from interest, dividends, annuities." Such receipts are also not in the nature of rents or royalties.

A "passive activity" is defined in section 469(c)(1) to include an activity involving the conduct of a trade or business in which the taxpayer does not materially participate. We are aware of no authority addressing the passive activity status of payments received by Indian tribal members from tribal funds. However, tribal members are not partners with the tribe or shareholders of a tribal enterprise. The activity of the tribe has not been imputed to the tribal members. As such, the conduct of business by a tribal enterprise should not be viewed as a "passive activity" of the tribal member. Consequently, the receipt of income received by Indian tribal members should not be viewed as passive income.

Since the payments received by an Indian tribal member from the Indian tribe are not gross income from interest, dividends, annuities, rents or royalties, and since such payments are not passive activity income, the IRS should include in the final regulations a provision that such payments are not subject to the section 1411 tax.

The AICPA requests that the final regulations clearly exclude income received by Indian tribal members from the section 1411 tax.

¹⁴ *Choteau v. Commissioner*, 283 U.S. 691 (1931).

¹⁵ Rev. Rul. 58-320, 1958-1 C.B. 24 .

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10. Payments for a Covenant not to Compete

The AICPA believes that income from a covenant not to compete should not be subject to the section 1411 tax.

According to section 1411(c)(1), the NII is the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business, (ii) other gross income derived from a passive activity and a trade or business of trading in financial instruments or commodities and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business, minus the deductions allowed by this subtitle which are properly allocable to such gross income or net gain.

Payments received under a covenant not to compete, clearly do not represent income from “interest, dividends, annuities, royalties and rents” as that phrase is used in section 1411(c)(1)(A)(i).

The IRS and courts have agreed, in the frequently cited *Barrett* case,¹⁶ that “non-competition does not constitute the carrying on of a trade or business.” This position prevents inclusion of income from covenants not to compete under sections 1411(c)(1)(A)(ii) or 1411(c)(2) (Bucket 2) taxing passive trade or business income.

This position is further confirmed by the government’s position, in regulation, that a covenant not to compete is not considered to be passive activity income.¹⁷ Thus, income from a covenant not to compete would clearly not be subject to the section 1411 tax through the passive income inclusion rules.

The AICPA requests that the final regulations exclude income from a covenant not to compete from the section 1411 tax.

11. State and Local Income Tax Refunds

The AICPA requests that the final regulations provide additional guidance on the treatment of refunds of state and local taxes in the current or a subsequent year.

¹⁶ *Barrett v. Comr.*, 58 TC 284 (1972).

¹⁷ Treas. Reg. § 1.469-2(c)(7)(iv). The validity of this regulation has been upheld in *Schaefer v. Comr.*, 105 TC 227(1995).

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The proposed regulations provide for a deduction of state and local tax expense against the gross income under section 1411(c)(1). As a result, the proposed regulations allow any reasonable method when allocating a portion of state and local tax deductions in determining net investment income. Examples in the proposed regulations allocate the deduction based on the ratio of investment income to total gross income. We believe such a method is an appropriate method.

However, the treatment of state and local tax refunds is not addressed in the proposed regulations. A taxpayer may receive a refund in a subsequent year for which a deduction against NII was taken in a previous year. For regular tax purposes, individuals generally include in income the portion of the state income tax refund received in the current year for which a tax benefit was derived in a prior year.

The AICPA recommends that the final regulations include clear guidance on how to determine the portion of the refund that should be included in net investment income (if any, noting that a tax refund is not one of the enumerated items of gross income in section 1411(c)(1)(A)). Consequently, we suggest that, for individual taxpayers, the state or local income tax refunds be apportioned between NII and non-NII using the same reasonable method that was used to determine the allocable deductions in the prior year.

12. Treatment of Losses and Properly Allocable Deductions Under Section 1411

The AICPA believes that losses recognized in connection with taxable business and investment activities, the income of which is subject to section 1411, should be included in deductions properly allocable to such gross income or net gain described under section 1411(c)(1)(B). Section 165 provides that a taxpayer is allowed *as a deduction* [emphasis added] any loss sustained during the taxable year and not compensated by insurance or otherwise.

As noted above, the statutory formula of NII in section 1411(c) utilizes three “buckets” of gross income and gain, the sum of which is then reduced by “properly allocable” deductions. Prop. Reg. § 1.1411-4(d) specifies the types of gains and losses that the Treasury believes are appropriately included in the net gains bucket of the NII formula (Bucket 3). Importantly, the proposed regulations stipulate that the Bucket 3 net gain amount cannot be less than zero for purposes of the NII tax. In addition, Prop. Reg. § 1.1411-4(f)(4) provides that “deductions allowed under this paragraph (f) do not include losses described in section 165, whether described in section 62 or section 63(d). Under the proposed regulations, losses deductible under section 165 are deductible only in determining net gain under paragraph (d) of this section, and only to the extent of gains.” We do not agree with this interpretation of section 1411(c)(1).

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The AICPA notes that section 1411 is constructed in a manner similar to section 163(d). Section 163(d) limits a non-corporate taxpayer's deduction for investment interest expense to net investment income. NII is defined under section 163(d)(4) as the excess of investment income over investment expenses. According to section 163(d)(4)(B), the term "investment income" means the sum of –

- (i) gross income from property held for investment (other than any gain taken into account under clause (ii)(I),
- (ii) the excess (if any) of –
 - (I) the net gain attributable to the disposition of property held for investment, over
 - (II) the net capital gain determined by only taking into account gains and losses from dispositions of property held for investment, plus
- (iii) so much of the net capital gain referred to in clause (ii)(II) (or, if lesser, the net gain referred in clause (ii)(I)) as the taxpayer elects to take into account under this clause.

Section 163(d)(4)(C) defines "investment expenses" as the deductions allowed under chapter 1 (other than interest) which are directly connected with the production of investment income.

Congress modified the statutory language in section 163(d) when it enacted the passive activity loss limitations in 1986. Prior to 1986, investment expenses were defined as the deductions allowable under sections 162, 164(a)(1) or (2), 166, 167, 171, 212, or 611 which are directly connected with the production of investment income. We specifically note that losses deductible under section 165 were not treated as investment expenses under pre-1986 section 163(d). The Tax Reform Act of 1986 amended the definition of investment expenses under section 163(d)(4)(C) to read as it does today. No explanation for this change is provided in the legislative history. We believe that under current law, losses deductible under 165 in excess of gains included in computing net gain under section 163(d)(4)(B)(ii) are included in investment expenses under section 163(d)(4)(C) to the extent they are directly connected with the production of net investment income.

As mentioned above, section 1411 is constructed in a manner similar to section 163(d). Section 1411(c) permits a taxpayer to include the deductions allowed under subtitle A of the IRC which are properly allocable to gross income or net gain described in subparagraphs (i), (ii), or (iii) of section 1411(c)(1)(A) in computing net investment income subject to the tax under section 1411.

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Sections 165 and 1411 are in Chapter 1 and Chapter 2A of Subtitle A of Title 26 of the United States Code, respectively. As mentioned above, section 165(a) also specifically provides that a taxpayer is allowed a deduction for losses and section 1411(c)(1)(B) permits a taxpayer to reduce NII by “the deductions *allowed by this subtitle* which are properly allocable to such gross income or net gain” [emphasis added]. Therefore, any loss allowed as “a deduction” under section 165 is a deduction allowed by Subtitle A.

As a result, we believe the losses and deductions under both sections 165 and 1411 fall under Subtitle A of the United States Code. In addition, the AICPA believes that section 165 losses fall within the category of deductions meeting the initial test for consideration under section 1411(c)(1)(B), and therefore, should be allowed as deductions properly allocable to such gross income or net gain under section 1411.

Under the proposed section 1411 regulations, a net tax loss from an NII-producing asset may reduce a taxpayer’s adjusted gross income, but have no impact on the amount of the taxpayer’s NII tax. As noted in the preamble to the proposed regulations, one of the general purposes of section 1411 is to impose a tax on unearned income or investments of certain individuals, estates, and trusts. The general purpose of section 1411 is thwarted if a taxpayer is denied the ability to utilize a tax loss related to the type of assets that produce NII. Furthermore, because section 1411 does not appear to allow losses to be carried forward or back, this result would be permanent. Our concern is illustrated in the following example:

Example: An individual taxpayer has \$400,000 of adjusted gross income for a taxable year beginning after 2012 which includes a deductible section 1231 loss of \$100,000 from the sale of an NII-producing investment asset. This taxpayer has suffered an economic and taxable loss on the investment asset. Assume this taxpayer has \$75,000 of gross income described in sections 1411(c)(1)(A)(i) or (ii). Under the proposed regulations, the taxpayer would pay the NII tax on the \$75,000 in spite of the fact that the taxpayer suffered an overall loss of \$25,000 from NII-producing assets during the year.

The result in the above example is contradictory to the intent of the statute, as the IRS stated in the preamble to the proposed regulations. A more appropriate result would be to allow net losses related to NII-producing assets to be treated as properly allocable deductions in the year that such losses are recognized under Chapter 1 for regular income tax purposes. This treatment would be consistent with the language of section 165(a), which provides as a general rule that “[t]here shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.” If deductions or net losses related to NII-producing assets are allowed for regular tax purposes under section 165, it is appropriate to treat such losses and deductions as

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“properly allocable” to gross income realized from other NII-producing assets, especially when considering that any gross income recognized in connection with the NII-producing asset prior to sale would be included in the NII calculation.

Therefore, the AICPA recommends that the final regulations treat net losses recognized for income tax purposes in connection with NII-producing assets as properly allocable deductions.

13. Treatment of Suspended Passive Losses

The AICPA strongly believes that suspended passive losses triggered under section 469(g)(1) should be considered properly allocable deductions under section 1411(c)(1)(B) to the gross income and net gain described in section 1411(c)(1)(A)(i) through (iii).

The Treasury and IRS have requested comments on whether the losses triggered under section 469(g)(1) upon disposition of a passive activity should be taken into account in determining the taxpayer’s net gain on the disposition of the activity under section 1411(c)(1)(A)(iii) or whether the losses should be properly allocable deductions against gross income described in section 1411(c)(1)(A)(i).

According to section 469, losses from passive activities are generally not allowed to reduce income from non-passive activities for individuals, estate, and trust. However, section 469(b) specifically states that “Except as otherwise provided in this section, any loss or credit from an activity which is disallowed under subsection (a) shall be treated as a *deduction* or credit allocable to such activity in the next taxable year.” [emphasis added]. Since such carryover loss is not an item of “gross income,” it cannot be included in section 1411(c)(1)(A), but must instead be an allocable deduction under section 1411(c)(1)(B) against the sum of the items of section 1411(c)(1)(A).

The suspended losses from passive activities should retain the same character as a passive activity deduction from the year of generation for purposes of section 1411. The timing of suspended losses should not change the original character of activities. Thus such losses should be fully allowed to reduce NII from all sources in the year of disposition.

Furthermore, suspended losses are allowed under section 469 when a taxpayer disposes of his or her interest in any passive activity (or former activity).¹⁸ Consequently, such passive losses are allowed for purposes of calculating MAGI in the year of disposition.

¹⁸ Section 469(g)(1)(A)

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The AICPA recommends that the final regulations confirm suspended passive losses as a properly allocable deduction under section 1411(c)(1)(B) to offset NII described in section 1411(c)(1)(A), when allowed for Chapter 1.

14. Comments on Disposition of an Interest in a Partnership or S Corporation

The AICPA believes that the proposed regulations should be changed to eliminate the requirement that a partnership or S corporation calculate the gain on the deemed sale of all its properties on a property by property basis in order to determine the amount of the gain on the disposition of certain active interests in such partnership or S corporation. Furthermore, the AICPA believes that a simplified method and a "safe harbor" provision for complying with the requirements of section 1411(c)(4) be considered. The AICPA believes the proposed modifications for complying with the requirements of section 1411(c)(4) would benefit both taxpayers and the IRS. The modifications would reduce the cost of administering the provision by allowing the partnership or S corporation to determine only the gain on the deemed sale of its investment assets or the trade or business assets in which the shareholder does not materially participate. The gain on the deemed sale of the net investment income assets would then be allocated to the S corporation shareholder or partner in the partnership. The required statement of adjustment would not need to be as detailed as proposed and would include only the S shareholder/partner information needed for the owner to properly calculate the tax liability.

Section 1411(c)(4) provides that "(A) gain from such disposition shall be taken into account under clause (iii) of paragraph (1)(A) only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest, and (B) a rule similar to the rule of subparagraph (A) shall apply to a loss from such disposition". The statutory language requires only that the section 1411 non-trade or business assets from the deemed sale be considered in net investment income.

The proposed regulations provide that gain (or loss) from the disposition of an interest in a partnership or S corporation is generally net investment income resulting from the disposition of non-trade or business property under section 1411(c)(1)(iii) and subject to the section 1411 tax. However, if a partner or S corporation shareholder materially participates in an activity of a partnership or S corporation, some or all of the gain may not be subject to tax under the special exception in section 1411(c)(4). Under that exception, gain on disposition of a partnership interest or S corporation stock is taken into account under section 1411(c)(1)(A)(iii) only to the extent of the gain (or loss) that would be taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value (FMV) immediately before the disposition of such

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interest. Such analysis is necessary when the taxpayer materially participates in one or more of the entity's trades or businesses. For business income in an activity in which the selling partner or shareholder materially participates, the statutory language achieves parity between a sale of an interest in the S corporation or partnership and an asset sale. Rather than applying the property-by-property analysis to determine how much of the income should be treated as business income not subject to tax, the final regulations should provide that the analysis would only be required to include those section 1411 assets subject to the net investment income tax.

Prop. Reg. § 1.1411-7(c)(3) provides that a reporting burden is on the entity when it states that "the partnership or S corporation determines the amount of gain or loss attributable to each property by comparing the FMV of each property with the adjusted basis of each property." The proposed regulations provide no *de minimis* exception to either recognize an individual taxpayer's relatively insignificant total gain on the disposition, or the taxpayer's relatively insignificant ownership position in the entity. An array of penalties may be imposed on the entity under sections 6698, 6699, 6037, 6031, 6722 and 7203 for failure to provide necessary information for the individual owner to properly compute tax liability.

For example, a distribution may be received by an S corporation shareholder in excess of her basis in the stock. A pro rata distribution may only create taxable income for this one shareholder. She may own a very small percentage of stock and the distribution itself may be only slightly in excess of her basis. However, the proposed regulations, if implemented unchanged, would require the S corporation to complete an exceedingly detailed "property-by-property" analysis, including an analysis of the goodwill of the S corporation, to determine the portion of the gain excluded from the NII tax as gain from the disposition of an interest in a trade or business in which the taxpayer materially participates. It is also worth noting that S corporations are not required, and typically do not, maintain shareholder basis information. Accordingly, an S corporation would not know when it has made a distribution to a shareholder in excess of that shareholder's basis in his or her stock, thereby requiring the corporation to determine the portion of the gain recognized by the shareholder excluded from the NII tax.

Prop. Reg. § 1.1411-7 provides an exceedingly complex set of rules for complying with section 1411(c)(4). The AICPA believes the property-by-property, deemed sale analysis under the Prop. Reg. § 1.1411-7 imposes a significant burden on taxpayers including the entity, the individual taxpayer, and the IRS (in auditing and administering the computations).

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AICPA's Simplified Method Recommendation

As noted above, the AICPA recommends that the final regulations also provide a simplified method to further significantly reduce the compliance burdens for taxpayers and tax practitioners. The sole purpose of Prop. Reg. § 1.1411-7 is to determine the amount of net gain which would be taken into account if all of the underlying property of the entity were sold for FMV immediately before the disposition of the ownership interest, which necessarily considers appreciated and depreciated portfolio assets and passive activities. For taxpayers using the simplified method, the amount of gain attributable to assets used in a trade or business by the materially participating seller of an interest in a partnership or S corporation could be calculated using the sales price of the disposed ownership interest in the S corporation or the partnership to determine a reasonable estimate of the FMV of the entity assets. Rules similar to those applicable in the context of section 338(h)(10) could be used to determine the gross selling price (i.e., gross up the sales price based on the percentage interest sold and increase that amount for liabilities). To the extent that there would be a concern with respect to estimated amounts, the taxpayer/entity could file Form 8275 to disclose that an estimate has been used. Filing of Form 8275 would avoid the portions of the accuracy related penalty due to a substantial understatement of income tax for non-tax shelter items, provided that the return position had a reasonable basis. This simplified method would allow the entity to more easily compute the amount of gain or loss on the section 1411 assets subject to tax by the S shareholder or the partner in the partnership.

With our recommendation above for calculating the gain, we also recommend that the entity not be required to provide the net investment income gain or the property-by-property analysis unless requested and that such request be received by the due date of the owner's tax return excluding extensions. The section 1411 gain information should be provided on a newly designed form that may be filed either with the return or as a stand-alone submission. The IRS could use language similar to the language contained in Treas. Reg. § 1.743-1(k)(2), modified to recognize that it is the transferor that would need to notify the partnership of a disposition, by sale or exchange, of the interest in the partnership. Presumably, such language would be within the proposed regulations for section 1411, and would apply to dispositions of interests in both S corporations and partnerships. Thus, there would be no requirement imposed on the entity if the entity were not notified.

The ability for the entity to use section 338(h)(10) type concepts to determine the fair market value of the entity's assets would significantly reduce the cost to calculate the amount of gain subject to section 1411.

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AICPA's Safe Harbor Recommendation

As noted above, the AICPA recommends that the final regulations also provide a safe harbor method to further significantly reduce the compliance burdens for taxpayers and tax practitioners. Such safe harbor method would be available to the individual taxpayer without requiring the detailed information from the entity for the property-by-property analysis or our proposed simplified method. As a result, we offer the detailed safe harbor method below for consideration.

The AICPA recommends providing a safe harbor method for taxpayers if one or more of the following is applicable:

- a. The partnership or S corporation is not required to file a Schedule M-3 with its tax return for the tax year immediately prior to the taxpayer's disposition;
- b. For a disposition of a partnership interest, the taxpayer owned, directly or indirectly, no more than a 25% interest in partnership capital or profits at the end of the year preceding the date of the sale or exchange;
- c. For a disposition of an interest in an S corporation, the taxpayer owned, directly or indirectly, no more than 25% of the corporation's outstanding stock at the end of the year preceding the date of the sale or exchange;
- d. For a disposition of a partnership interest, the taxpayer disposed of no more than a 10% interest, including related party transfers, in partnership capital or profits during the 12-month period ending on the date of sale or exchange;
- e. For a disposition of an interest in an S corporation, the taxpayer disposed of no more than a 10% interest, including related party transfers, in the S corporation's outstanding stock during the 12-month period ending on the date of the sale or exchange;
- f. For a disposition of a partnership or S corporation interest, if the taxpayer's gain or loss is \$250,000 or less;
- g. As noted above under our comment #7 above, if the taxpayer's gain from the repayment of reduced basis debt is \$250,000 or less;
- h. As noted above under our comment #8 above, if the taxpayer's gain from a distribution in excess of basis in the ownership interest is \$250,000 or less.

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For partnerships, the percentage interest rules and the amount transferred should be determined consistent with the existing rules under section 708. For example, if a partner owning 40% of a partnership required to file a Schedule M-3 reduces his interest in the partnership to 33% by selling some of his interest, the safe harbor calculation method would apply, based on item (d) above.

For S corporations, a shareholder owning 25% of the outstanding stock of an S corporation required to file a Schedule M-3 could sell all her stock and qualify for the safe harbor calculation method. Distributions to partners or S corporation shareholders that result in gain should also qualify for the safe harbor calculation method if the entity is not required to file a Schedule M-3 or the amount of the distribution which exceeds the taxpayer's basis does not exceed \$250,000.

In addition, the sole purpose of Prop. Reg. § 1.1411-7 is to obtain the amount of net gain which would be taken into account if all of the underlying property of the entity were sold for FMV immediately before the disposition of the ownership interest, which necessarily considers appreciated and depreciated portfolio assets and passive activities. For taxpayers provided the safe harbor, the amount of gain attributable to assets used in a trade or business by the materially participating seller of an interest in a partnership or S corporation shall be calculated using existing information the partner or shareholder will have.

Under our safe harbor method, the taxpayer would use an average of the income reported on his/her Schedule K-1s from the passthrough entity for the years, not to exceed three years including the year of disposition, during which the taxpayer owned his/her interest in the passthrough entity. The safe harbor method will result in a ratio of gain excluded from section 1411(c)(1)(A)(iii) to total gain. This ratio will utilize the amounts of all income, expense, gain or loss items, as reported on Schedule K-1, attributable to the materially participating trade or business activities of the seller in the entity, as a percentage of all income, expense, gain or loss shown for the three or less calculation years including the year of sale. This ratio will arrive at the percentage of disposition gain not subject to the section 1411 tax. This method is intended to exclude from the section 1411 tax calculation the percentage of total gain or loss equal to the ratio of active source income to total income from the entity. This alternative requires no information from the entity, relieving the entity of the valuation cost and penalty exposure for failing to provide detailed information.

For example, the rules of the AICPA recommended calculated ratio method would apply as follows:

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- a. If the total of items of income and expense, gain or loss from a material participation activity are a positive number, and the total of items of income and expense, gain or loss from all other sources is a positive number, then the amount of gain from the disposition of an interest in the entity subject to inclusion under section 1411(c)(1)(A)(iii) shall be the ratio or percentage of income from sources other than material participation activity sources to all income and expense, gain or loss as shown on the Schedule K-1.
- b. If the total of items of income and expense, gain or loss from a material participation activity are a negative number, and the total of items of income and expense, gain or loss from all other sources is a negative number, then the amount of gain from the disposition of an interest in the entity subject to inclusion under section 1411(c)(1)(A)(iii) shall be the ratio or percentage of income and expense, gain or loss from sources other than material participation activity sources to all income and expense, gain or loss as shown on the Schedule K-1.
- c. If the total of items of income and expense, gain or loss from a material participation activity are a positive number, and the total of items of income and expense, gain or loss from all other sources is a negative number, then the amount of gain from the disposition of an interest in the entity subject to inclusion under section 1411(c)(1)(A)(iii) shall be zero.
- d. If the total of items of income and expense, gain or loss from a material participation activity are a negative number, and the total of items of income and expense, gain or loss from all other sources is a positive number, then the amount of gain from the disposition of an interest in the entity subject to inclusion under section 1411(c)(1)(A)(iii) shall be 100%.

Furthermore, the calculated ratio method should have the following rules for inclusion or exclusion:

- a. The prior three tax years of the taxpayer are to be used unless the entity interest was acquired and sold in the current year in which case the current year is used.
- b. Items included in the ratio calculation are the items as shown on the Schedules K-1, as filed or most currently amended prior to sale of the entity interest.
- c. All items of taxable income and expense, and gain or loss are to be used in the ratio calculation. The fact that some items of income or expense, gain or loss might otherwise be limited in any given year will not impact the inclusion of income or expense, gain or loss in the ratio calculation.

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- d. Thus investment expenses, which might be subject to itemized deduction limitations, or long-term capital losses, which may be subject to limitation, depending on the amount of other capital gains on the taxpayer's return, are to be taken into account without limitation.
- e. Expense items which may be limited in actual application, such as section 179 expense, are to be considered in full, as shown on the Schedule K-1.
- f. Items not to be included in the ratio calculation include non-taxable income, such as interest on tax-exempt bonds, and non-deductible expenses, such as penalties.
- g. Items affecting only alternative minimum tax (adjustments, preferences or private activity bond income) are not to be included in the ratio computation.
- h. Items from prior years which could affect the taxability of Schedule K-1 items in any given year, such as suspended passive losses, losses suspended due to lack of basis, or section 179 carryover are to be disregarded.

This safe harbor calculation method allows the taxpayer to easily compute, on a timely basis, the amount of gain or loss on the sale of the partnership or S corporation interest that will be exempt from the section 1411 tax. This approach relies solely on information known to the taxpayer. This approach can be reduced to an algorithm, thereby aiding electronic tax preparation and electronic tax administration. As the section 1411 tax needs to be included in estimated payments, the look-back (to the aggregate of the prior years) provides the selling taxpayer with a means of estimating the amount of NII associated with the sale. While this alternative does not explicitly calculate the gain or loss on each asset, it provides a very easy process that will frequently differ only insignificantly from the results achieved under the much more complex proposed process.

In conjunction with this recommendation for taxpayers qualifying for the safe harbor calculation method, the entity would not be required to provide the information required under our previously described simplified calculation mechanism unless requested and such request is received by the due date of the owner's tax return excluding extensions.

Anti-Abuse Rules

We realize that there may be a small number of situations where the safe harbor method can be manipulated to avoid the tax. As a result, we further recommend the following provision to address these concerns.

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a. Anti-Stuffing Provision for the Safe Harbor Method

We recommend inclusion of a 12-month look-back rule. Under this provision, the safe harbor will not apply if the FMV of cash and property contributed by the taxpayer, either directly or indirectly through related parties, to the passthrough entity within 12 months of a sale or disposition of an interest in the passthrough entity equals 25% or more of the aggregate FMV of the passthrough entity's assets at the time cash or property is first contributed to the passthrough entity during such 12-month period.

To illustrate, assume that Member A, an individual, owns a 25% interest in XYZ, an LLC classified as a partnership for Federal income tax purposes. The remaining 75% interest is held by Members B and C, Member A's son and daughter. Up until June 30, 2013, all of the assets of XYZ are used in a trade or business in which Member A materially participates. Member A disposes of 9% of his interest in XYZ on June 30, 2014, recognizing a \$140,000 gain.

Before the sale by Member A, Members A, B, and C had contributed the following assets to XYZ on September 1, 2013:

Member A - Marketable securities with a basis of \$50,000 and a FMV of \$375,000
Member B - Cash of \$562,500
Member C - Marketable securities with a basis of \$75,000 and a FMV of \$562,500

The total value of XYZ's assets immediately before the contribution equaled \$5 million.

The contribution by Member A alone does not trigger the anti-stuffing provision because Member A's contribution of \$375,000 of marketable securities equals 7.5% (which is less than 25%) of the total FMV of XYZ's assets (\$5 million) immediately before the contribution. When the related party rules are applied, however, the anti-stuffing provision would apply because Members A, B, and C's contributions together equal 30% of the total FMV of XYZ's assets immediately before the contribution. Therefore, Member A's \$140,000 gain does not qualify for the safe harbor, and Member A must use our proposed simplified calculation mechanism to determine how much of his gain is subject to the section 1411 tax.

b. Application of the Safe Harbor Method to Carryover Basis Transactions

Under our safe harbor proposal, the taxpayer would be permitted to use an average of the income reported on his/her Schedule K-1 from the passthrough entity for the current year and the immediately preceding years (but not to exceed three years) during which the taxpayer owned his/her interest in the passthrough entity. Our proposal would provide

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that if the taxpayer acquires an interest in a passthrough entity in a transaction in which the taxpayer's basis in the entity is determined in whole or in part by reference to the transferor's basis in such entity (e.g., by gift or by divorce), the taxpayer will include the Schedule K-1 information from the years the interest was held by the transferor in calculating the section 1411 tax due under the safe harbor method. The character of the income in the hands of the taxpayer or transferee (e.g., passive vs. non-passive) will remain the same as in the hands of the transferor for purposes of the safe harbor method. Thus, if a father gifts an interest in a partnership in which he does not materially participate to his son, who does materially participate in the partnership's business, the son will use his father's Schedule K-1 income from the current year and the years preceding the date of the gift (but not to exceed three years) to calculate the section 1411 tax due under the safe harbor method. Thus, any income reported on Line 1 of the father's Schedule K-1 would be treated as passive income in the hands of the son for purposes of the safe harbor calculation. A taxpayer may have both materially participating and passive interests for purposes of using the safe harbor to characterize that portion of the gain on the disposition as subject to the section 1411 tax.

In addition, if the safe harbor method does not apply and the taxpayer is determining the share of the gain or loss from the disposition of an interest in a passthrough entity, we believe that the section 469 rules should apply. If the taxpayer materially participates in the entity for the year, or is deemed to materially participate due to the "look-back provision" (five out of ten previous years), the taxpayer materially participates in all interests, including interests received through a transaction that has carryover basis. As noted above, we recommend that the regulations under section 469 apply to determine that portion of the gain on the disposition that is subject to the section 1411 tax when the safe harbor method is not utilized.

We believe our specific recommendation above concerning the anti-abuse rule can prevent such abuses. We also believe that the 3.8% tax will not be sufficient to create a significant incentive for multi-year manipulative planning except in extreme cases.

The AICPA recommends that Treasury and the IRS consider providing a safe harbor method or more cost-effective means of determining that portion of gain or loss from the disposition that can be excluded from net investment income under section 1411(c)(4). We strongly recommend that Treasury and the IRS consider our recommendations and the final regulations provide a simplified mechanism designed to reduce the complexity and cost of calculations under section 1411(c)(4) for taxpayers and tax practitioners.

If the safe harbor approach recommended above is adopted, the following issue will be of concern only to a small number of transactions not eligible for the safe harbor. Finally, the AICPA notes an incorrect interpretation of section 1411(c)(4) in Examples 1 and 2

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under Prop. Reg. § 1.1411-7(e). Given the facts listed in the example that 100% of the assets of the company are devoted to a trade or business, there should be no investment asset. By definition, if the S corporation's only activity is a business activity (as given in Examples 1 and 2 of Prop. Reg. § 1.1411-7(e)), materially participated in by the shareholder, all of the shareholder's gain must be attributed to the materially participating business. Such gain would be excludable from the section 1411 tax.

The Committee Report to section 1411 confirms this interpretation in the paragraph addressing the disposition of an interest in a partnership or S corporation when it states "Thus, only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account." If there is no such property attributable to any activity other than the active trade or business, no portion of the gain on disposition can be considered subject to the section 1411 tax even if the gain on the stock disposition is larger than the pro-rata gain on all assets within the entity.

If there are both active trade or business assets and other assets in an entity and the selling owner of the entity interest materially participates in the active trade or business, gain from the sale of the entity interest greater than the pro-rata gain on all assets within the entity is excluded from the section 1411 tax, along with gain attributable to active trade or business assets. Only the gain attributable to assets other than active trade or business assets would be subject to the section 1411 tax. This interpretation is fully consistent with the Committee Report cited above. More importantly, this interpretation is fully consistent with the statute under section 1411(c)(4), which provides that gain on the disposition is taken into account "only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for FMV before disposition of such interest." If all the assets of the entity were sold at FMV, only gain from the sale of assets other than active trade or business assets would be subject to the section 1411 tax.

15. Section 704(c) Implications (Inside and Outside Basis)

The AICPA requests additional guidance with respect to the adjustment rules under Prop. Reg. § 1.1411-7.

Disposition gain on the sale of a partnership interest or S corporation stock is subject to a statutory exception from inclusion in NII to the extent that the partner or shareholder would be able to exclude any gain on a deemed sale of all assets of the entity if sold at FMV because the partner or shareholder materially participated in the trade or business in which the assets were held. The proposed regulations provide an adjustment rule that can result in a partner or shareholder recognizing NII on the sale of the interest in an entity

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that only holds assets used in a trade or business in which the shareholder materially participates. This result exists in situations where there is a difference in the equity holder's basis in its equity interest, versus its share of the entity's basis in its assets (an "inside/outside basis disparity").

Prop. Reg. § 1.1411-7(e), Example 2 illustrates the impact of an inside/outside basis disparity in an S corporation context. We note that in a partnership context, inside/outside basis disparities can arise when a partner engages in an equity transaction at a time when there is no section 754 election in effect (e.g., a partner purchases a partnership interest and takes a FMV basis in its interest).

However, basis disparities may also arise due solely to the choice of the section 704(c) method that is utilized by the partnership to make allocations of gain or loss on disposition of property. These ceiling rule limitations represent timing differences that are generally reversed when the partners terminate their interests in the partnership. In a deemed sale of the partnership assets, the partner would recognize gain or loss from the deemed sale, as well as gain or loss on the liquidating distribution of the cash sales proceeds in situations where there have been ceiling rule limitations. This common fact pattern is illustrated in the following example:

Example 2: Partnership is held 50/50 by partners A and B. Partner A originally contributed appreciated depreciable property for which the partnership is using the Traditional Method (without curatives) to account for section 704(c) allocations. Partner B contributed only money to the partnership. The property has generated depreciation which has been subject to ceiling rule limitations, resulting in non-contributing Partner B being subject to an \$18 ceiling limitation on tax depreciation deductions. Partner B thus has a built-in loss of \$18 in his partnership interest, and conversely Partner A has an \$18 built-in gain attributable to the ceiling limitation in her partnership interest. Partner A sells her interest in a fully taxable transaction, recognizing \$18 more gain on the sale of her interest than she would be allocated if the partnership sold all of its assets for FMV. In this situation, Partner A would have \$18 net gain includible in NII, even though all of the assets in the partnership were used in a trade or business in which Partner A materially participated.

Conversely, if the Partnership were using the Traditional Method with Curative allocations (where the ceiling rule limitations were cured with gain on the sale of the property), the result to the partners under section 1411 would be entirely different. Partner A would be allocated \$18 more in tax gain attributable to the prior aggregate ceiling rule limitation under section 704(c) on a hypothetical sale of the underlying asset. Thus, the gain Partner A recognizes on the sale of her interest would be

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subject to an adjustment that takes into account an additional amount of \$18 of gain as excludable from NII due solely to the use of the Traditional Method with Curatives.

A partnership that desires to use the Traditional Method with Curatives that use gain on sale to cure the disparity must provide for this treatment in the partnership agreement in the year the property is contributed or revalued. Because of this requirement, partnerships that are now facing disparate results for their partners under new section 1411 cannot change their existing section 704(c) method.

The AICPA recommends that Treasury and the IRS consider an amendment to the adjustment rules of Prop. Reg. § 1.1411-7 to adjust the gain or loss from a deemed sale of all assets to include the liquidation gain/loss caused by section 704(c) ceiling rule distortions. Alternatively, for partnerships that selected the Traditional Method when section 1411 had not been enacted, we recommend that Treasury and the IRS consider a rule that allows a one-time election for such partnerships to amend their partnership agreements to use the Traditional Method with curatives using gain on sale for all properties currently subject to the Traditional Method.¹⁹

16. Sale or Disposition of an S Corporation Owned by a Qualifying Subchapter S Trust (QSST)

The AICPA recommends that a simplified method and a safe harbor method be utilized when the trustee (transferor) computes the gain or loss from the sale or disposition of an S corporation owned by a QSST and taken into account for purposes of section 1411.

Only certain types of trusts are generally allowed to be S corporation shareholders under section 1361(c)(2). These types include an electing QSST, which allows a trust with successive beneficiaries (e.g., separate income beneficiaries and remainder beneficiaries) to hold S corporation stock if specific criteria under section 1361(d) are met, and an electing small business trust (ESBT).

If the following specific criteria are met, a trust will be allowed to hold S corporation stock as a QSST under section 1361(d):

- a. The trust has only one income beneficiary during the life of the current income beneficiary, and that beneficiary is a U.S. citizen or resident.

¹⁹ The AICPA notes that the alternative recommendation is not preferable as the distortion caused by a ceiling rule limitation may not always be cured under the Traditional Method with Curatives in situations where there are not sufficient items of like character to cure with.

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- b. All of the fiduciary accounting income is, or is required to be, distributed currently to the one income beneficiary pursuant to Treas. Reg. § 1.1361-1(j)(1)(ii). Since a simple trust is required by the terms of the document to distribute all of its accounting income, it will qualify as a QSST. A complex trust can qualify as a QSST if the trustee, although not required to do so by the terms of the trust instrument, actually does distribute all the trust's fiduciary accounting income currently.
- c. Any principal distributions, including a termination distribution, must go to the income beneficiary if made during the beneficiary's lifetime.
- d. The income beneficiary's interest must terminate on the earlier of the beneficiary's death or the trust's termination.
- e. The trust's income beneficiary must make a QSST election related to the stock of each S corporation held by the trust.
- f. No distribution (income or principal) by the trust can satisfy the grantor's legal obligation to support the income beneficiary pursuant to Treas. Reg. § 1.1361-1(j)(2)(ii)(B).

A QSST is treated as a grantor trust for income tax purposes, therefore the Schedule K-1 items are reported on the income tax return of the beneficiary. Although the income beneficiary is treated as the owner of the portion of the trust that consists of the S corporation stock, the trust, not the beneficiary, recognizes gain or loss upon disposition of the S corporation stock under Treas. Reg. § 1.1361-1(j)(8). A beneficiary of a QSST is allowed to deduct the QSST's share of S corporation losses that have been suspended under the at-risk or passive loss rules when the QSST disposes of the related S corporation stock under section 1361(d)(1)(C) and Treas. Reg. § 1.1361-1(j)(8).

We believe that allowing the QSST to utilize the simplified method or safe harbor method recommended above (when computing the gain or loss from the sale or disposition of an S corporation owned by a QSST and taken into account for purposes of section 1411) would greatly ease the burden of compliance for the trustee.

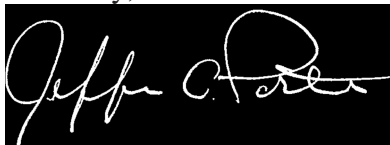
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We welcome the opportunity to discuss these comments. If you have any questions regarding this submission, please contact me at (304) 522-2553 or jporter@portercpa.com; Jonathan Horn, Chair of the AICPA Individual Income Tax

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Technical Resource Panel, at (212) 744-1447, or jmhcpa@verizon.net; Chris Hesse, Chair of the AICPA S Corporation Technical Resource Panel, at (612) 397-3071, or chris.hesse@cliftonlarsonallen.com; William O'Shea, Chair of the AICPA Partnership Technical Resource Panel, at (202) 758-1780, or woshea@deloitte.com; or Jason Cha, AICPA Technical Manager, at (202) 434-9231, or jcha@aicpa.org.

Sincerely,

A black and white image of a handwritten signature in cursive script, which appears to read "Jeffrey A. Porter". The signature is written in white ink on a black rectangular background.

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