McPherson Building
901 15th Street, NW, Suite 525
Washington, DC 20005
(202) 684-8460 Fax (202) 684-8459
www.actec.org

The American College of Trust and Estate Counsel



Please Address Reply to:

**Executive Director**
DEBORAH O. MCKINNON

February 26, 2014

Via Electronic Mail: Notice.Comments@irscounsel.treas.gov

CC:PA:LPD:PR (REG-130843-13)
Room 5205
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station, Washington, DC 20044

Re: Recommendations for REG-130843-13 regarding the Net Investment Income Tax

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel (the "College") is pleased to submit these recommendations pursuant to REG-130843-13, released on December 2, 2013, at Fed. Reg. Vol. 78, No. 231, p. 72451, which invites comments on, among other items, Proposed Regulation section 1.1411-7(a)(4)(iii)(C), dealing with determining net investment income on a Qualified Subchapter S trust's disposition of S corporation stock. Furthermore, Treasury Decision 9644, effective December 2, 2013, invited comments on the scope of possible future regulations on the material participation of trusts and estates under Internal Revenue Code section 469, which we are including with this submission.

The College is a professional organization of approximately 2,600 lawyers from throughout the United States. Fellows of the College are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of the College have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift, and GST tax planning, fiduciary income tax planning, and compliance. The College offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

**QSST Issue**

When a Qualified Subchapter S trust (QSST) sells S corporation stock, any gain or loss from the sale is taxed to the trust, even though all other S corporation items are taxable to the beneficiary. Proposed Regulation section 1.1411-7(a)(4)(iii)(C) correctly provides that any part of this gain or loss that constitutes net investment income (NII) would be reported at the trust level as well.

The natural implication of this NII rule is that the determination of whether such gain or loss constitutes NII (including whether there is material participation in a trade or business) would also be made at the trust level. For the reasons stated in the attached detailed analysis, we respectfully suggest that material participation would more appropriately be determined at the beneficiary level rather than at the trust level and that this special rule need not await comprehensive guidance regarding material participation of trusts under Internal Revenue Code section 469. Given that this would constitute an important change from the proposed regulations, we respectfully request that taxpayers not be required to apply this change to sales that occurred before date of publication of the final regulation in the Federal Register.

**Comments Regarding Material Participation of Trusts Generally**

We welcome and affirm the contemplated regulation project under Internal Revenue Code section 469 to address the material participation of trusts. Such regulations might address:

- Whose participation should be attributed to the trust or estate?
- What is the consequence for this purpose of a trust's changing from being deemed owned by one or more individuals (a "grantor trust") to being a nongrantor trust or vice versa, for example when a trustee changes or a deemed owner dies?
- Should the rules that apply to determine the material participation of individuals also apply to the material participation of those whose participation is attributed to the trust or estate?

We intend to prepare recommendations and detailed analysis supporting those recommendations. Our submission will take at least a few months to prepare.

**Preparation of these Comments**

This submission was prepared principally by Steven B. Gorin and reviewed by Ellen Harrison, Chair of the ACTEC Washington Affairs Committee. The task force included members of the College's Business Planning and Fiduciary Income Tax Committees: Stephen R. Akers, Jonathan G. Blattmachr, Richard L. Dees, T. James Lee, Mary Ann Mancini, Janet Rae Montgomery, Lisa M. Rico, and Gregg M. Simon. Some of the members of this task force also participated in a task force of the American Bar Association's Real Property, Trust & Estate Law Section, which has the same comments regarding QSST material participation.

Although the lawyers who participated in preparing these comments have clients who may be affected by the legal issues addressed by the comments or have advised clients on these issues, no such member (or firm or organization to which any such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

If you or your staff would like to discuss the recommendations, please contact Steven B. Gorin (314-552-6151), at sgorin@thompsoncoburn.com, Ellen Harrison, Chair of the ACTEC Washington Affairs Committee, at (202) 663-8316, or ellen.harrison@pillsburylaw.com; or Leah Weatherspoon, ACTEC Communications Director, at (202) 688-0271, or lweatherspoon@actec.org.

Sincerely yours,

Duncan E. Osborne

Duncan E. Osborne
President

Enclosure

<u>Detailed Discussion of QSST Issue</u>

<u>Executive Summary</u>

Prop. Reg. § 1.1411-7(a)(4)(iii)(C) provides that, when a QSST disposes of S corporation stock, the trust is treated as the owner for purposes of the net investment income (NII) tax.

We agree that any NII generated from the sale of S corporation stock should be included in the QSST's NII tax calculation.

However, we do not agree that the determination of whether gain from the sale is NII should be made at the trust level. We respectfully submit that, when determining whether gain or loss on the sale of S corporation stock sold by a QSST constitutes NII, material participation should be determined at the beneficiary level (as it is other than for such a sale) and that this issue can be resolved now, rather than waiting for any larger project covering material participation by trusts.

Below is the analysis supporting our recommendation.

<u>Analysis</u>

Prop Reg. § 1.1411-7(a)(4)(iii)(C) provides:

> *Treatment of Qualified Subchapter S Trusts (QSSTs)*. In the case of a disposition of S corporation stock by a QSST, the rules of this section are applied by treating the QSST as the owner of the S corporation stock.

The preamble explained the reasoning:[1]

> H. <u>Qualified subchapter S trusts (QSSTs)</u>
>
> The preamble to the 2012 Proposed Regulations requested comments on whether special coordination rules are necessary to address dispositions of stock in an S corporation held by a QSST. Specifically, the request for comments deals with the application of section 1411(c)(4) to the existing QSST stock disposition mechanics in § 1.1361-1(j)(8).
>
> In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361-1(j)(8), however, provides that the trust, rather than the 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. Section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8) provide that, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST is treated as a disposition by the income beneficiary.

[1] REG-130843-13. We commend the preamble for explaining the government's position so well. We further commend the authors of the preamble to all of the proposed and final regulations under section 1411 for explaining the background and reasoning behind each significant decision.

However, in this special case, the QSST beneficiary, for chapter 1 purposes, does not have any passive activity gain from the disposition. Therefore, the entire suspended loss (to the extent not allowed by reason of the beneficiary's other passive net income in the disposition year) is a section 469(g)(1) loss, and is considered a loss from a nonpassive activity.

For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469. However, because gain or loss resulting from the sale of S corporation stock by the QSST will be reported by the QSST and taxed to the trust by reason of § 1.1361-1(j)(8), it is not clear whether the beneficiary's section 469 status with respect to the S corporation is attributed to the trust.

One commentator recommended that the disposition of S corporation stock by a QSST should be treated as a disposition of the stock by the income beneficiary for purposes of determining material participation for purposes of section 1411. In addition, the commentator recommended that the final regulations confirm that the special rule stated in the last sentence of § 1.1361-1(j)(8) applies for purposes of section 1411 as it does for section 469 and 465.

After consideration of the comments, these proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level.

This treatment is consistent with the chapter 1 treatment of the QSST by reason of § 1.1361-1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons.

First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust. As discussed in part 4.F of the preamble to the 2013 Final Regulations, the Treasury Department and the IRS believe that the issue of material participation by estates and trusts, including QSSTs, is more appropriately addressed under section 469.

Additionally, one commentator noted that the IRS has addressed the treatment of certain asset sales as the functional equivalent of stock sales for purposes of § 1.1361-1(j)(8) in a limited number of private letter rulings. In these cases, the private letter rulings held that gain from the sale of assets, which was followed by a liquidation, would be taxed at the trust level under § 1.1361-1(j)(8) rather than being taxed at the beneficiary level. The commentator recommended that an asset sale followed by a liquidation, within the context of § 1.1361-1(j)(8), should have a similar result under section 1411(c)(4). Similar to the issue of material participation by QSSTs discussed in the preceding paragraph, the Treasury Department and the IRS believe that the issue of whether an asset sale (deemed or actual) is the equivalent of a stock sale for purpose of the QSST rules should be addressed under the § 1.1361-1(j) QSST regulations, rather than in § 1.1411-7. However, the Treasury Department and the IRS believe that

> proposed § 1.1411-7(a)(4)(i), which provides that asset sales followed by a liquidation is a disposition of S corporation stock for purposes of section 1411(c)(4), address the commentator's QSST issue.
>
> Second, with respect to the section 1411 treatment of the disposition by the beneficiary by reason of section 1361(d)(1)(C) and the last sentence of § 1.1361-1(j)(8), the Treasury Department and the IRS believe that the general administrative principles enumerated in § 1.1411-1(a), when combined with the general treatment of section 469(g) losses within § 1.1411-4, provide an adequate framework for the treatment of QSSTs beneficiaries without the need for a special computational rule within § 1.1411-7.

The regulations properly determine NII by characterizing various components of regular taxable income as NII or not NII. As the preamble correctly points out, a QSST's gain on the sale of stock in an S corporation is taxable at the trust level for regular income tax purposes; therefore, the gain must also be included in the trust's NII calculation.

The proposed regulation does not directly address how the material participation rules apply in determining whether the QSST's gain on the sale of S corporation stock is passive income and therefore constitutes NII. However, the trust being treated for NII purposes as the owner of the stock implies that material participation might be determined at the trust level. As described below, we believe that material participation regarding the QSST's gain on the sale of S corporation stock should be tested at the beneficiary level. These reasons do not relate to the overall rules regarding testing a trust's material participation; rather, they are specific to policies underlying QSSTs.

Below we review how a QSST, rather than its beneficiary, is taxable on the gain of the sale of the QSST's S corporation stock because of concerns practitioners expressed about the harshness of a contrary rule in the context of installment sales. We then discuss how the proposed NII rules approach that special case of installment sales by basing the calculation of NII on the facts at the time of the sale without regard to the installment element. That approach of the proposed NII rules to installment sales, as well as the treatment of QSSTs under the passive loss rules, supports our recommendation.

Reg. § 1.1361-1(j)(8) provides:

> *Coordination with grantor trust rules*. If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1,



5900683

> except as otherwise required by subpart E of the Internal Revenue Code. 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.

Treasury Decision 8600 explains why, when a QSST sells its S corporation stock, Reg. § 1.1361-1(j)(8) taxes the sale proceeds to the trust rather than the beneficiary:

> The final regulations also change the result in Rev. Rul. 92-84, 1992-2 C.B. 216. Rev. Rul. 92-84 holds that if a QSST sells its S corporation stock, the current income beneficiary and not the trust must recognize any gain or loss. After the publication of Rev. Rul. 92-84, practitioners expressed concern with respect to the sale of the stock by a QSST in an installment sale. Practitioners questioned whether the trust could effectively use the installment method under section 453 to report gain realized on the sale of the stock and expressed concern about how the IRS would treat an installment sale of S stock by a QSST. Practitioners suggested that since the income beneficiary was treated as the owner of the stock sold, the income beneficiary would be treated as the owner of the installment obligation received in exchange for the sale of the stock. However, concern was expressed that because the QSST ceases to be a QSST as to the S corporation stock that was sold, the income beneficiary would no longer be treated as the owner of the installment obligation held by the trust and there may have occurred a disposition of the installment obligation under section 453B(a).
>
> On further consideration, the IRS and Treasury have determined that the income beneficiary of a QSST who is a section 678 deemed owner of the S corporation stock solely by reason of section 1361(d)(1) should not be treated as the owner of the consideration received by a QSST upon its disposition of S corporation stock. Under the final regulations, the consideration is treated as received by the trust in its status as a separate taxpayer under section 641. Thus, for example, any gain recognized on a sale of the S corporation stock is the gross income of the trust. Similarly, the trust may report any gain realized upon the sale under section 453 if the sale otherwise qualifies as an installment sale. This provision of the final regulations reflects an interpretation of section 1361(d)(1) and has no bearing upon the operation or effect of the principles of sections 671 through 679 beyond the context of a QSST.

Thus, Regulation section 1.1361-1(j)(8) taxes the sale proceeds to the trust rather than the beneficiary because installment sales would produce an anomalous result. In making policy regarding the interaction between that regulation and the NII rules, we respectfully submit that the government consider how the NII rules treat installment sales.

Generally, Proposed Regulation section 1.1411-7(d) determine the character of an installment sale for NII purposes by looking to the facts in the year of sale and then mechanically applying them to receipts in future years.[2] This implies that one looks to material participation at the instant of the sale without

[2] The proposed regulation provides:

> *Deferred recognition transactions*. In the case of a disposition of a Passthrough Entity in an installment sale under section 453 (or in exchange for an annuity contract), the calculations described in paragraphs (b) and (c) of this section shall be applied in the year of the disposition as if the entire amount of gain recognized for chapter 1 is taken into account by the transferor in the

being concerned with material participation in future years. In the partnership realm, this implication is made explicit when looking to redemptions of partnership interests under Internal Revenue Code section 736.[3] Section § 736(b) payments are treated as sales of partnership interests,[4] and section § 736(b) payments are treated as an installment sale in the year of disposition for Code § 1411 purposes[5] even though for income tax purposes each year's payment stands alone.[6] The preamble to the proposed regulation explains:

---

year of the disposition. For this purpose, it is assumed that any contingencies potentially affecting consideration to the transferor that are reasonably expected to occur will occur, and in the case of annuities based on the life expectancy of one or more individuals, the present value of the annuity (using existing Federal tax valuation methods) is used to determine the estimated gain. If the calculations in this section result in a transferor excluding only a portion of the chapter 1 gain from net investment income, the amount of excluded gain will constitute an addition to basis for purposes of applying section 453 to determine the amount of gain is includable in net investment income under § 1.1411-4(a)(1)(iii) as payments are received.

[3] Section 736 provides:

*Payments to a retiring partner or a deceased partner's successor in interest.*

(a) *Payments considered as distributive share or guaranteed payment.* Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered—

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

(b) *Payments for interest in partnership.*

(1) *General rule.* Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) *Special rules.* For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for—

(A) unrealized receivables of the partnership (as defined in section 751(c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

(3) *Limitation on application of paragraph (2).* Paragraph (2) shall apply only if—

(A) capital is not a material income-producing factor for the partnership, and

(B) the retiring or deceased partner was a general partner in the partnership.

[4] Proposed Regulation section 1.1411-4(g)(ii)(iv) provides:

Gain or loss attributable to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) and paragraphs (a)(1)(iii) and (d) of this section as gain or loss from the disposition of a partnership interest.

[5] Proposed Regulation section 1.1411-4(g)(ii)(iv) provides:

A taxpayer who elects under § 1.736-1(b)(6) must apply the principles that are applied to installment sales in § 1.1411-7(d).

[6] Regulation section 1.736-1(a)(6). Although a partner retires when he ceases to be a partner under local law, a retired partner or a deceased partner's successor will be treated as a partner for partnership income tax purposes (subchapter K, chapter 1 of the Code) until the partner's interest in the partnership has been completely liquidated. Regulation section 1.736-1(a)(1)(ii).

> Section 736(b) payments to retiring partners in exchange for partnership property (other than payments to retiring general partners of service partnerships in exchange for Section 736(a) Property) are governed by the rules generally applicable to partnership distributions. Thus, gain or loss recognized on these distributions is treated as gain or loss from the sale or exchange of the distributee partner's partnership interest under section 731(a).
>
> The proposed regulations provide that section 736(b) payments will be taken into account as net investment income for section 1411 purposes under section 1411(c)(1)(A)(iii) as net gain or loss from the disposition of property. If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply § 1.1411-7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4). Gain or loss relating to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) regardless of whether the payments are classified as capital gain or ordinary income (for example, by reason of section 751).
>
> In the case of section 736(b) payments that are paid over multiple years, the proposed regulations provide that the characterization of gain or loss as passive or nonpassive is determined for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced and is not retested annually. The proposed regulations thus adopt for section 1411 purposes the section 469 treatment of section 736(b) payments paid over multiple years as set forth in § 1.469-2(e)(2)(iii)(A).

Probably because Internal Revenue Code section 469(g)(1) prevents the passive loss rules from restricting losses when an activity is sold and frees all suspended passive losses,[7] no guidance explains

---

[7] Section 469(g) provides as follows:

(g) *Dispositions of entire interest in passive activity*. If during the taxable year a taxpayer disposes of his entire interest in any passive activity (or former passive activity), the following rules shall apply:

(1) *Fully taxable transaction*.

(A) *In general*. If all gain or loss realized on such disposition is recognized, the excess of—

(i) any loss from such activity for such taxable year (determined after the application of subsection (b)), over

(ii) any net income or gain for such taxable year from all other passive activities (determined after the application of subsection (b)),

shall be treated as a loss which is not from a passive activity.

(B) Subparagraph (A) not to apply to disposition involving related party. If the taxpayer and the person acquiring the interest bear a relationship to each other described in section 267(b) or section 707(b)(1) , then subparagraph (A) shall not apply to any loss of the taxpayer until the taxable year in which such interest is acquired (in a transaction described in subparagraph (A)) by another person who does not bear such a relationship to the taxpayer.

(C) *Income from prior years*. To the extent provided in regulations, income or gain from the activity for preceding taxable years shall be taken into how the passive loss rules treat the installment sale of stock in an S corporation. However, given that generally the proposed and final regulations under Internal Revenue Code section 1411 treat owners of S corporations and partnerships the same, section 1411 should treat shareholders who sell S corporation stock on an installment basis the same as partners whose interests are redeemed in installments under Internal Revenue Code section 736(b). Because partners whose interests are redeemed in installments under Internal Revenue Code section 736(b) determine NII based on material participation at the beginning of the payments and do not re-test participation in subsequent years, owners of S corporation stock should determine NII based on material participation at the beginning of the payments and not re-test participation in subsequent years.

Regulation section 1.1361-1(j)(8) recognizes the tension between the application of the passive loss rules at the beneficiary level for perhaps many years, suddenly switching to taxation at the trust level for purposes of the sale. The regulation's last sentence recognizes this tension:

> 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.

We respectfully suggest that Proposed Regulation section 1.1411-7(d) should recognize this tension as well. Regulation section 1.469-5T(a) generally assumes that material participation will be determined over an entire taxable year or a number of years. Although short taxable years might create concerns, they also measure operating income over short periods of time. The general concept under section 1411 is for a person who is active in a business for a period of time not to be subject to NII tax with respect to the sale of business assets. Testing material participation for a person who is treated as owning the business solely for an instant in time, due to the artificial construct of Regulation section 1.1361-1(j)(8), seems to us to be contrary to the policy behind section 1411. That policy would require a QSST to establish participation at both the trust level and the beneficiary level, just in case the business is suddenly sold due to the appearance of a strategic investor or some other unexpected turn of events.

Therefore, we respectfully request that Proposed Regulation section 1.1411-7(d) provide that the beneficiary shall be treated as the owner for purposes of establishing a QSST's material participation as

---

account under subparagraph (A)(ii) for the taxable year to the extent necessary to prevent the avoidance of this section.

(2) *Disposition by death*. If an interest in the activity is transferred by reason of the death of the taxpayer—

(A) paragraph (1)(A) shall apply to losses described in paragraph (1)(A) to the extent such losses are greater than the excess (if any) of—

(i) the basis of such property in the hands of the transferee, over

(ii) the adjusted basis of such property immediately before the death of the taxpayer, and

(B) any losses to the extent of the excess described in subparagraph (A) shall not be allowed as a deduction for any taxable year.

(3) *Installment sale of entire interest*. In the case of an installment sale of an entire interest in an activity to which section 453 applies, paragraph (1) shall apply to the portion of such losses for each taxable year which bears the same ratio to all such losses as the gain recognized on such sale during such taxable year bears to the gross profit from such sale (realized or to be realized when payment is completed).

applied to section 1411 when the QSST sells S corporation stock and that the trust be treated as the owner for all other purposes under section 1411.

Although the government has decided to consider opening a regulation project under section 469 to determine a trust's material participation, the issue facing QSSTs is unique and – we suggest – need not be contingent on the outcome of any such project.

If the government adopts this suggestion, we respectfully request that it be adopted effective on or after the date the final regulations are published, so that taxpayers who planned transactions based on the proposed regulations will not be adversely affected.

Thank you for considering our suggestions. We would be happy to discuss this with you further.