MEDICARE TAX

Imposition of the 3.8% Medicare Tax on Estates and Trusts

Estates and trusts with even modest earnings now face the complexity of calculating the new Medicare tax on net investment income.

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The Health Care and Education Reconciliation Act of 2010 (commonly called Obama Care) added new Section 1411 and modified Section 3101(b) effective for tax years beginning after 2012. Essentially, the amendment to Section 3101(b) increases by .9% to 3.8% the Medicare tax (previously 2.9%) that has been imposed under that section on wages, compensation, and self-employment income, [1] although the additional .9% is imposed only when such income exceeds a certain threshold. Section 1411, beginning for such years, imposes a 3.8% Medicare tax (sometimes, called the “net investment income tax” or “NIIT” [2]) on certain “passive” income of individuals, [3] estates, and trusts.

The NIIT will never be greater than 3.8% of the net investment income (NII) of the taxpayer, and it may be less if the taxpayer's (modified) adjusted gross income (AGI) exceeds a certain dollar threshold by an amount less than the taxpayer's NII (see Exhibit 1). Hence, no matter how great a taxpayer's gross income, AGI, or taxable income, the taxpayer incurs no tax under Section 1411 if the taxpayer has no NII.

Exhibit 1. Thresholds for the New Medicare Tax Provisions

Under Section 3101(b)(2), the thresholds for the 3.8% Medicare tax rate on compensation income are:

- $250,000 for those married filing jointly.
- $125,000 for those married but filing separately.

- $200,000 for single taxpayers.
- $200,000 for heads of household (with a qualifying person).
- $200,000 for qualifying widow(er)s with a dependent child.

Unlike the basic Medicare tax imposed on compensation (which is in Sections 3101(b)(1) and 3111(b)), one-half on the employee and the employer, the .9% increased tax beginning in 2013 is imposed solely on the employee.

Section 1411 provides for an analogous 3.8% Medicare tax on investment income. This tax is imposed on the lesser of:

(1) The taxpayer's NII (undistributed NII of an estate or trust).

(2) The excess, if any, of the taxpayer's modified AGI (or, for an estate or trust, AGI) over a dollar threshold.

Section 1411(b) provides that the threshold amount for an individual is:

- $250,000, for a taxpayer making a joint return under Section 6013 or a surviving spouse (as defined in Section 2(a)).
- $125,000, for a married taxpayer (as defined in Section 7703) filing a separate return.
- $200,000, in any other case (e.g., an unmarried individual who is not a surviving spouse within the meaning of Section 2(a)).

With respect to an estate or trust, Section 1411(a)(2) imposes the 3.8% Medicare tax on the lesser of:

(1) The estate's or trust's undistributed NII.

(2) The excess, if any, of (a) the estate's or trust's AGI (as defined in Section 67(e)), over (b) the dollar amount at which the highest tax bracket in Section 1(e) begins for the tax year ($11,950 for 2013).

That prevents compensation income, for example, from being subject to a “double” Medicare tax. The compensation income is subject to the 2.9% tax imposed by Section 3101(b) (plus an additional .9% tax on the amount of compensation income above the threshold set forth in Exhibit 1). But because the NIIT can never be imposed on more than the taxpayer's NII and because NII does not include compensation income, the taxpayer pays no tax under Section 1411 on the compensation income.

NII consists of dividends, interest, rents, annuities, [4] royalties, and gains (unless derived in the ordinary course of a trade or business to which the tax does not apply). Trade or business income is generally excepted from the tax unless the trade or business [5] is a passive activity [6] with respect to the taxpayer, constitutes trading in financial instruments or commodities, or is income from the investment of the company's working capital. [7] In each case, the NII [8] is reduced by income tax deductions properly allocable to such income. [9] The NIIT does not apply to tax-exempt income (such as life insurance proceeds excluded from gross income under Section 101(a) or interest on a municipal bond excluded from gross income under Section 103(a)) or income from “qualified” (retirement) plans, such as an individual retirement account (IRA). The NIIT is in addition to any other income taxes that are imposed by the Code and is not deductible for other federal income tax purposes. Last December, the IRS issued proposed regulations under Section 1411. [10]

Section 1411(c)(1)(A) defines net investment income, in part, by reference to trades or businesses described in

Section 1411(c)(2). A trade or business is described in Section 1411(c)(2) and, therefore, its income may be subject to the NIIT if such trade or business is either:

(1) A passive activity (within the meaning of Section 469) with respect to the taxpayer.

(2) A trade or business of trading in financial instruments or commodities (as defined in Section 475(e)(2), which deals with a mark-to-market accounting method for dealers in securities).

Income on the investment of working capital is not treated as derived from a trade or business for purposes of Section 1411(c)(1) and, therefore, may be subject to NIIT even if the business is active and its income is not derived from trading in financial instruments of commodities. [11]

This article discusses aspects of the application of the tax to estates and trusts. [12] Certain areas involving the application of Section 1411 to estates and trusts are reserved. [13] Generally, the regulations are proposed to be effective for tax years beginning after 2013. Taxpayers may rely on the proposed regulations for purposes of complying with Section 1411 until the effective date of the final regulations. Note that, although the regulations are proposed to be effective, in general, for tax years beginning after 2013, the NIIT applies for tax years beginning after 2012.

A key factor is that trusts and estates will be subject to higher taxes beginning in 2013 and that additional planning with respect to them may be in order. For instance, estates of individuals who died in 2012 probably should consider adopting a November 30 tax year. Doing so would postpone the time when the Medicare tax and the increased tax rates (up to 39.6%) take effect until the second tax year of the estate, which would begin on 12/1/2013, effectively avoiding NIIT for up to 11 months. A return for the fiscal year ending 11/30/2014 (the first fiscal year the NIIT would apply) would not be due until 3/15/2015.

Overview of the proposed regulations

The Preamble (or explanation) and the proposed regulations are over 150 pages long. They deal with a large variety of tax issues from S corporation income to income of controlled foreign corporations. In order to understand the application to estates and trusts (and their beneficiaries) it is appropriate to consider, to a limited degree, how the proposed regulations apply to individuals on account of the general rule that estates and trusts are taxed as individuals. [14]

Application of the Medicare tax

Sections 1411(a)(1) and (2) impose a 3.8% tax on certain income of individuals, estates, and trusts. The tax does not apply to a nonresident alien [15] or to a trust all of the unexpired interests in which are devoted to one or more of the charitable purposes described in Section 170(c)(2)(B). [16] Also, it does not apply to a trust that is exempt from income tax pursuant to Section 501(c)(3) or to a charitable remainder trust [17] described in Section 664 (although, as discussed later, it may apply to income distributed from a charitable remainder trust to an individual). [18]

Section 1411(a)(1) imposes the NIIT on an individual for each tax year equal to 3.8% of the lesser of:

(1) The individual's *net investment income* for such tax year.

(2) The excess, if any, of (a) the individual's *modified AGI* for such tax year, over (b) the *threshold amount* applicable to the taxpayer.

Section 1411(b) provides that the threshold amount for an individual is:

(1) In the case of a taxpayer making 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.

(3) In any other case (such as an unmarried individual who is not a surviving spouse within the meaning of Section 2(a)), $200,000. [19]

Section 1411(a)(2) imposes Medicare tax for each tax year on an estate or trust equal to 3.8% of the lesser of:

(1) The estate's or trust's *undistributed* net investment income.

(2) The excess, if any, of (a) the estate's or trust's AGI [20] (as defined in Section 67(e)) for such tax year, over (b) the dollar amount at which the highest tax bracket in Section 1(e) begins for such tax year (which for 2013 is $11,950). [21]

Summary of when no tax is due. As a consequence, no NIIT liability arises if (1) the taxpayer has no NII for the year (for an estate or trust, no undistributed NII for the year [22]) or (2) the taxpayer's modified AGI (in the case of an estate or trust, its AGI, which will also exclude distributable net income (DNI) distributed or deemed distributed to a beneficiary) for the year does not exceed the applicable threshold amount (e.g., $250,000 for a married couple filing jointly or, in 2013, $11,950 for an estate or trust). Hence, even if the taxpayer has substantial NII, NIIT is not imposed where the taxpayer's AGI is below the dollar threshold applicable to the taxpayer for purposes of Section 1411.

Because all items in NII are in AGI, if NII is reduced, the NIIT is also reduced in all events, whether the tax is computed based on AGI reduced by the threshold or on NII, if lower. [23] (As mentioned above, the tax cannot be imposed on more than NII and may be imposed on less if AGI reduced by the applicable dollar threshold is less than NII.) Note that, for an estate or trust, distributions to charity qualifying for a deduction under Section 642(c) or to another beneficiary qualifying for deduction under Section 651 or 661 reduce undistributed NII to the extent such distributions consist of NII, but any Section 642(c) deduction does not reduce the estate or trust's AGI. Hence, a trust or estate usually can reduce or eliminate its taxable amount by making distributions of NII. [24]

Thus, in order to conclude the extent, if any, to which the individual, estate, or trust is subject to the tax, a determination must be made of the taxpayer's NII (or undistributed NII of an estate or trust) and modified AGI (or AGI in the case of an estate or trust). [25] The tax is the *lesser* of (1) .038 *times* net investment income (or undistributed net investment income in the case of an estate or trust) or (2) .038 *times* the modified AGI (or AGI of an estate or trust) *minus* the applicable threshold. Hence, if the taxpayer has no NII (or for an estate or trust, no undistributed NII) or if the taxpayer's modified AGI (or, for an estate or trust, AGI) does not exceed the applicable dollar threshold, no NIIT is imposed by Section 1411.

Distributions of DNI that are deductible under Section 651 or 661 reduce the AGI of an estate or trust, but such distributions reduce the NII of an estate or trust only to the extent the DNI consists of NII. NII of an estate or trust is reduced by the distribution of NII to charity for which a Section 642(c) deduction is allowed but AGI of an estate

or trust is not reduced by any Section 642(c) deduction. As discussed below, that may present planning opportunities in certain situations.

Determining modified AGI

Section 1411(d) defines modified AGI of an individual as AGI, determined under Section 62, [26] increased by the excess of (1) the amount excluded pursuant to Section 911(a)(1) from gross income of certain U.S. taxpayers working outside of the U.S., over (2) any deductions (taken into account in computing AGI) or exclusions disallowed under Section 911(d)(6) with respect to the amount excluded from gross income under Section 911(a)(1). Therefore, unless an individual taxpayer has income from working outside of the U.S. that is excluded in whole or in part from the taxpayer's gross income pursuant to Section 911(a), modified AGI is AGI. A taxpayer who may exclude income earned overseas pursuant to Section 911, however, cannot exclude it for purposes of the Medicare tax.

AGI of an estate or trust

In the case of an estate or trust, AGI is defined in Section 67(e), which is AGI as would be determined under Section 62 for an individual reduced by:

> (1) The expenses of administration of the estate or trust that would not have been incurred if the property were not held in the estate or trust.
>
> (2) Any DNI distributed to a beneficiary for the year that is deductible by the estate or trust pursuant to Section 651 or 661.
>
> (3) Any amount allowed as a personal exemption under Section 641(b).

The AGI of an estate or trust is not reduced by the deduction allowed under Section 642(c) for gross income paid (or, for an estate and certain trusts, permanently set aside) for charitable purposes, although such amounts to the extent they consist of NII (as well as DNI to the extent consisting of NII distributed or deemed distributed to a beneficiary) reduce the NII of the estate or trust that is subject to the tax.

Example. A trust has NII of $100,000 and AGI of $120,000. [27] Unless the trust makes a distribution of its NII to a beneficiary that is deductible under Section 651 or 661 or to charity entitling the trust to a deduction under Section 642(c), the trust pays a 3.8% NIIT on its $100,000 NII, as this is lower than the trust's $120,000 AGI reduced (for 2013) by the $11,950 threshold amount. Hence, the trust would owe $3,800 in Medicare tax.

Example. A trust has $50,000 of NII and AGI (before any deduction under Section 651 or 661). The trust distributes $30,000 of NII to a beneficiary for which the trust is entitled to a deduction under Section 651 or 661. Its undistributed NII is $20,000, and its AGI (after the deduction under Section 651 or 661) is also $20,000. Hence, the NIIT is imposed on only $8,050 (i.e., $20,000 AGI reduced, for 2013, by the $11,950 threshold).

In order to avoid the tax, the trust would have to distribute sufficient NII entitling it to deductions under Section 651, 661, or 642(c) that reduce its AGI in excess of the threshold to zero.

In *Knight*, [28] the Supreme Court held that certain investment advisory fees paid by a trust were not deductible in determining the AGI of the trust for purposes of Section 67(a). In general, Section 67(a) permits certain

deductions only to the extent they exceed 2% of a taxpayer's AGI. Proposed regulations have been issued under Section 67(e), but have not been adopted as final. [29]

Section 67(e) creates an exception for trusts by permitting a deduction in determining AGI of an estate or trust for expenses that would not have been incurred if the property were not held in trust. Failing to qualify for the Section 67(e) exception may have broader implications for purposes of Section 1411 than for purposes of Section 67(a). The latter disallows those expenses (which cannot be established as ones that would not have been incurred if the property were not held in the estate or trust) except to the extent they exceed 2% of the estate's or trust's AGI. To the extent they exceed that 2% “floor,” they are deductible in determining the taxable income of the estate or trust. [30]

If, however, the administration expenses of the estate or trust are not the type that would not have been incurred if the property were not held in the estate or trust, then they do not reduce the AGI of the estate or trust at all. In that event, the NIIT is imposed not on the taxable income of the estate or trust but on its AGI (to the extent it exceeds the threshold) or, if less, on its undistributed NII.

Example. A trust has NII of $20,000, AGI (before any reduction for those administration expenses that would not have been incurred if the property were not held in the trust) of $30,000, and administration expenses of $20,000.

- If the administration expenses would not have been incurred if the property were not held in trust, then the trust's AGI under Section 67(e) is $10,000 (i.e., $30,000 AGI less Section 67(e) expenses of $20,000). This is less than the $11,950 threshold. Hence, no NIIT is due.
- If the expenses do not qualify for the Section 67(e) exception, then the 3.8% tax is imposed on the lesser of the $20,000 NII [31] or $18,050 (i.e., $30,000 AGI minus the $11,950 threshold) which would be an NIIT of $685.90.

The impact on the trust's regular income tax is less than the impact on its NIIT. Section 67(a) causes an amount equal to 2% of the $30,000 AGI (or $600) to be disallowed for purposes of computing the trust's taxable income; at a 39.6% income tax bracket, that results in only a $237.60 increase in regular income tax. As explained below, however, deductions otherwise allowable for income tax purposes may reduce the net investment income to the extent those deductions are “properly allocable” to such income.

Net investment income

All of the taxpayer's NII is in the taxpayer's AGI, but items that are included in AGI (e.g., income from an active trade or business not derived from trading in financial instruments or commodities and that is not income from the investment of its working capital) are not necessarily in NII. In any case, NII means the excess, if any, of certain income over deductions. The NII is the sum of:

(1) Gross income from interest, dividends, annuities, royalties, and rents, *other than* such income derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer, is not derived from the trading in financial instruments or commodities, and is not income from the investment of its working capital. [32]

(2) Gross income derived from a passive trade or business or from trading in financial instruments or commodities or from the investment of its working capital.

(3) Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in an active trade or business (unless it is a passive activity with respect to the taxpayer, is derived from trading in financial instruments or commodities or the investment of its working capital).

The deductions are those allowed by subtitle A, which are properly allocable to such gross income or net gain. In other words, interest, dividends, annuities, royalties, rents, and gain are in net investment income unless they are excluded as being derived from an active trade or business not involving trading in financial instruments or commodities and not from the investment of its working capital. Therefore, not only must the taxpayer determine interest, dividends, annuities, royalties, rents, and gain, but must also determine those items of income (i.e., interest, dividends, annuities, royalties, rents, and gain) that are not subject to the tax because they qualify for the ordinary course of business exception to which the tax does not apply—i.e., income from an active trade or business not derived from trading in financial instruments or commodities or from the investment of its working capital. Note the tax rate applicable to ordinary income and net gain is the same, 3.8%

Determining if the dividends, gains, etc. are NII

Dividends, interest, rents, royalties, annuities (to the extent producing taxable income), and gains are included in NII unless they are derived from an active trade or business not attributable to trading in financial instruments or commodities or from the investment of working capital. The determination of whether an active trade or business is involved is tested differently if it is a proprietorship or another form of business, such as a partnership or an S corporation. The determination for a proprietorship is made at the taxpayer level (e.g., the individual). Hence, if the taxpayer materially participates within the meaning of Section 469, the income is not included in NII (unless derived from trading financial instruments or commodities or from the investment of working capital).

Trust material participation. Material participation for purposes of Section 469 in the case of an estate or trust has not been definitively determined. The 2003 case *Mattie K. Carter Trust* [33] is the only real "authority" although there are also a technical advice memorandum and a private letter ruling, discussed below—neither of which, under Section 6110(k)(3), can be cited or used as precedent—on how to determine if the activity is passive or active under Section 469 where a trust is an owner. Section 469 prevents the deduction of losses from a trade or business (while an ownership interest is held by the taxpayer) unless the taxpayer "materially participates" in the trade or business, which means on a regular, continuous, and substantial basis (or disposes of the investment). Although regulations contain rules describing material participation for individual taxpayers, no regulations have been promulgated for trusts or estates.

In the *Mattie K. Carter Trust* case, the trust initially owned one-half of a ranch but later acquired the whole. The IRS contended that a trust could be found to have materially participated only if the trustee materially participated. The court rejected that contention and held material participation would be determined by the activities of those who worked on the ranch and conducted the ranching operation on behalf of the trust. Because the court found those activities, collectively, were regular, continuous, and substantial, the losses from the ranch operations were not passive for purposes of Section 469.

In TAM 200733023, the IRS ruled, based on its position in the *Mattie K. Carter Trust* case, that material participation of a trust could be determined only by the activities of the trustee. In Ltr. Rul. 201029014, the IRS ruled the same way. In the 2007 TAM, the IRS stated that although the activities of employees and others who

were not fiduciaries would not be attributed to the trustee for purposes of determining if the activities of the trustee were regular, continuous, and substantial, it held the activities of the employees and others who worked on the ranch did not foreclose a finding that the trustee materially participated. In this instance, the “materially participating” fiduciaries were “special trustees” who reviewed operating budgets and tax disputes, prepared financial documents, and negotiated a sale of the trust's interest in the ranch operation (which was through a limited liability company, taxed as a partnership) to a third party. However, an agreement between the “regular” trustees and the special trustees provided that the latter “will not possess the capacity to legally bind or commit the Trust to any transaction or activity” and that “[Trust] acknowledges that it retains all decision making responsibilities related to [Trust's] financial, tax, or business matters.”

The IRS notes that a fiduciary must be vested with some degree of discretionary power to act on behalf of the trust to be considered a trustee for purposes of Section 469 and that, under the circumstances set forth in the TAM, the special trustees were not trustees for those purposes. The private letter ruling reaches a similar holding regarding when a trust materially participates.

Planning for trust material participation. With only one district court case and two non-precedential “rulings” from the IRS, it is difficult to establish a framework for material participation by a trust (or an estate). Despite the statement by the district court in *Mattie K. Carter Trust* that the IRS position espoused was “arbitrary, subverts common sense and attempts to create ambiguity where there is none,” the IRS almost certainly could issue a regulation adopting the position in the technical advice memorandum and private letter ruling. [34] In the meantime and, perhaps, in anticipation that such regulations will be issued, it may be appropriate to ensure the trustee (or executor) [35] materially participates in any trade or business in which the trust (or estate) owns an interest and which is expected to produce tax losses. Appointing a “special” trustee whose role would be limited to participating in the operations of the trade or business may make sense and possibly increase the chances of success of proving material participation.

For example, if a ranch is managed by a “foreman,” that person might be made a special trustee. A “deal” would have to be worked out on that person's compensation, entitlement, or eligibility to account and resignation or removal, but that may make good sense if enough is involved. It may be easiest and most practical to allow the “main” executor or trustee to appoint special trustees or special executors. To fit within the espoused position of the IRS, however, these special fiduciaries must have considerable decision-making authority. This may not only permit losses to be deducted for regular income tax purposes but would also mean any profits would be excluded from the NIIT. [36]

Another “unknown” is whose material participation “counts” for purposes of Sections 469 and 1411 where the trade or business interest is owned by a former revocable trust that elects to be taxed for income tax purposes pursuant to Section 645 as part of the decedent's estate. Perhaps, the activities of the trustee of the revocable trust will be the ones considered rather than those of the executor. To help reduce issues in such a case, it may be preferable to have a special executor and a special trustee to “run” the trade or business and have the same person or persons be both special fiduciaries.

Gain from sales of partnership interest or S shares. Holding an interest in a partnership or stock in an S corporation normally would not be a trade or business itself so the sale of the interest or stock would be included in NII. However, gain or loss from a taxable disposition of such an interest or stock is limited to gain or loss that would be taken into account as NII if the entity sold all of its assets immediately before the taxable disposition of

the partnership interest or the S stock. To the extent the property deemed sold by the partnership or S corporation was used in an active trade or business that is not in the trade or business of trading in financial instruments of commodities, it would be excluded from NII. The proposed regulations provide special rules for adjusting basis for purposes of allocating gain where the property has been used in more than one business during the 12 months prior to the sale and for other purposes. [37]

Income from tax-exempt pension arrangements

Distributions from qualified and other tax-exempt plans or arrangements such as IRAs, generally, are included in gross income (except for distributions from Roth IRAs). [38] However, such distributions, even if included in gross income, do not comprise part of NII. [39] Therefore, the amount converted from an IRA to a Roth IRA is not included in NII even though it may be subject to ordinary income tax.

Gains subject to the tax

Net gains (to the extent taken into account in computing taxable income) attributable to the disposition of property are in NII unless:

(1) The property was held in a trade or business that is not a passive activity.

(2) The income is not derived from trading in financial instruments or commodities, or from the investment of working capital.

Hence, gains from the sale of securities on an exchange, real estate, or other property not part of an active trade or business are included in NII.

Gain that is not recognized for federal income tax purposes, however, is not included in NII. This includes:

(1) The excludable portion of gain under Section 121 on the sale of a principal residence.

(2) Gain not recognized in certain installment sales under Section 453.

(3) Gain not recognized on account of a like-kind exchange under Section 1031 or an involuntary conversion under Section 1033.

Deductions properly allocable to NII

NII is determined by reducing investment income by "the deductions allowed by this subtitle [i.e., for income tax purposes] which are properly allocable to such gross income or net gain." [40] There are many references for tax and other purposes [41] to the phrase "properly allocable thereto" or similar phrases. The proposed regulations provide that only amounts paid or incurred by a taxpayer to produce gross income or net gain may be deducted in determining NII. Examples of properly allocable deductions seem to include:

(1) Investment interest expense.

(2) Investment advisory and brokerage fees.

(3) Expenses related to rental and royalty income.

(4) State and local income taxes properly allocable to items included in NII.

Before turning to how a determination is made under the proposed regulations as to whether a deduction is properly allocable to NII, it is important to mention that other rules apply to limit any reduction in NII. For example, the Preamble to the proposed regulations provides that a deferral or disallowance under the income tax provisions that apply to determine AGI for federal income tax purposes apply for purposes of determining NII. Hence, a limitation on the deduction under Section 163(d) on investment interest applies for purposes of Section 1411. The "at risk" and passive loss rules of Sections 465 and 469 are applicable to the determination of NII. Furthermore, the limitations under Section 704(d) to partners of a partnership on partnership losses, the capital loss carryover limits of Section 1212(b), and the limitations under Section 1366(d)(2) on a shareholder's ability to deduct S corporation losses also apply for purposes of computing NII.

The proposed regulations provide that investment interest allowed as a deduction by reason of Section 163(d)(1), investment expenses described in Section 163(d)(4)(C), and taxes imposed on investment income that are described in Section 164(a)(3) are deductible in determining NII. When taxes are imposed on both investment income and non-investment income, the proposed regulations provide that taxpayers may determine the portion of taxes properly allocable to investment income using any reasonable method. [42]

The Preamble to the proposed regulations also provides that several itemized deductions are properly allocable deductions under Section 1411. The proposed regulations provide that investment interest allowed as a deduction by reason of Section 163(d)(1), investment expenses described in Section 163(d)(4)(C), and taxes imposed on investment income that are described in Section 164(a)(3) are deductible in determining NII. For taxes imposed on both investment income and non-investment income, the proposed regulations provide that the portion of taxes properly allocable to investment income may be determined by taxpayers using any reasonable method. Perhaps the regulations contain no direction about allocation of interest expense and investment expenses because those were presumed always to be attributable to NII.

The proposed regulations also provide that properly allocable deductions that are itemized deductions subject to the 2% floor on miscellaneous itemized deductions under Section 67 or subject to the overall limitation on itemized deductions under Section 68 [43] may be deducted in determining NII only to the extent that they are deductible for income tax purposes after the application of the 2% floor and the overall deduction limitation. Some deductions, such as investment expenses, are subject to a limitation under both Sections 67 and 68, while other deductions, such as state taxes, are subject only to the limitation under Section 68.

Further, other deductions—such as the deduction under Section 213 (relating to medical, etc. expenses), the deduction for investment interest (as defined in Section 163(d)), and deduction under Section 165(a) for casualty or theft losses described in Section 165(c)(2) or (3) or for losses described in Section 165(d)—are not subject to the limitation under Section 68 but are subject to the 2% floor rule of Section 67. The proposed regulations provide a method for apportioning these limitations to determine the deductions allowed in computing NII after applying Sections 67 and 68.

This method first applies Section 67 to all deductions subject to that limitation. The disallowance is applied proportionately to each deduction subject to Section 67. The proposed regulations then apply a similar process to deductions subject to Section 68. Section 68, however, does not apply to estates and trusts. [44]

Application of the properly allocable rule to NII of an estate or trust. The regulations [45] relating to items of deduction of a trust that enter into the computation of DNI (which is used to determine the character of the

income in the hands of the beneficiary to which it is distributed) essentially provide, in general, that all deductible items directly attributable to one class of income must be allocated to that income, and any such items in excess of that class of income and any deductions not directly attributable to a specific class of income may be allocated to any item of income. However, a portion must also be allocated to income exempt from tax in accordance with Section 265. Reg. 1.265-1(c) provides in part, “If an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.”

Because Section 1411(c)(1)(B) uses the phrase “properly allocable thereto,” it is not certain that the normal regulatory method of deduction allocation for trusts and estates just discussed would apply for NIIT purposes. This seems to be reinforced by the proposed regulations under Section 1411 which provide, in part, that deductions for losses under Section 165 are taken into account only in computing net gain, which is different from the normal rules for estates and trusts. Because net gain in Section 1411(c)(1)(A)(iii) cannot be less than zero for purposes of Section 1411, any losses in excess of gains are not allowable in the computation of NII. Accordingly, properly allocable deductions do not include excess deductions under Section 165. In addition, the proposed regulations take the position that a net operating loss in one year is allowed to determine AGI in a later year but not for purposes of determining NII because, by the later year, such a loss is not properly allocable any NII.

Income excluded from NII from a trade or business

NII does not include certain income from a trade or business.

Ordinary course of business exception. Interest, dividends, annuities, royalties, rents, and gains are not subject to the tax if they are treated as derived in the ordinary course of a trade or business, provided that the trade or business is neither (1) a passive activity (within the meaning of Section 469) with respect to the taxpayer, (2) trading in financial instruments (as defined in proposed Reg. 1.1411-5(c)(1)) or commodities (as defined in Section 475(e)(2)), nor (3) income from working capital. In order to fall under the ordinary course of business exception, three conditions must be met:

(1) The income must be derived in the ordinary course of a trade or business.

(2) The business cannot be a passive activity under Section 469 [46] with respect to the taxpayer.

(3) The income cannot be derived from a trade or business of trading in financial instruments or commodities.

For example, rental income from a trade or business where the taxpayer is “active” is not included in the taxpayer's NII for purposes of Section 1411 and, therefore, cannot be subject to NIIT.

Disregarded entities. In the case of an individual who is engaged in the conduct of a trade or business directly (e.g., a sole proprietor) or through ownership of an interest in an entity that is disregarded as an entity separate from the individual owner under Reg. 301.7701-3, the determination of whether an item of gross income is derived in a trade or business for purposes of the NIIT is made at the individual level. For example, if an individual is engaged in a trade or business and the trade or business has gross income (e.g., royalties), such gross income is derived in the trade or business. Therefore, the individual meets the first part of the ordinary course of a trade or business exception. However, if the trade or business is a passive activity with respect to the taxpayer or if the

trade or business is trading in financial instruments or commodities or represents income from investment of the company's “working capital,” the ordinary course of a trade or business exception is inapplicable, and such income may be subject to NIIT.

Entities that are not disregarded. An individual, estate, or trust may own an interest in a trade or business through one or more pass-through entities (such as a partnership or an S corporation). The determination of whether an item of gross income allocated by the pass-through entity to the individual, estate, or trust is a passive activity with respect to the taxpayer or is trading in financial instruments or commodities is made at the taxpayer level (i.e., at the level of the individual, estate, or trust) in accordance with the general principles of Section 469 (relating to passive losses). For example, if an individual owns an interest in a partnership, which is engaged in a trade or business, the determination of whether the partnership's trade or business is a passive activity with respect to the trust is made in accordance with Section 469 and the regulations under that section, perhaps with respect to the activities of the trustee as previously discussed.

Entities that trade in financial instruments or commodities. The determination of whether a trade or business from which the income is derived is in the trade or business of trading in financial instruments or commodities is made at the pass-through entity level (i.e., the partnership or S corporation level). If the pass-through entity is engaged in a trade or business of trading in financial instruments or commodities, the trade or business exception under Section 1411 would not apply (and the income, therefore, may be subject to NIIT), the income from that trade or business retains its character as it passes from the entity to the taxpayer. Therefore, regardless of whether the individual is directly engaged in a trade or business or whether an intervening pass-through entity is engaged in a trade or business, such income does not qualify for the ordinary course of a trade or business exception in Section 1411(c)(1)(A)(i) because the income is derived in a trade or business of trading in financial instruments or commodities (as described in Section 1411(c)(2)(B)). [47]

Entities not engaged in a trade or business. Moreover, if the pass-through entity is not engaged in a trade or business (determined at the pass-through entity level), income allocated to an individual from the entity does not qualify for the ordinary course of a trade or business exception from the NIIT even if the individual or an intervening entity is engaged in a trade or business. For instance, suppose an individual owns an interest in a partnership (the “upper-tier” partnership), which is engaged in a trade or business. That partnership owns an interest in another partnership (a “lower-tier” partnership), which is not engaged in a trade or business. Any income described in Section 1411(c)(1)(A)(i) (e.g., rents or royalties) passed through from the lower-tier partnership to the upper-tier partnership and, in turn, to the individual partner is not treated as derived in a trade or business because the lower-tier partnership is not engaged in a trade or business. This characterization applies even though the upper-tier partnership is engaged in a trade or business and even if:

(1) The individual partner is engaged in a trade or business.

(2) That partner provides services with respect to upper-tier partnership's trade or business.

(3) The partner provides services to the lower-tier partnership.

Special rules for estates and trusts

Estates and trusts are subject to certain special rules.

Undistributed NII of an estate or trust. As mentioned above, the NIIT is imposed on an estate or trust on the lesser of its adjusted gross income (over the threshold) or its *undistributed* NII. In effect, a reduction in NII for an estate or trust occurs by shifting NII to a beneficiary in a manner similar to the shifting of DNI from an estate or trust to a beneficiary. Adjusted gross income of an estate or trust is computed by subtracting the distribution deduction under Section 651 or 661 for taxable DNI distributed to a beneficiary to determine its taxable income for regular income tax purposes. That deduction (but only to the extent consisting of NII) is also used to determine the undistributed NII of an estate or trust for purposes of the NIIT. Any deduction for a distribution of gross income (but only to the extent consisting of NII) of the estate or trust allowed under Section 642(c) reduces its undistributed NII but not its AGI.

Unless capital gain of the estate or trust enters into the computation of DNI, it cannot be deemed distributed under Section 651 or 661 from the estate or trust to a beneficiary and is taxed to the estate or trust for regular income tax purposes. The same rule seems to apply for purposes of calculating the undistributed NII of an estate or trust. That is, to the extent income is not included in DNI, it cannot be treated as distributed to a beneficiary for NIIT purposes and the DNI deduction for purposes of Section 1411 is based, at least in general, on the proportionate classes of income that make up the pool of NII of the estate or trust. This seems to be confirmed by Prop. Reg. 1.1411-3(f), Example 1.

However, that Example seems to contain an error in the calculation of the trust's DNI. In the Example, the trust, with no expenses, has income consisting of $15,000 of dividends, $10,000 of interest, $60,000 from an IRA, and $5,000 of capital gain. The Example indicates that the trust's accounting income consists of the $15,000 of dividends, the $10,000 of interest, and $25,000 of the $60,000 from the IRA—for a total of $50,000. There is no explanation of why $25,000 of the IRA distribution is allocated to accounting income. [48] It says that DNI is comprised of the same items of dividends, interest, and the part of the IRA that is allocated as accounting income. It states that neither the $35,000 balance of the IRA distribution nor the capital gain is included in DNI. However, unless $35,000 of the distribution from the IRA is deemed comprised of capital gain, all of it also is included in DNI even if allocated to fiduciary accounting corpus. [49]

The Example states that $10,000 of the accounting income is distributed to a beneficiary and correctly concludes that the distribution deduction to the trust under Section 661(a) [50] is allowed for $10,000 and that the beneficiary includes that amount in gross income under Section 662(a). It further states that the $10,000 deductible by the trust and included in the gross income of the beneficiary is deemed to consist of a proportionate part of the income that comprised the DNI—i.e., $3,000 of dividend income, $2,000 of interest income, and $5,000 of ordinary income from the IRA.

The Example concludes that $5,000 (the dividends and interest income) deemed received by the beneficiary pursuant to Section 662(a)) is part of the beneficiary's NII for the year because the portion deemed to consist of a distribution from the IRA is not subject to NIIT as mentioned earlier in this article. It further concludes that the trust has undistributed NII of $25,000, consisting of the $5,000 of capital gain income (no part of which was treated as distributed to the beneficiary), $12,000 of dividends income (the $15,000 received, reduced by the $3,000 portion deemed distributed to the beneficiary), and $8,000 of interest income (the $10,000 received, reduced by the $2,000 portion deemed distributed to the beneficiary). The portion of the IRA distribution not treated as distributed (i.e., $35,000) is not subject to NIIT.

The Example seems to be incorrect in the calculation of DNI and may not be correct on the calculation of

accounting income. The incorrect computation of DNI affects the outcome. It appears DNI should have been $85,000, consisting of $15,000 of dividends, $10,000 of interest income and $60,000 of ordinary income from the IRA. [51] Based on the proportionate classes of income comprising DNI, $1,500 of dividend income, $1,000 of interest income, and $8,500 of the IRA distribution would be treated as having been distributed to the beneficiary for purposes of the NIIT so that only $2,500 (consisting of the $1,500 of dividends and $1,000 of interest) would be NII in the hand of the beneficiary and $13,500 of dividends and $9,000 of interest income would be undistributed NII of the trust.

The trust has $30,000 of NII and $90,000 AGI (before any deduction under Section 651 or 661).

One more subtle point about the Example: It seems to assume that the ordinary course of business exception for purposes of the NIIT does not apply.

Prop. Reg. 1.1411-3(f), Example 2 deals with the same facts as Example 1 except that the trust is required to distribute $30,000 to its individual beneficiary (in Example 1 the distribution seems to have been discretionary), and the trust makes a $10,000 discretionary distribution to another individual beneficiary. It also makes a $10,000 distribution to charity for which the trust is entitled to a deduction under Section 642(c). [52] This Example also seems to calculate the DNI incorrectly. However, it does seem to allocate the classes of income that form part of DNI correctly in that it is based on proportionality, although the numbers are incorrect because the calculation of DNI seems wrong. [53]

In addition, Example 2 is unclear on how the character of the distribution for purposes of Section 1411 to the individual beneficiaries may be affected by the charitable distribution for which a deduction under Section 642(c) may be allowed. As mentioned above, Example 2 fails to state whether the distribution to charity is from accounting income. The Code and regulations contain a special rule for computing DNI where a Section 642(c) deduction is allowed for purposes of computing the character of income deemed distributed to a noncharitable beneficiary. Section 662(b), in directing the tax character of distributions to beneficiaries, provides, in effect, that the distribution is deemed, in general, to consist of a proportionate part of all classes of income forming DNI. It goes on to state that, for purposes of determining the character of a distribution of fiduciary accounting income required to be distributed currently, DNI "shall be computed without regard to any portion of the deduction under Section 642(c) which is not attributable to [fiduciary accounting income]."

Hence, it seems that any distribution to charity of gross income of the trust, for which a Section 642(c) deduction is allow and that is attributable to fiduciary accounting income, does reduce DNI. The regulations under Section 662(b) flesh that out. Reg. 1.662(b)-2 provides, in part:

> [T]he charitable contributions deduction allowed under section 642(c) is ... allocated among the classes of income entering into the computation of estate or trust income in accordance with the rules set forth in paragraph (b) of section 1.643(a)-5. In the application of the preceding sentence, for the purpose of allocating items of income and deduction to beneficiaries to whom income is required to be distributed currently, the amount of the charitable contributions deduction is disregarded to the extent that it exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently.

This regulation seems to limit the extent to which the charitable deduction can reduce DNI for purposes of

determining the character or flavor of a distribution of fiduciary accounting income required to be distributed so it has no practical effect.

Deductions properly allocable to NII of an estate or trust. As mentioned above, NII is determined by reducing investment income by “the deductions allowed by this subtitle [i.e., for income tax purposes] which are properly allocable to such gross income or net gain.” [54] These deductions appear to include:

(1) Investment interest expense.

(2) Investment advisory and brokerage fees.

(3) Expenses related to rental and royalty income.

(4) State and local income taxes properly allocable to items included in NII.

An estate or trust may have other expenses, such as fiduciary commissions, court costs, and legal fees. These latter items will reduce the AGI of the estate or trust if they are “deductions for costs that are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate.” [55] Although not certain, such items seem to be considered properly allocable to the gross income or net gain of an estate or trust, so they reduce NII (at least to the extent NII is proportionate to the total income of the estate or trust). If so, they would reduce the NIIT a beneficiary would pay with respect to a distribution of NII from an estate or trust or the amount of NIIT that an estate or trust would pay on undistributed NII.

For purposes of determining the character of DNI in the hands of a beneficiary, all deductible items directly attributable to one class of income are allocated thereto. For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. If the deductions directly attributable to a particular class of income exceed that income, the excess is applied against other classes of income in the manner provided in the regulations. The deductions that are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing DNI, but a portion must be allocated to nontaxable income pursuant to Section 265 and the regulations thereunder. [56]

This flexibility for non-directly attributable expenses perhaps does not apply for purposes of determining NII of an estate or trust that is distributed out to a beneficiary who would add the NII to his, her, or its own NII even though the distribution of NII seems to be based, in the proposed regulations, on DNI distribution principles. As mentioned above, in the case of taxes imposed on both investment income and non-investment income, the proposed regulations provide that the portion of taxes properly allocable to investment income may be determined by taxpayers using any reasonable method. Perhaps the regulations contain no direction about allocation of interest expense and investment expenses because those expenses were presumed always to be attributable to NII. Other classes of expenses of an estate or trust (e.g., trustee commissions), however, may be properly allocable (at least in part) to NII of the estate or trust. But those expenses may apply to NII as well as other forms of income. The proposed regulations do not seem to provide guidance on how any allocation may be made. [57]

Allocation of NII among trust beneficiaries. NII apparently is allocated among multiple beneficiaries based on the “tier” system used in Section 662. Under that section, DNI is generally allocated first to those entitled to current distributions of fiduciary accounting income of the estate or trust (a first-tier distribution), on a pro-rata

basis unless the governing instrument or local law requires a special allocation of a class of DNI income to a particular beneficiary and that allocation has economic effect. Any remaining DNI allocated to beneficiaries to whom distributions are properly paid, credited, or required to be distributed (a second-tier distribution), are also made on a pro-rata basis.

As just mentioned, if the terms of the governing instrument specifically allocates different classes of income that make up the pool of DNI to different beneficiaries, or if local law requires such an allocation, then that allocation applies for purposes of determining the character of amounts each beneficiary reports in gross income. [58] It would seem this rule of specific allocation would apply for purposes of allocating NII to beneficiaries because the allocation of NII apparently is based on the DNI principles of the tax law.

This might provide some planning flexibility. For example, a trust might require that all (or a certain percentage of) NII of an estate or trust be distributed to an individual beneficiary if it is anticipated that the beneficiary would not be required to pay any or as much NIIT as the trust would. Individuals, in general, have much higher thresholds (based on their AGI) before they are subject to the tax than trusts (or estates) where it will apply once AGI exceeds $11,950 (adjusted for inflation in future years) or, if lower, on NII (undistributed NII) of the estate or trust.

In fact, it seems that the entire complement of the DNI rules apply for purposes of allocating NII between and estate or trust, on the one hand, and the beneficiary on the other. Thus, the trustee (or fiduciary of the estate) can make distributions within 65 days of the close of the year to distribute out NII to a beneficiary. [59]

Non-exempt trusts. As mentioned above, neither a charitable remainder trust nor a trust all of the unexpired interests in which are devoted to one or more of the charitable purposes described in Section 170(c)(2)(B) is subject to NIIT. [60] However, if the trust is organized for other purposes even though contributions to it may qualify for the income tax deduction under Section 170(a), such as a trust for an organization of war veterans organization, which is organized in the U.S. and no part of the net earnings of which inures to the benefit of any private shareholder or individual, under Section 170(c)(3), it is not exempt from the tax although it almost certainly could obtain an exemption from taxation pursuant to Section 501.

Under the proposed regulations, income distributed for charitable purposes that entitles the estate or trust to a deduction under Section 642(c) is not subject to NIIT in the hands of the trust or estate or presumably in the hands of any tax-exempt recipient. [61]

No NIIT is imposed on a foreign trust, in general, except that the proposed regulations reserved rules for foreign trusts with U.S. beneficiaries. [62]

The fact that an estate or trust can shift its NII to a charity may provide it with an advantage compared to an individual taxpayer. Because an individual pays the NIIT on the lesser of NII or adjusted gross income (over the threshold), charitable contributions do not reduce NII. However, they do for an estate or trust. [63]

A pooled income fund is a fund or trust that provides for its fiduciary accounting income to be paid to one or more individuals with the corpus being paid to a designated “publicly supported” charity when the individual beneficiary or beneficiaries die. [64] The fund or trust is not tax exempt but is entitled to a charitable set aside deduction for any long-term capital gain it experiences. Section 1411 does not make the Medicare tax inapplicable to a pooled income fund. Although its NII would be reduced for distributions to the individual beneficiaries consisting of such income, the proposed regulations indicated that pooled income funds may be subject to NII [65] which

presumably, in the normal case, would be limited to capital gain.

It seems surprising that the proposed regulations do not provide that the amount set aside for charity reduces the undistributed NII of a pooled income fund. The implication is that the set aside deduction under Section 642(c) for an estate would reduce its undistributed NII. [66]

Electing small business trusts. An electing small business trust (ESBT), defined in Section 1361(e)(1), is a type of trust that is an eligible shareholder of an S corporation and whose S corporation income is subject to a special tax calculation regime under Section 641(c), which occurs by essentially dividing its income into the S corporation income portion (called the S portion) and the balance (called the non-S portion) for purposes of determining its regular income tax. ESBTs may be subject to NIIT under a three-step process:

> (1) The ESBT separately calculates the NII of the S portion and on the non-S portion and then adds those together to determine its total NII.
>
> (2) The ESBT calculates its adjusted gross income by adding the net income or loss from the S portion to that of the non-S portion.
>
> (3) The NIIT is equal to the 3.8% tax on the lesser of (a) its combined NII and (b) its AGI over its threshold amount ($11,950 for 2013). [67]

Charitable remainder trusts. As mentioned above, charitable remainder trusts described in Section 664 are not subject to NIIT. However, NII of the trust that is distributed to a beneficiary as part of any annuity or unitrust distribution from such a trust may be taxed in the hands of the beneficiary. The beneficiary must include as the beneficiary's own NII the lesser of total distributions for the year and the trust's current and accumulated NII. [68] If there are multiple beneficiaries, they are treated as receiving the trust's NII on a proportionate basis.

The proposed regulations provide that the income constituting NII is deemed treated as distributed to a beneficiary of a charitable remainder trust before other classes of income are. This may be complicated because distributions from such trusts for regular income tax purposes are treated as consisting first from the most highly taxed income classes before others are. [69]

The Preamble states that the IRS considered a different ordering trust for classes of income that would be deemed distributed so that income subject to the same federal rate of income tax and that consists in part of NII and part that is not NII but decided not to adopt it as it would create significant record keeping problems for trustees of charitable remainder trusts.

Conclusion

The NIIT rules applicable to estates and trusts are complex, to say the least. It is incumbent on fiduciaries to analyze the opportunities to reduce the overall tax burden on the estate or trust and the beneficiaries. The appropriateness of making distributions to reduce the overall tax burden needs to be considered, including whether such distributions reduce the transfer tax savings or asset protection benefits of keeping the assets in trust. The analysis would not be necessary if the property were not held in an estate or trust; therefore, the associated cost should be deductible.

1

Section 1401(b) imposes the Medicare tax on self-employment income. Section 1411(c)(6) provides that net investment income (NII) does not include income on which Section 1401(b) imposes tax.

2

xhibit

As is discussed in more detail later in this article, the tax can never be imposed on more than a taxpayer's net investment income (NII). The reason is that, even if the taxpayer's AGI is substantially greater than the taxpayer's NII, the Medicare tax is imposed on the lesser of (1) the taxpayer's (modified) AGI, to the extent it exceeds the applicable threshold, and (2) the taxpayer's NII. Hence, the name "net investment income tax" seems appropriate to use.

3

The proposed regulations contain special rules for the application of the NIIT for bona fide residents of U.S. territories. See Prop. Reg. 1.1411-2(a)(iv).

4

This seems to refer to income derived from a nonqualified annuity. Qualified annuities are those purchased as a part of an employer provided retirement plan or an individual retirement arrangement. The taxation of payments from an annuity is set forth in Section 72. The portion included in gross income from a nonqualified annuity is considered NII for purposes of Section 1411 unless derived in the ordinary course of a trade or business that is not subject to the tax. The Preamble to the proposed regulations states, "Gain or loss from the sale of an annuity would be treated as net investment income for purposes of section 1411. To the extent the sales price of the annuity does not exceed its surrender value, the gain recognized would be treated as gross income described in section 1411(c)(1)(A)(i) and proposed §1.1411-4(a)(1)(i). If the sales price of the annuity exceeds its surrender value, the seller would treat the gain equal to the difference between the basis in the annuity and the surrender value as gross income described in section 1411(c)(1)(A)(i) and proposed §1.1411-4(a)(1)(i), and would treat the excess of the sales price over the surrender value as gain from the disposition of property under section 1411(c)(1)(A)(iii) and proposed §1.1411-4(a)(1)(iii)." Cf. Rev. Rul. 2009-13, 2009-21 IRB 1029, and Rev. Rul. 2009-14, 2009-21 IRB 1031. As discussed below, special rules apply to annuity payments from a charitable remainder trust defined in Section 664.

5

Trade or business is more broadly defined for purposes of Section 469 (dealing with passive losses) than it is for purposes of Section 1411 where it is limited to a trade or business within the meaning of Section 162. Hence, for purposes of the NIIT, it does not include, for example, "any activity involving research or experimentation" within the meaning of Section 174 which constitutes a trade or business for purposes of Section 469. See Section 469(c)(5).

6

An activity is passive under Section 469 if the taxpayer does not “materially participate” in it or it is from a rental activity, whether or not the taxpayer materially participates, unless the taxpayer is a real estate professional.

7

Section 1411 does not define “working capital.” The proposed regulations provide a guide to determine its meaning. See Prop. Reg. 1.1411-6.

8

However, income that is not included in gross income (e.g., interest on municipal bonds described in Section 103) is not subject to the tax even if generated by the investment of working capital.

9

Income with respect to investments in foreign corporations generally is included in the calculation of NII for Section 1411 purposes. Specifically, dividends and gains derived with respect to the stock of a controlled foreign corporation or CFC (within the meaning of Section 957(a)) or a passive foreign investment company or PFIC (within the meaning of Section 1297(a)) are taken into account in computing NII. See Prop. Reg. 1.1411-2(c). Additional rules in Prop. Reg. 1.1411-10 apply to an estate or trust that holds an interest in a CFC or a PFIC.

10

REG-130507-11, 12/5/2012.

11

See Section 1411(c)(3).

12

This article does not deal with bankrupt estates. See Prop. Reg. 1.1411-2(a)(iii).

13

This includes sales by qualified Subchapter S trusts, foreign estates with U.S. beneficiaries, and foreign trusts with U.S. beneficiaries. See, respectively, Prop. Reg. 1.1411-7(b)(2), Prop. Reg. 1.1411-3(d)(2) and Prop. Reg. 1.1441-3(c)(3).

14

Section 641(b). Note that many of the special rules for individuals are not relevant to estates and trusts. For example, NII of an individual may include the NII of his or her child to the extent the parent elects pursuant to Section 1(g)(7) to report certain of his or her child's income on the parent's income tax return. See IRS Form 8814. Such income above the “threshold amount” and other than the child's Alaska Permanent Fund Dividends is included in the parent's NII for purposes of Section 1411.

15

Although U.S. income tax is imposed on a nonresident alien on certain U.S. income (such as dividends paid by a U.S. corporation), no NIIT is imposed on a nonresident alien.

16

Section 1411(e). Section 170(c)(2)(B) relates to charitable contributions to entities “(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.” Section 170(c)(2)(B). It would, therefore, not apply to other “charitable” purposes, such as a state, a possession of the U.S., or any political subdivision of any of the foregoing, or the U.S. or the District of Columbia for exclusively public purposes as described in Section 170(c)(1).

17

See Section 664. Unrelated business taxable income received by a charitable remainder trust is subjected, under Section 664(c)(2) to an excise tax, not an income tax.

18

Apparently, the tax also does not apply to certain trusts that are not taxed as trusts are under the Code. Hence, it seems the tax is not imposed on real estate investment trusts described in Section 856 and common trust funds described in Section 584. The tax is not imposed on a trust to the extent deemed owned by another (i.e., a grantor trust) under subpart E of part 1 of Subchapter J of Chapter 1 of the Code because the income of the trust is attributed directly to the owner for income tax purposes and to that extent may be subject to NIIT. Prop. Reg. 1.1411-3(b)(5); cf. Rev. Rul. 85-13, 1985-1 CB 184. Moreover, trusts that are regarded as business entities under Reg. 301.7701-4(b) are not, it seems, subject to the Medicare tax.

19

It does not seem that these thresholds are adjusted for inflation or otherwise (except the threshold for trusts and estates). They are prorated for short tax years, such as the year of death of an individual. Prop. Reg. 1.1411-2(d)(2).

20

Because neither an estate nor a trust can have excludable income pursuant to Section 961(a), no “modification” of its AGI need be made.

21

The IRS released the tax rates and brackets for 2013 in Rev. Proc. 2013-15, 2013-5 IRB 444. Note that the threshold for an estate or trust is not prorated for any “short” tax year. See Prop. Reg. 1.1411-3(a)(1)(ii).

22

One way an estate or trust may not have NII subject to the tax is if it is distributed or deemed distributed to a beneficiary under Sections 651 and 652 or to charity in a manner qualifying for the deduction under Section 642(c). Of course, the amounts distributed to a noncharitable beneficiary may be subject to the tax in the "hands" of the beneficiary, including an estate or trust that is itself a beneficiary.

23

See Keebler, "Understanding the 3.8% Medicare Surtax," LISI Income Tax Planning Newsletter #28, (7/30/2012) at http://www.leimbergservices.com ("[A]ssuming a taxpayer is subject to the surtax in the first place, reducing NII will always reduce the amount of surtax payable dollar for dollar. The reason is that any reduction in NII also reduces [modified AGI].")

24

Distributions that are deductible under Section 651 or 661 are limited to the taxable distributable net income (DNI) of the estate or trust for the year. DNI is defined in Section 643(a). Capital gain income allocable to the corpus of the estate or trust, unlike most other income, may not be included in DNI; income that does not form part of DNI cannot be treated as distributed to a beneficiary and cannot, therefore, reduce NII if that income was part of NII. For ways in which capital gain can be made part of DNI, see Blattmachr and Gans, "The Final 'Income' Regulations: Their Meaning and Importance," Tax Notes, p. 891, 5/17/2004. Capital gain paid or permanently set aside for charity for which a deduction is permitted under Section 642(c) also may reduce the amount of NII that may be subject to tax in the hands of the estate or trust. Note, that as a technical matter, distributions qualifying for deduction pursuant to Section 651, 661, or 642(c) do not reduce NII but rather reduce undistributed NII. Hence, the general rule that any reduction of NII (as opposed to undistributed NII) also reduces AGI remains valid even for an estate or trust.

25

Even if the taxpayer has considerable NII for the year, no NIIT may be imposed because the taxpayer's (modified) AGI does not exceed the dollar threshold. On the other hand, no threshold applies for determining the amount of NII that may be subject to the tax.

26

Section 62 defines AGI as gross income (defined in Section 61) reduced by certain deductions described therein.

27

The trust's AGI may exceed its NII for many reasons, including that it has trade or business income that is not treated as NII.

28

101 AFTR 2d 2008-544, 552 US 181, 169 L Ed 2d 652, 2008-1 USTC ¶50132 (2008).

29

See, e.g., Prop. Reg. 1.67-4, REG-128224-06, 9/6/2011.

30

Reg. 1.212-1(i).

31

Although administration expenses may reduce the AGI of an estate or trust, they may not reduce NII. On the other hand, as stated, distributions deductible under Section 642(c) reduce its NII but not its AGI. Also, NII is reduced by expenses properly allocable to NII.

32

Alimony, Social Security payments, and Alaska Permanent Fund dividends do not appear to be within the category of net investment income or from a passive trade or business activity and, therefore, are not in NII. As to Alaska Permanent Fund dividends treatment, see Rev. Rul. 90-56, 1990-2 CB 102. However, these types of income will be included in AGI (except to the extent, for an estate or trust, such income is less than the personal exemption allowed under Section 642(b) or is deemed distributed to a beneficiary entitling the estate or trust to a deduction under Section 651(a) or 661(a)). As indicated above, NII paid (or permanently set aside for an estate and certain trusts) to charity for which a deduction is allowed under Section 642(c) does not reduce AGI.

33

91 AFTR 2d 2003-1946, 2003-1 USTC ¶50418, 256 F Supp 2d 536 (DC Tex., 2003).

34

See, generally, Gans, "Deference and the End of Tax Practice," 36 Real Prop. Prob & Tr J. 731 (2002), on how regulations may even override a decision of the Supreme Court on tax issues.

35

In many states, the person who administers a decedent's estate is no longer called an executor or administrator but rather a personal representative.

36

As pointed out in note 5, *supra*, the meaning of a passive activity is broader for purposes of Section 1411 than it is for Section 469.

37

See, e.g., Prop. Reg. 1.1411-7.

38

See, generally, Choate, *Life and Death Planning for Retirement Benefits,* 6th Ed. (Ataxplan Publication, 2006), at 2.4.06 for a discussion of when a distributions may be treated as long-term capital gain.

39

Specifically, income from a plan or arrangement described in Section 401(a), 403(a), 403(b), 408, 408A, or 457(b) is not NII but may be in AGI. See Section 1411(c)(5). NII also does not include any item taken into account in determining self-employment income for a tax year on which a tax is imposed by Section 1401(b).

40

Section 1411(c)(1)(B).

41

See, e.g., Reg. 1.199-4(a). The phrase is even used under Chinese law. See http://www.websaru.com/allocable.html.

42

Prop. Reg. 1.1411-4(f)(2). The requirement of a reasonable method allocation seems to be required only for certain taxes (e.g., state income taxes) and not all expenses.

43

Under Section 68, certain itemized deductions are disallowed to the extent of the lesser of 80% of such deduction amount and 3% of the taxpayer's AGI above an “applicable amount.” The applicable amount was $100,000 (or $50,000 for a married person filing separately), adjusted for inflation since 1990 (e.g., $166,800 for 2009 for individuals other than those married filing separately). The limitation did not apply for 2010, 2011, or 2012 but is back in effect for years thereafter. The “thresholds” for 2013 are $300,000 for joint return filers, $275,000 for heads of households, $250,000 for singles, and $150,000 for married persons filing separately.

44

Section 68(e).

45

See Reg. 1.652(b)-3. Cf. Reg. 1.662(c)-4(e) indicating a similar rule for decedents' estates and “complex” trusts.

46

Under Section 469, a taxpayer may not currently deduct losses from the operation of a trade or business that is “passive” with respect to the taxpayer. A trade or business is regarded as passive unless the taxpayer is regarded as being active in the business. The regulations under Section 469 set forth the tests to determine whether the taxpayer is active.

47

See Prop. Reg. 1.1411-4(b)(3), Example 2.

48

Cf. Rev. Rul. 2006-26, 2006-1 CB 939, modifying and superseding Rev. Rul. 2002-2, 2000-1 CB 305, in which the IRS notes the under the Uniform Principal and Income Act, adopted by several states, if no part of a payment from an IRA is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be distributed currently to the beneficiary, the trustee must allocate 10% of the minimum required distribution payment from the IRA to accounting income and the balance to principal with respect to a trust described in Section 2056(b)(7) that qualifies thereupon for the estate marital deduction and is required annually to pay its accounting income to the surviving spouse.

49

Subject to other exceptions not applicable to the facts of the Example, only certain capital gain is the category of income excluded from the definition of DNI under Section 643(a). In a few “grandfathered” circumstances, distributions from a qualified plan may be treated as capital gain. See, generally, Choate, supra note 38.

50

The fact that the Example provides that the trust's deduction is allowed under Section 661 rather than 651 suggests it is not a mandatory distribution to the beneficiary but a discretionary one.

51

As mentioned earlier, there is no suggestion in the Example that any portion of the IRA distribution is deemed to be comprised of capital gain. In fact, the Example indicates it is all ordinary income. It speaks at least in part, of “ordinary income attributable to the individual retirement account.”

52

Under Section 642(c), in the case of an estate or trust, there is allowed as a deduction in computing its taxable income, any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the tax year, paid for a charitable purpose specified in Section 170(c).

53

The Example does not indicate whether the distribution to charity is payable from fiduciary account income or not. That can be important under the so-called “tier” system under which amounts of fiduciary account income required to be distributed currently (which are known as “first tier” distributions) “absorb” the DNI first. “For purposes of the limitation on taxability of the first tier, the trust's charitable deduction for income tax purposes may not be taken into account in computing distributable net income. Section 662(a)(1). (Even when deductible charitable distributions are paid out of trust accounting income, trust-accounting income (required to be distributed currently) may exceed distributable net income and therefore the limitation imposed by distributable net income may be important.) In effect, therefore, charitable distributions are in a middle category: available

income is first treated as going to first-tier beneficiaries; then, to the extent that income has actually been distributed to charity, there is a charitable deduction; and thereafter only the residue of income is taxed to the second-tier beneficiaries." Boyle and Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (PLI 15th Ed. 2012) at 3-118.

54

Section 1411(c)(1)(B).

55

Section 67(e)(1).

56

Special allocation of expenses rules are contained in Reg. 1.664-1(d)(2) for charitable remainder trusts.

57

Prop. Reg. 1.67-4 would require certain expenses to be "unbundled" to determine which part is deductible in computing the AGI of an estate or trust under Section 67(e) and which part is not. Perhaps, such a system will be developed to allocate certain expenses between NII and other income. Unfortunately, the Examples in the proposed regulations under Section 1411 do not discuss expenses. Furthermore, Example 3 of Prop. Reg. 1.1411-3(f) does not seem to provide for the trustee's commission to be unbundled for purposes of computing the trust's NII.

58

Regs. 1.652(b)-1 and 1.662(b)-1.

59

Section 663(b). That provision applies only by election and only to the extent the distribution, together with distributions already made during the year, does not exceed the lesser of the fiduciary accounting income or DNI of the trust for the year. In certain circumstances, the NII of the trust may exceed its fiduciary accounting income and its DNI, such as where capital gain is allocated to corpus and is not treated as distributed to a beneficiary under the DNI rules.

60

Section 1411(e). Section 170(c)(2)(B) relates to charitable contributions to entities "(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals." It would, therefore, not apply to other "charitable" purposes, such as contributions to a state, a possession of the U.S., or any political subdivision of any of the foregoing, or the U.S. or the District of Columbia for exclusively public purposes as described in Section 170(c)(1). Note that the tax does not apply to any trust that is exempt from income tax

pursuant to Section 501. Prop. Reg. 1.1411-3(b)(2).

61

It is beyond the scope of this article to discuss the matter in detail, but the deduction under Section 642(c) is permitted when the distribution is for a charitable purpose, which might not include an income tax exempt charity. In any case, it seems that no part of a distribution of NII could be considered unrelated business taxable income within the meaning of Section 512(a). See, generally, Blattmachr, “Something Pretty Scary: Application of Certain Private Foundation and UBTI Rules in Estate Planning and Administration” The Twenty Sixth Annual Philip E. Heckerling Institute on Estate Planning (1992).

62

Prop. Reg. 1.1411-3(b)(6) and Prop. Reg. 1.1441-3(c)(3).

63

However, as stated in the quoted material above from Boyle, *supra* note 53, it may not reduce the NII allocated to a noncharitable beneficiary of an estate or trust to the extent the beneficiary is entitled to a current distribution of fiduciary accounting income.

64

Section 642(c)(5).

65

In the proposed regulations, the IRS requests comments about the application of Section 1411 to pooled income funds described in Section 642(c)(5), cemetery perpetual care funds described in Section 642(i), and qualified funeral trusts described in Section 685. Similarly, Section 1411 applies to certain Alaska Native settlement trusts described in Section 646.

66

The Preamble to the proposed regulations states, in part, “[T]he share of net investment income allocated to the section 642(c) deduction of the estate or trust in accordance with §1.642(c)-2(b).” Reg. 1.642(c)-2(b) deals with deductions for only trusts (and covers set aside deductions for some “pre-1969” trusts), not estates, which Reg. 1.642(c)-2(a) covers. However, the proposed regulations themselves suggest that an estate set aside deduction under Section 642(c) does exempt the NII from tax. Prop. Reg. 1.1411-3(e)(4) states in part, “Deduction for amounts paid *or permanently set aside* for a charitable purpose. In computing the estate's or trust's undistributed net investment income, the estate or trust shall be allowed a deduction for amounts of net investment income that are allocated to amounts allowable under section 642(c). In the case of an estate or trust that has items of income consisting of both net investment income and excluded income (as defined in paragraph (e)(5) of this section), the allowable deduction under this paragraph (e)(4) must be allocated between net investment income and … income (that is not subject to NIIT) in accordance with §1.642(c)-2(b) as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. For an

estate or trust with deductions under both sections 642(c) and 661, see §1.662(b)-2 and Example 2 in paragraph (f) of this section." (Emphasis added.) Hence, it is not clear why the proposed regulations do not exempt NII of a pooled income fund set aside for charity and for which a Section 642(c) deduction is allowed.

67

See Prop. Reg. 1.1411-3(f), Example 3.

68

Prop. Reg. 1.1411-3(c)(2). Note that NII would include only such income received after 2012.

69

See Reg. 1.664-1(d). If distributions are made to a charitable organization, the order of the "make-up" of the income deemed distributed is reversed. Reg. 1.664-1(e).

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