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Via Electronic and Postal Mail

Internal Revenue Service
CC:PA:LPD:PR (REG-130507-11), Room 5203
PO Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Net Investment Income Tax; REG–130507–11; 77 Federal Register 72612 (December 5, 2012).

Dear Sir or Madam:

The American Bankers Association[1] (ABA) appreciates this opportunity to comment on the proposed guidance under section 1411 of the Internal Revenue Code (Code) pursuant to the Health Care and Education Reconciliation Act of 2010. Section 1411 imposes a 3.8 percent tax on the net investment income (NII) of certain individuals, estates, and trusts. Although commonly referred to as the Medicare Tax, the revenue collected under section 1411 is not designated for the Medicare Trust Fund, but will be added to general government revenues.

ABA represents banks, savings associations, and trust companies (collectively referred to as banks) that engage in trust and fiduciary services as well as provide tax preparation services for third-party trustees and individuals. In these capacities, our member institutions will be required to calculate and remit the NII tax imposed on their trust, estate, and individual clients. We understand the great complexity of this new tax and appreciate the work put into the drafting of these regulations. In keeping with that effort we have identified a number of areas where additional guidance or clarity is needed to facilitate compliance with the new requirements.

Section 212 Expenses

The proposed guidance generally allows properly allocable deductions to be taken into account when arriving at NII. With respect to trusts and estates, the proposal does not provide any special rules and simply states: "Generally, an estate's or trust's net investment income (as defined in §1.1411-4) is calculated in the same manner as that of an individual."[2]

[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees.

[2] Proposed §1.1411-3(e)(1).

The proposal defines NII to mean the excess (if any) of investment income over "the deductions allowed by subtitle A that are properly allocable to such gross income or net gain (as determined in paragraph (f) of this section)."[3] Subtitle A includes section 212 expenses, such as fiduciary fees, legal fees, and other administration expenses, that are commonly incurred by trusts and estates. However, proposed paragraph (f) does not explicitly include section 212 expenses in its list of allowable expenses for purposes of the NII Tax. We believe it is reasonable and appropriate to allow section 212 expenses to be deductible under Section 1411 to the extent they are allocable to investment income under the rules of Subchapter J. In other words, where section 212 expenses are deducted by the trust or estate in determining the trust's or estate's distributable net income (DNI), and are allocated to items of investment income included in DNI, these expenses should be deductible under Section 1411 in the same manner.

State and Local Income Taxes for Trusts and Estates

The proposed rule generally allows a deduction for state and local income taxes, subject to a required allocation, in arriving at NII. Due to some conflicts (described below), we urge the Department of the Treasury to modify this provision for trusts and estates so that it is consistent with rules in other parts of the Code.

The proposed regulations require that the state and local taxes paid by the taxpayer be allocated to both investment and non-investment income for NII purposes using any reasonable method. The proposed regulations further state that an allocation of the deduction based on the ratio of the amount of a taxpayer's investment income to the amount of the taxpayer's total gross income is an example of a reasonable method. However, for a trust or estate, this method of allocation creates a problem because the trust or estate deducts state and local taxes for DNI purposes in a different manner.

Subchapter J of the Code specifies the rules for allocating deductions to items of income. In these rules, deductions not directly attributable to a specific class of income may be allocated to any item of income included in DNI, as long as a reasonable proportion is allocated to tax-exempt income.[4] In almost every instance, the Subchapter J rules will result in a different allocation of the state and local tax deduction for DNI purposes than for NII purposes. This difference in allocation creates a problem because DNI will be used to determine the amount of NII that is allocable to a beneficiary.[5] In other words, the beneficiaries' NII will be based on one allocation of the state and local taxes (DNI allocation), while the trust's or estate's allocation of undistributed NII will be based on a different allocation of state and local taxes (NII allocation). To eliminate this conflict in allocation methods, for trusts or estates, the section 1411 guidance should follow the long-standing state and local tax allocation rules of Regulation § 1.652(b)-3(b),

[3] Proposed §1.1411-4(a)(2).

[4] Regulation § 1.652(b)-3(b).

[5] Proposed §1.1411-3(e)(3)(i).

so that to the extent the state and local taxes are deducted by the trust or estate in determining the trust's or estate's DNI and are allocated to items of investment income included in DNI, these expenses would be deductible under Section 1411 in the same manner.

Examples for Trusts and Estates

We respectfully request that the Department of the Treasury include, to the extent possible, more comprehensive examples in section §1.1411-3(f) in order to illustrate more fully how the provisions will apply to trusts and estates. In particular, we ask that these examples include trusts and estates with deductions relating to fiduciary fees, legal fees, or other administration expenses, as well as state and local income taxes and investment interest expenses.

Estimated Tax Penalties

Due to the likelihood that many taxpayers will not know whether they will incur NII tax during the year, we urge the Department of the Treasury to grant some penalty relief for failure to pay the appropriate estimated tax payments. By excluding the NII in the penalty calculations in Form 2210, much needed relief from a very complex and new tax can be granted.

Guidance Needed on Passive Activity Loss Rules for Trusts

As the proposal states, "Principles applied in determining the amount and timing of a deduction for purposes of Federal income taxation generally apply for purposes of determining a deduction under section 1411." Given this deference to the rules on deductibility in the Federal income tax regime, we urge the Department of the Treasury to clarify the treatment of passive activity losses within trusts under section 469.[6] Section 469 provides the passive activity loss rules for persons such as trusts, requiring that the taxpayer "materially participate" in the activity that incurred a loss in order to recognize the loss during the taxable year. By its very nature, the trust may only materially participate through the trustee or, in the case of a bank trustee, the trustee's employees.

ABA urges the IRS to allow employees of a trust (through the trustee and the trustee's employees) to be taken into account in determining whether the trust materially participated in the trade or business at issue. Such guidance would be particularly useful and fair to bank trustees that can only act through their employees and furthermore allow the trust to recognize properly losses for purposes of determining the NII.

[6] In 2007, the IRS issued Technical Advice Memorandum 200733023, which allows a trust to recognize losses only if "the fiduciaries of the trust participate in the operations of the activity on a basis which is regular, continuous, and substantial." Unfortunately, the TAM conflicts with the only judicial interpretation of section 469 as it applies to trusts, Mattie K. Carter Trust v. United States, 256 F.Supp.2d 536 (N.D. Tex. 2003). This court decision specifically allows such losses for trusts that engage in the activity through the trustee's employees.

Conclusion
ABA appreciates this opportunity to provide comments on the new NII tax. We understand the complexity of creating a whole new tax base. However, with the comments suggested here, the tax can become incrementally less complex while still supporting the intentions of Congress.

Sincerely,

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