SECTION OF TAXATION
State Bar of Texas

May 31, 2013

CC:PA:LPD:PR (REG-130507-11)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20044

Re: Comments of the State Bar of Texas, Tax Section on Proposed Regulations Regarding Net Investment Income Tax under Section 1411 of the Internal Revenue Code

Dear Ladies and Gentlemen:

On December 5, 2012, the Department of Treasury and the Internal Revenue Service published proposed Treasury regulations under section 1411 of the Internal Revenue Code and requested comments on the proposed rules. On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the following comments on the proposed procedures.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP

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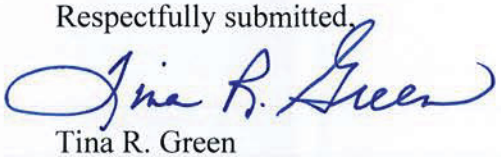
OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We appreciate being extended the opportunity to participate in this process.

Respectfully submitted,



Tina R. Green
Chair, Section of Taxation
The State Bar of Texas

RESPONSE TO REQUEST FOR COMMENTS ON PROPOSED REGULATIONS ISSUED TO PROVIDE GUIDANCE UNDER SECTION 1411 OF THE INTERNAL REVENUE CODE (IRS REG-13057-11)

This response to the request for comments with respect to proposed Treasury regulations issued under section 1411 of the Internal Revenue Code is presented on behalf of the Section of Taxation of the State Bar of Texas.

This response is a joint project between the Corporate Tax Committee and the Partnership and Real Estate Tax Committee of the State Bar of Texas Section of Taxation. The Chairs of those committees are Jeffry Blair and Daniel Baucum, respectively. Principal responsibility for drafting the S corporation comments was exercised by Jeffry Blair, David Peck and Sam Merrill; and principal responsibility for drafting the partnership comments was exercised by Jack Howell, Bryan Jepson, Steve Phillips, Tara Aevermann Potts and Daniel Baucum. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. David Wheat, past Chair of the Section of Taxation of the State Bar of Texas, reviewed the comments and made substantive suggestions on behalf of COGS. Stephanie Schroepfer, the Chair of COGS, also reviewed the comments on behalf of COGS.

Although members of the Section of Taxation who participated in preparing, reviewing and approving these Comments have clients who would be affected by the federal tax law principles addressed by these Comments and have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 31, 2013

For tax years beginning January 1, 2013, section 1411[1] of the Internal Revenue Code imposes a 3.8% tax on certain income of individuals, estates, and trusts. The Department of Treasury (the *"Treasury"*) and the Internal Revenue Service (the *"Service"*) have recognized the need for guidance in the interpretation of this section and the calculation of the tax imposed thereby. The intention of these Comments is to address specifically certain issues under the proposed Treasury regulations with respect to (i) the limitation under section 1411(c)(4) on the amount of gain or loss included as net investment income upon the disposition of an interest in a partnership or an S corporation and (ii) the application of the proposed regulations regarding net investment income tax under section 1411 to self-charged rental income.

I. Limitation on the amount of gain or loss included as net investment income upon the disposition of an interest in a partnership or an S corporation under section 1411(c)(4)

A. Executive Summary

We respectfully recommend that section 1.1411-7 of the proposed regulations be modified to provide that upon a transferor's disposition of an interest in a partnership or S corporation:

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[1] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the *"Code"*), unless otherwise indicated.

- the transferor's net gain under section 1411(c)(1)(A)(iii) will equal the lesser of (1) the amount of gain recognized by the transferor upon the disposition of the interest or (2) the amount of net gain that would have been allocable to the transferor if the partnership or S corporation had sold all of its assets in a taxable transaction for fair market value; and

- the transferor's net loss under section 1411(c)(1)(A)(iii) will equal the lesser of (1) the amount of loss recognized by the transferor upon the disposition of the interest or (2) the amount of net loss that would have been allocable to the transferor if the partnership or S corporation had sold all of its assets in a taxable transaction for fair market value.

We believe that modifying section 1.1411-7 of the proposed regulations as described above is more consistent with the language and legislative history of section 1411(c)(4).

B. Background

In general, the term "net investment income" includes the net gain attributable to the disposition of property except for property held in an active trade or business (i.e., a trade or business other than a trade or business described in section 1411(c)(2)).[2] Section 1411(c)(4) provides that in the case of a disposition of an interest in a partnership or S corporation, gain from such disposition shall be taken into account as net gain under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest. Section 1411(c)(4)(B) states that a similar rule applies with respect to losses from dispositions.

Section 1.1411-7 of the proposed regulations provides that in calculating the amount of net gain, a transferor must include as net investment income upon the disposition of an interest in a partnership or S corporation the actual gain or loss recognized by the transferor as adjusted in accordance with the proposed regulations. This amount is determined under section 1.1411-7(c) of the proposed regulations as follows:

- First, the partnership or S corporation is deemed to dispose of all of its properties for fair market value in a fully taxable transaction.

- Second, the partnership or S corporation determines the amount of gain or loss attributable to each property.

- Third, the partnership or S corporation determines the amount of gain or loss allocable to the transferor's interest. For purposes of this calculation, the transferor of a partnership interest must take into account partnership allocations under sections 704(b) and 704(c), and basis adjustments under section 743. The transferor of stock in an S corporation, however, would not take into account any reduction in that shareholder's distributive share resulting from a deemed built-in gains tax under section 1374.

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[2] *See* Section 1411(c)(1)(A)(iii).

- Finally, the partnership or S corporation determines the amount of net gain or loss allocable to the transferor that is attributable to a trade or business not described in section 1.1411-5(a) of the proposed regulations (hereinafter, an "Active Business") and makes a negative adjustment (if there is a net gain attributable to an Active Business) or a positive adjustment (if there is a net loss attributable to an Active Business) to the amount of the transferor's gain. The transferor's gain or loss, after such adjustment, is the amount of net gain for purposes of section 1411(c)(1)(A)(iii).

C. Recommendation

We recommend that section 1.1411-7 of the proposed regulations be modified to provide that upon a transferor's disposition of an interest in a partnership or S corporation:

- the transferor's net gain under section 1411(c)(1)(A)(iii) will equal the lesser of (1) the amount of gain recognized by the transferor upon the disposition of the interest or (2) the amount of net gain that would have been allocable to the transferor if the partnership or S corporation had sold all of its assets in a taxable transaction for fair market value; and

- the transferor's net loss under section 1411(c)(1)(A)(iii) will the lesser of (1) the amount of loss recognized by the transferor upon the disposition of the interest or (2) the amount of net loss that would have been allocable to the transferor if the partnership or S corporation had sold all of its assets in a taxable transaction for fair market value.

As so modified, we believe that the proposed regulations would be more consistent with the intent of section 1411(c)(4), as evidenced by the text and legislative history of the statute.

D. Analysis / Explanation

Section 1.1411-4(d)(3)(ii)(B)(1) of the proposed regulations states that a partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock generally is net gain for purposes of section 1411(c)(1)(A)(iii). Under the proposed regulations, the gain or loss is then adjusted, as described above, by the amount of net gain or net loss that is attributable to an Active Business. In effect, the method in section 1.1411-7 of the proposed regulations results in the entire gain or loss from the disposition of an interest in a partnership or S corporation being treated as net investment income, except to the extent such gain or loss is attributable to an Active Business.

We respectfully submit that the methodology of section 1.1411-7 is inconsistent with the intent of section 1411(c)(4), as evidenced by the statute's plain language and legislative history. Section 1411(c)(4) states that upon a sale of a partnership interest or S corporation stock, gain from such sale shall be taken into account as net gain under section 1411(c)(1)(A)(iii) "only to

the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest." Similarly, the Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010" provides that "only net gain or loss attributable to property held by the entity which is not property attributable to an active trade or business is taken into account."[3] In our view, the text and legislative history of section 1411(c)(4) do not support the supposition that the sale of a partnership interest or S corporation stock generally is treated as the sale of an asset that gives rise to net gain. Instead, the statute and legislative history clearly indicate that the transferor's net gain must be limited to the amount of net gain that would be allocated to the transferor upon a taxable sale of the assets of the partnership or S corporation. Thus, we respectively propose that upon the sale of an interest in a partnership or S corporation, the transferor's net gain should be calculated as the lesser of (1) the amount of gain or loss recognized by the transferor upon the disposition of the interest or (2) the amount of net gain that would have been allocable to the transferor if the partnership or S corporation had sold all of its assets in a taxable transaction for fair market value.

In most cases, the approach contained in the Proposed Regulations and the approach we recommend would result in the transferor recognizing the same amount of net gain upon the sale of an interest in a partnership or S corporation. In particular, we believe that in each of the examples provided in Section 1.1411-7(e) of the Proposed Regulations, other than Example 2 (noted below), the amount of net gain recognized by the transferor would be the same regardless of which method applies.

In two situations, however, the approach we recommend produces a different result than the method contained in the Proposed Regulations. The first such situation involves those instances where there is an inside-outside basis disparity. This scenario may arise where the taxpayer purchases an interest in an S corporation for a price that is greater than or less than the taxpayer's share of the S corporation's inside basis. This scenario may also arise where the taxpayer purchases an interest in a partnership for a price that is greater than or less than the taxpayer's share of the partnership's inside basis and the inside basis of the partnership assets are not adjusted as a result of a Section 754 election or otherwise.[4]

For example, suppose that A and B each own 50% of the stock of S, a Subchapter S corporation. A and B each initially contributed $100 to S in exchange for stock, and S used the $200 to acquire an asset used in S's trade or business. After the value of S has declined to $100, A sells its 50% interest to Z in exchange for $50. Thereafter, the value of S increases to $200, and Z sells its 50% interest in S to Y for $100. At the time of the sale, S's asset has an adjusted basis of $200, and such asset is used in an Active Business with respect to Z.

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[3] Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10) (March 21, 2010), at 135; *see also* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS-2-11) (March 24, 2011), at 364.

[4] With respect to the purchase of a partnership interest, such inside-outside basis disparity will not exist for a transferor if the partnership elects (or is required) to adjust the basis of its assets under Section 743.

Z would recognize gain of $50 upon the sale of its stock in S. Under the Proposed Regulations, there can be no adjustment to Z's gain for purposes of calculating Z's net gain because there is no built-in gain or loss in S's asset. Accordingly, Z recognizes net gain of $50. The result reached by applying the Proposed Regulations is clearly inconsistent with Section 1411(c)(4)(A) because if S had sold all of its assets for fair market value, S would not have recognized any gain that could be allocated to Z. Moreover, all of S's assets are used in an Active Business with respect to Z. Thus, even if S recognized a gain upon a sale of its assets, none of that gain would constitute net gain for purposes of Section 1411(c)(1)(A)(iii).

The modification that we recommend would correct the problem illustrated by the above example. Under our recommended approach, Z's net gain would equal the lesser of (1) the gain recognized by Z upon the sale of its stock ($50) or (2) the amount of net gain that would have been allocable to Z if S had sold all of its assets in a taxable transaction for fair market value ($0). Thus, Z would not recognize any net gain upon the sale of its interest in S.[5] This result is appropriate because all of S's assets are attributable to an Active Business, and the sale of such assets was not intended to give rise to net investment income.[6]

A second scenario in which the method we recommend would differ from the Proposed Regulations is where a taxpayer sells a partnership interest or S corporation stock at a premium over asset value. For example, suppose that A owns a 50% interest in an S corporation (S) with an adjusted basis of $100. S owns a single asset with an adjusted basis and fair market value of $200, and S uses such asset in an Active Business with respect to A. A sells its stock in S for $150.

A would recognize gain of $50 upon the sale of its stock in S. Under the Proposed Regulations, there can be no adjustment to A's gain for purposes of calculating A's net gain because there is no built-in gain or loss in S's asset. Accordingly, A recognizes net gain of $50. The result reached by the Proposed Regulations is clearly inconsistent with Section 1411(c)(4)(A) because if S had sold all of its assets for fair market value, S would not have recognized any gain that could be allocated to A. Moreover, all of S's assets are used in an Active Business with respect to A. Thus, even if S recognized a gain upon a sale of its assets, none of that gain would constitute net gain for purposes of Section 1411(c)(1)(A)(iii).

The modification that we recommend would correct the problem illustrated by the example above. Under our recommended approach, A's net gain would equal the lesser of (1) the gain recognized by A upon the sale of its stock (i.e. a $50 gain) or (2) the amount of net gain that would have been allocable to A if S had sold all of its assets in a taxable transaction for fair market value (i.e. $0 gain). Thus, A would not recognize any net gain upon the sale of its interest in S. This result is appropriate because all of S's assets are attributable to an Active Business, and the sale of such assets was not intended to give rise to net investment income.[7]

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[5] Example 2 of Section 1.1411-7(e) of the Proposed Regulations contains a fact pattern similar to the example set forth above. We respectfully submit that the outcome in Example 2 should be that A has zero net gain with respect to the sale of stock for purposes of Proposed Regulation Section 1.1411-4(a)(1)(iii).

[6] *See* I.R.C. § 1411(c)(1)(A)(iii).

[7] *See* I.R.C. § 1411(c)(1)(A)(iii).

We recommend modifying the Proposed Regulations as described above in order to ensure that the Proposed Regulations are consistent with Section 1411(c)(4). The text and legislative history of Section 1411(c)(4) demonstrate a clear Congressional intent that gain from the sale of an interest in a partnership or S corporation will be treated as net gain only to the extent of the net gain that would have been taken into account if the partnership or S corporation sold all of its assets for fair market value. We believe that our proposed methodology will eliminate those situations where taxpayers recognize net gain that is attributable to an Active Business of a partnership or S corporation while ensuring that gain attributable to a passive trade or business is treated as net gain.

II. New safe harbor under Section 1.1411-4(d)(3)(ii)(C) for active trades or businesses with no working capital gain.

A. Executive Summary

We respectfully recommend that a new section 1.1411-4(d)(3)(ii)(C) be added to the proposed regulations to include the following safe harbor:

> (C) Safe harbor. Net gain described in paragraph (a)(1)(iii) of this section shall not include any gain from the disposition of stock in an S corporation or of an interest in a partnership if, regarding the S corporation or the partnership, the transferor is engaged only in trades or businesses that are not described in § 1.1411–5(a)(1) and there is no gross income from or net gain attributable to an investment in working capital (within the meaning of Section 469(e)(1)(B)) held by the S corporation or the partnership.

B. Background

In certain situations when stock in an S corporation or a partnership interest is sold, there is no need to apply Code section 1411(c)(4). The preamble to the proposed regulations states that

> the exception in section 1411(c)(4) does not apply where (1) there is no trade or business, (2) the trade or business is a passive activity (within the meaning of proposed §1.1411-5(a)(1)) with respect to the transferor, or (3) where the partnership or the S corporation is in the trade or business of trading in financial instruments or commodities (within the meaning of proposed §1.1411-5(a)(2)), because in these cases there would be no change in the amount of net gain determined under proposed §1.1411-4(a)(1)(iii) upon an asset sale under section 1411(c)(4).[8]

[8] Net Investment Income Tax, 77 Fed. Reg. 72626 (proposed Dec. 5, 2012) (to be codified at 26 C.F.R. pt. 1411) (citing Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS–2–11) (March 24, 2011), at 364, fn. 976 (and accompanying text)).

Using the drafters' logic as outlined in the preamble, the proposed safe harbor exempts a transferor of S corporation stock or partnership interests from the provisions of section 1.1411-4(a)(1)(iii) if (i) the transferor of the S corporation stock or the partnership interest is engaged only in trades or businesses that are not described in section 1.1411-5(a)(1) and (ii) there is no gross income or net gain attributable to an investment in working capital.

C. Recommendation

We respectfully recommend that a new section 1.1411-4(d)(3)(ii)(C) be added to the proposed regulations:

> (C) Safe harbor. Net gain described in paragraph (a)(1)(iii) of this section shall not include any gain from the disposition of stock in an S corporation or of an interest in a partnership if, regarding the S corporation or the partnership, the transferor is engaged only in trades or businesses that are not described in § 1.1411–5(a)(1) and there is no gross income from or net gain attributable to an investment in working capital (within the meaning of Section 469(e)(1)(B)) held by the S corporation or the partnership.

We respectfully believe that the proposed safe harbor is consistent with congressional intent and would lessen the burden on taxpayers and the IRS.

D. Analysis / Explanation

Under the terms of the safe harbor, there would be no change in the character of any net gain determined to exist in a sale of stock in an S corporation or of an interest in a partnership. The reasoning behind the safe harbor tracks the reasoning underpinning proposed section 1.1411-4(a)(1)(iii). Under section 1.1411-4(a)(1)(iii) there is no change in the character of any net gain in a deemed asset sale under section 1411(c)(4) if the trade or business is a passive activity with respect to the transferor.[9] Consequently, it is consistent with the current provisions to have a presumption of no change in the character of net gain where (i) the transferor of the S corporation stock or the partnership interest is engaged only in trades or businesses that are not described in section 1.1411-5(a)(1) and (ii) there is no gross income or net gain attributable to an investment in working capital, just like the situations where (i) there is no trade or business, (ii) the trade or business is a passive activity (within the meaning of proposed section 1.1411-5(a)(1)) with respect to the transferor, or (iii) the partnership or the S corporation is in the trade or business of trading in financial instruments or commodities (within the meaning of proposed section 1.1411-5(a)(2)).[10]

The proposed safe harbor eases the burden on both taxpayers and the IRS without reducing tax revenue. The proposed safe harbor will prevent taxpayers from having to make the computation provided in section 1.1411-7 in situations where that computation cannot change

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[9] *See id.*
[10] *See id.*

the character of the net gain recognized on the disposition of stock in an S corporation or of an interest in a partnership. However, the safe harbor will not reduce tax revenue under section 1411 since the applicable net gain is not currently subject to the section 1411 tax.

III. Potential application of the § 1411 tax to self-charged rental.

A. Executive Summary

We respectfully recommend that the proposed regulations be modified to provide that net rental income received by a taxpayer from a lessee that is engaged in a trade or business in which the taxpayer materially participates be excluded from the definition of net investment income. We believe that the proposed regulations unfairly target and subject to Section 1411 a common and sound structuring technique used by taxpayers otherwise involved in trades or businesses in which they actively participate.

B. Background

Section 1.1411-4(a) of the Proposed Regulations defines net investment income, in part, as the gross income from rents, over deductions allocable to such rental income. There is an exception for net rental income earned in a trade or business that is a non-passive activity.

Frequently taxpayers who own real estate that is used in the taxpayer's active trade or business hold the real estate in a separate pass-through entity and rent the property to the active entity. This leasing structure is put in place for many non-tax business reasons, including financing and asset protection purposes. The drafters of the passive activity regulations contemplated this leasing structure and provided specific rules to prevent a taxpayer from artificially creating passive income through related party rentals. Particularly, section 1.469-2(f)(6) of the Treasury Regulations treats the net rental income received by a taxpayer from a lessee which is a trade or business in which the taxpayer materially participates as non-passive.[11]

Similar to self-charged rental income, the passive activity rules recharacterize self-charged interest income. The rules specifically allow self-charged interest income to be recharacterized from portfolio income to passive activity income in order to allow the taxpayer to offset the interest expense arising from a passive activity against the interest income.[12] Similar to the matching of income and expenses addressed in section 1.469-2(f)(6), section 1.469-7 also ensures that the expenses and income are properly matched under the passive activity rules.

C. Recommendation

We respectfully recommend that the proposed regulations be modified to provide that net rental income received by a taxpayer from a lessee that is engaged in a trade or business in which the taxpayer materially participates be excluded from the definition of net investment income. As

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[11] Rental activities are per se passive activities under section 469, subject to certain rules that overcome this presumption in narrow circumstances.

[12] Treas. Reg. § 1.469-7.

modified, the proposed regulations would be more consistent with the passive activity rules and would avoid unnecessary taxpayer restructuring efforts.

D. Analysis / Explanation

Under the proposed section 1411 regulations, the described self-rental structure will cause rental income received by a related party to be subject to the section 1411 tax. The section 1411 tax arises because the activities of the entity owning the real estate and leasing the property may not satisfy the material participation standard. If the real estate were owned by precisely the same entity as the lessee no rent would change hands for tax purposes and the taxpayer would be in exactly the same economic position, but without the effects of the section 1411 tax.

While we agree with the overall approach taken by the drafters of the proposed section 1411 regulations in paralleling the section 469 regulations, we believe that the self-charged rule should be applied to the definition of net investment income. That is, income determined to be non-passive pursuant to section 1.469-2(f)(6) of the Treasury Regulations should not be considered to be net investment income.

There are a number of ways to apply the self-charged rule in the proposed regulations. The definition of net investment income in section 1.1411-4(c)(1) could exclude income described in section 1.469-2(f)(6). Alternatively, the activity could be deemed to be a non-passive trade or business activity. Specifically, section 1.1411-5(b) could exclude from the definition of "passive activity" those activities referred to in section 1.469-2(f)(6). If the IRS believes it is bound by the trade or business requirement of Code section 1411(c)(2), then it may find a solution through application of the "properly allocable expense" precept found under section 1411. That is, the rental expense incurred by the related lessee entity can and should be deemed to be a properly allocable expense against the rental income earned by the related lessor entity – at least in those same circumstances where 1.469-2(f)(6) would apply.

Ultimately, if section 1411 is not modified and continues to target taxpayers who hold real estate in a related entity and lease the property to an active entity, it is likely that little to no additional tax would be collected because these taxpayers will either collapse the two entities into one or reduce the amount of rent paid between the entities.