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September 29, 2010

The Honorable Max Baucus,
Chairman
Committee on Finance
US Senate
Washington, DC 20510

The Honorable Charles E. Grassley,
Ranking Minority Member
Committee on Finance
US Senate
Washington, D.C. 20510

The Honorable Sander E. Levin,
Chairman
Committee on Ways and Means
US House of Representatives
Washington, DC 20515

The Honorable Dave Camp
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1111 Constitution Avenue, NW
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The Honorable William J. Wilkins
Chief Counsel
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The Honorable Michael Mundaca
Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: Medicare Contribution Tax Definition of Net Investment Income

Dear Sirs:

We write for clarification of the meaning of "net investment income" and "undistributed net investment income" for purposes of the unearned income Medicare contribution tax and for clarification regarding the application of the unearned income Medicare contribution tax to

foreign estates and trusts.[1] The unearned income Medicare contribution tax was enacted as Section 1411 of the Internal Revenue Code of 1986, as amended,[2] as part of the Health Care and Education Reconciliation Act of 2010 (P.L. 11-152). Under Section 1411(a), beginning in 2013, certain individuals will be required to a pay a 3.8% tax on "net investment income" for the taxable year, and certain trusts and estates will be required to pay the 3.8% tax on "undistributed net investment income" for the taxable year.[3]

Under Section 1411(c), "net investment income" means (a) 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 neither a passive activity with respect to the taxpayer nor a trade or business of trading in financial instruments or commodities, (2) other gross income derived from a trade or business that is a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities, and (3) net gain attributable to the disposition of property, other than property held in a trade or business that is neither a passive activity with respect to the taxpayer nor a trade or business of trading in financial instruments or commodities,[4] over (b) allowable deductions properly allocable to such gross income or net gain.

There are some types of income derived from investment activities that are not expressly described in the definition of "net investment income", and it is unclear whether they are included. In other cases, certain types of income derived from investment activities do not appear to be included in this definition, but there are no apparent tax policy reasons to exclude them. The legislative history on the unearned income Medicare contribution tax does not provide any guidance on the treatment of these types of income. If the intent of Congress was to impose the unearned income Medicare contribution tax on these types of income, in some cases,

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[1] This letter may be cited as New York State Bar Association Tax Section, *Medicare Contribution Tax Definition of Net Investment Income* (Report No. 1221, September 29, 2010). The principal drafters of this letter were Lisa A. Levy, Amy Heller and Jeffrey N. Schwartz, with substantial contributions from Amanda Padgett and David S. Miller, and helpful comments from Elizabeth T. Kessenides, Dale S. Collinson, Stephen Land, Michael L. Schler, and Diana L. Wollman.

[2] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

[3] More specifically, an individual will be required to pay a 3.8% tax on the lesser of (a) net investment income for the taxable year, or (b) the excess (if any) of (i) the individual's modified adjusted gross income ("AGI") for the taxable year over (ii) $250,000, in the case of an individual filing a joint return or as a surviving spouse, $125,000 in the case of a married individual filing a separate return and $200,000 in any other case. Modified AGI is AGI increased by the amount excluded from income as foreign earned income under Section 911(a)(1) (net of the deductions and exclusions disallowed with respect to foreign earned income). In the case of a trust or estate, the tax is 3.8% of the lesser of (x) undistributed net investment income or (y) the excess of AGI (as defined in Section 67(e)) over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins (currently $11,200).

[4] This definition appears to be derived, in part, from Section 469(e)(1)(A) (gross income from interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business are not treated as income from a passive activity). See also Reg. Section 1.469-2T(c)(3) (definition of "portfolio income" that is excluded from passive activity gross income). In addition, Section 163(d) (limitation on investment interest) uses the same definition for purposes of defining gross income from property held for investment. See Section 163(d)(4) and (5).

regulations could clarify the meaning of the statute and, in other cases, a technical correction to the statute may be necessary.

Under Section 1411(a)(2), an estate or non-grantor trust that is subject to the rules of subparts A through D of part I of subchapter J of chapter one of the Code will be required to pay the unearned income Medicare contribution tax on the lesser of (1) its "undistributed net investment income" for the taxable year and (2) an amount calculated by reference to its AGI (as defined in Section 67(e)) for the taxable year. Section 1411, however, contains no definition of "undistributed net investment income," and there is ambiguity about what the term means, raising potential issues discussed below as to the appropriate treatment of payments in excess of an estate or trust's "distributable net income" and items of income paid or set aside for charitable purposes. We also request guidance with respect to the application of Section 1411 to foreign estates and trusts.

1. Investment Income Earned Through Foreign Corporations

An individual who is a "United States shareholder" of a "controlled foreign corporation" ("CFC")[5] generally will include in her gross income her pro rata share of the CFC's net foreign personal holding company income ("FPHCI"), regardless of whether that income is distributed to the individual by the CFC.[6] Subject to certain exceptions, FPHCI generally includes dividends, interest, annuities, certain royalties and rents, net gains from the disposition of property that produces the foregoing types of income, net gains from certain commodity transactions, net gains from certain foreign currency transactions, net gains from forwards, futures or options, net income from certain swap transactions, substitute dividends, and income equivalent to interest (including substitute interest payments and commitment fees for loans made).[7]

A foreign corporation generally is a "passive foreign investment company" ("PFIC") for any taxable year if either (1) 75% or more of its gross income for the taxable year is "passive income" or (2) 50% or more of its assets produce, or are held for the production of, "passive income."[8] Subject to certain exceptions, for this purpose, "passive income" means FPHCI. An individual who owns stock of a PFIC and makes a "qualified electing fund" ("QEF") election with respect to the PFIC[9] generally will include in his gross income his pro rata share of the

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5 A foreign corporation generally is a CFC if, on any day during the taxable year of the foreign corporation, more than 50% (by vote or value) of the foreign corporation is owned (or is treated as owned under applicable constructive ownership rules) by one or more "United States shareholders." Section 957. A "United States shareholder" is a United States person that owns (or is treated as owning under applicable constructive ownership rules) 10% or more (by vote) of the CFC.

6 Section 951(a)

7 Section 954(c); Reg. Section 1.954-2.

8 Section 1297(a).

9 A US shareholder of a PFIC, regardless of the size of his ownership interest in the PFIC, will be subject to a potentially punitive tax regime under Section 1291, unless the US shareholder makes a QEF election pursuant to Section 1295 or a "market-to-market" election pursuant to Section 1296 with respect to the PFIC.

PFIC's ordinary earnings (taxable at ordinary income tax rates) and net capital gain (taxable at capital gains tax rates), regardless of whether the PFIC actually distributes such income to him.[10]

In both of these cases, an individual will be treated as having received a deemed distribution of the CFC's or PFIC's net investment income. This type of income is not expressly described in the definition of net investment income for purposes of the unearned income Medicare contribution tax, and the law is unclear regarding whether such a deemed distribution is treated as a dividend for federal income tax purposes.[11] Moreover, the actual distribution by a CFC or PFIC of the previously taxed net investment income generally is not treated as a dividend, or otherwise included in gross income, for federal income tax purposes.[12]

Because the law is unclear, individuals may seek to invest in offshore investment funds that are CFCs or PFICs, or form wholly-owned offshore corporations through which they own assets held for investment, to try to shelter income from investment activities from the unearned income Medicare contribution tax.[13] For this reason, we suggest that guidance be issued regarding whether deemed distributions of a CFC's or PFIC's net investment income are subject to the unearned income Medicare contribution tax. Regulations may be appropriate to clarify that this income is subject to the unearned income Medicare contribution tax.

If an individual does not make a QEF election or a mark-to-market election with respect to a PFIC, certain distributions the individual receives on, and any gain the individual recognizes from a sale or other disposition of, the PFIC stock is allocated ratably over the individual's holding period for the stock. Under Section 1291(a), the individual will include in gross income

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[10] Section 1293. In order for a US shareholder of a PFIC to make a QEF election, the PFIC has to provide the US shareholder with information concerning his pro rata share of the PFIC's earnings and permission to inspect and copy the PFIC's books and records. In addition, the PFIC's ordinary earnings and net capital gain have to be computed using US federal income tax accounting principles. Reg. Section 1.1295-1

[11] See Notice 2004-70 (in the context of whether FPHCI inclusions are qualified dividend income: "Neither section 951(a)(1) nor the corresponding regulations characterize a section 951(a)(1) inclusion as a dividend."); PLR 8836037 (in the context of whether FPHCI inclusions are unrelated business taxable income: "Although the subpart F income will not be distributed and is technically not a dividend, such income can be characterized as a constructive dividend due to the interaction of [Sections 951(a)(1)(A)(i), 951(a)(2), 512(b)(1) and 512(b)(13)] of the Code. These sections produce a situation in which the income would be taxable on the part of shareholders as if it had been distributed by the subsidiary as a dividend, therefore, the income is functionally equivalent to a dividend. Consequently, this income will not be treated as unrelated business taxable income under section 512."). See also PLRs 9407007 and 9043039. Cf. Section 851(b) (flush language) (treating FPHCI and QEF inclusions as dividends for purposes of Section 851(b)(2) to the extent that "there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included") and Section 7704(d)(4) (qualifying income for a publicly traded partnership includes income that would qualify under Section 851(b)(2)(A)).

[12] See Sections 959(a) and 1293(c).

[13] We understand that individuals have been choosing to invest in offshore funds that are PFICs to avoid the limitations on the deductibility of miscellaneous itemized deductions and investment interest for federal and state income tax purposes that otherwise would apply if the individual had invested in a U.S. partnership. The imposition of the unearned income Medicare contribution tax might provide a further incentive for individuals to invest in such offshore funds.

(as ordinary income) the amount of the distributions or gain allocated to the current year. Under Section 1291(c), the individual will be subject to tax in the current year on the amount of the distributions or gain allocated to each prior taxable year at the highest applicable tax rate in effect for that prior taxable year. In this regard, we suggest that consideration be given to (i) clarifying that the amount of any excess distribution allocated to the current year is treated as net investment income, provided, however, that the unearned income Medicare contribution tax should not be imposed on the portion of an excess distribution allocated to years that precede the effective date of Section 1411 and (ii) amending the definition of the "aggregate increase in taxes" under Section 1291(c) to take into account the rate at which the unearned income Medicare contribution tax would have been imposed for a prior taxable year if the tax otherwise applied to the individual in that prior taxable year.

Moreover, the definition of FPHCI is a more "modern" definition of income derived from investment activities than that used in Section 469. Accordingly, we suggest consideration be given as to whether other concepts contained in the definition of FPHCI should be incorporated into the definition of net investment income.[14] Some of these would require a technical correction or even a substantive change to the statute.

2. Substitute Interest and Dividends

An individual who transfers stocks or securities (directly or through a partnership) in a securities lending transaction or sale-repurchase transaction typically will receive payments from the counterparty in the transaction that substitute for dividends or interest in respect of the transferred stocks or securities.

Substitute dividend and interest payments are not expressly included in net investment income when they are derived from an individual's investment activities conducted directly or through a partnership (i.e., activities other than those constituting a trade or business that is a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities).[15] However, these payments are substitutes for dividends and

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[14] In addition to the types of income discussed below, FPHCI includes (i) income equivalent to interest, such as income derived from commitment fees and transactions in which payments, net payments, cash flows or return predominantly reflect the time value of money. Section 954(c)(1)(E); Reg. Section 1.954-2(h)(2). FPHCI also includes the excess of foreign currency gains over foreign currency losses from Section 988 transactions. Section 954(c)(1)(D); Reg. Section 1.954-2(g). In some cases, an individual may recognize foreign currency gains from a Section 988 transaction that does not involve the disposition of property or a foreign currency and, thus, such gains might not be captured by the definition of net investment income for purposes of the unearned income Medicare contribution tax. For example, an individual may recognize foreign currency gain as a result of the accrual of original issue discount, amortization of bond premium or receipt of an installment payment of principal, on a debt instrument denominated in a foreign currency.

[15] As a general matter, portfolio income from investment activities is not treated as derived from a passive activity, although it is not completely clear whether substitute interest and dividend payments are excluded from passive activity gross income. See Section 469(e)(1)(a)(i)(I); Reg. Section 1.469-2T(c)(3) (definition of portfolio income that is excluded from passive activity gross income). In any case, investing (i.e., holding stocks and securities on a long-term basis to realize capital appreciation and income in the form of dividends and interest), as opposed to trading, generally does not constitute a trade or business. See, e.g., Higgins v. Comm'r, 312 U.S. 212

interest that otherwise would be included in net investment income. Moreover, in other areas of the tax law, these substitute payments are treated as investment-type income[16] or as equivalent to the underlying dividends or interest.[17] For this reason, we request guidance on whether the definition of net investment income includes substitute interest and dividend payments. If that is intended, a technical correction may be appropriate to definitively subject this income to the unearned income Medicare contribution tax.

3. Income from Notional Principal Contracts

A financial instrument is a notional principal contract ("NPC") if (1) it provides for the payment of amounts by one party to another party at specified intervals, (2) the payments are calculated by reference to a "specified index"[18] upon a notional principal amount and (3) the payments are made in exchange for specified consideration or a promise by the other party to pay similar amounts.[19] An individual may enter into an NPC (directly or through a partnership) for investment purposes in order to generate returns derivatively based on one or more stocks, securities, commodities or certain types of indices (e.g., the S&P 500 index) or to hedge an asset held for investment.

Income from an NPC is not expressly included in net investment income when the income is derived from an individual's investment activities conducted directly or through a

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(1941); Purvis v. Comm'r, 530 F.2d 1332 (9th Cir. 1976); Chiang Hsiao Liang, 23 T.C. 1040 (1955). Accordingly, income from investment activities should not to be treated as derived from a trade or business that is a passive activity with respect to the taxpayer.

[16] See, e.g., Section 512(a)(5) (all amounts received in respect of a Section 1058 securities loan are not unrelated business taxable income); Section 851(b)(2)(A) (qualifying income for a regulated investment company includes payments with respect to securities loans as defined in Section 512(a)(5)); Section 954(c)(1)(G) (payments in lieu of dividends made pursuant to a Section 1058 securities loan are FPHCI); Section 7704(d)(4) (qualifying income for a publicly traded partnership includes income that would qualify under Section 851(b)(2)(A)); and Reg. Section 1.954-2(h) (FPHCI includes "income equivalent to interest" which includes income derived from transfers of debt securities subject to section 1058).

[17] See, e.g., Section 871(l) (treating as a US source dividend any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a US source dividend); and Reg. Sections 1.861-2(a)(7) and 1.861-3(a)(6) (substitute interest and dividends have the same source as the underlying interest or dividends).

[18] A specified index includes (a) a fixed rate, fixed price or fixed amount, (b) a series of fixed rates, fixed prices or fixed amounts applicable in specified periods, (c) an index that is based on objective financial information, and (d) an interest rate index that is regularly used in normal lending transactions between a party to the NPC and unrelated persons. Objective financial information is any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances, e.g., a broadly based stock index but not the value of a party's stock. Reg. Section 1.446-3.

[19] Id. NPCs include transactions more commonly referred to as swaps, such as interest rate swaps, basis swaps, commodity swaps, equity swaps, equity index swaps and currency swaps. The notional principal amount is not actually exchanged, but is just a base against which the specified index is applied to compute the amount of the payments. The notional principal amount may vary over the term of the contract provided that it is set in advance or varies based on objective financial information.

partnership (i.e., activities other than those constituting a trade or business that is a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities).[20] In other areas of the tax law, income from an NPC is treated as investment-type income[21] or as equivalent to the income produced by the subject of the NPC.[22] For this reason, we request guidance on whether the definition of net investment income includes income from NPCs. If that is intended, a technical correction to the statute would appear to be the most appropriate way to subject this income to the unearned income Medicare contribution tax.

4. Mark-to-Market Income, Deemed Sales and Ordinary Income

Under certain circumstances an individual may be required, or may elect, to mark-to-market the individual's assets held for investment. In these cases, the individual is treated as having sold the particular asset at the end of the taxable year for an amount equal to its fair market value, and any gain or loss from the deemed sale is included in the individual's gross income (with appropriate adjustments to the individual's tax basis in the asset).[23]

Gain or loss from the exercise, settlement, lapse, expiration, cancellation or other termination of certain financial instruments sold or purchased by an individual as part of the individual's investment activities (conducted directly or through a partnership) are treated as gain or loss from the sale or exchange of a capital asset.[24]

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[20] See note 15, above

[21] See, e.g., Section 954(c)(1)(F) (net income from an NPC is FPHCI); Reg. Section 1.954-2(h) (FPHCI includes "income equivalent to interest" which includes income derived from NPCs the value of which are determined solely by reference to interest rates or interest rate indices); Reg. Section 1.512(b)-1(a) (income from NPCs are not unrelated business taxable income); Reg. Section 1.7704-3(a) (income from an NPC is included in qualifying income only if the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership).

[22] See Section 871(l) (treating as a US source dividend any payment made pursuant to a specified notional principal contract that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a US source dividend); but cf. Reg. Section 1.863-7(b) (income from an NPC is sourced by reference to the residence of the taxpayer).

[23] See Section 1296 (mark-to-market election with respect to stock of a PFIC); Section 1256 (market-to-market treatment generally is required for regulated futures contracts, foreign currency contracts and nonequity options); Section 1259 (constructive sale treatment of certain appreciated financial positions).

[24] See, e.g., Section 1234(a) (gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property is considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him); Rev. Rul. 88-31, 1988-1 CB 302 (if a cash settlement option is in fact settled in cash, the transaction is treated as a sale or exchange of the option); Section 1234(b) (in the case of the grantor of an option in property, gain or loss from any closing transaction with respect to, and gain on lapse of, the option is treated as a gain or loss from the sale or exchange of a capital asset held not more than 1 year); Section 1234A (gain or loss attributable to the cancellation, lapse, expiration, or other termination of (i) a right or obligation (other than a securities futures contract, as defined in Section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer or (ii) a Section 1256 contract which is a capital asset in the hands of the taxpayer, is treated as gain or loss from the sale of a capital asset).

In certain circumstances, an individual's gain (and, in some cases, loss) from the disposition (or marking to market) of an asset held for investment will be treated as ordinary income, rather than capital gain.[25]

Net investment income for purposes of the unearned income Medicare contribution tax includes net gain attributable to the disposition of property. But it is not completely clear that gains and losses from marking-to-market assets held for investment or from the foregoing occurrences with respect to certain financial instruments arise from the disposition of property, as opposed to the deemed sale or exchange of property. Also, it is not completely clear that net gain attributable to the disposition of property includes an individual's gain (and where applicable, loss) from the disposition (or marking to market) of an asset held for investment that is treated as ordinary income (or ordinary loss).

Accordingly, we suggest that guidance be provided concerning whether the definition of net investment income includes (i) the excess of gains over losses from transactions that are treated as deemed sales or exchanges of property and (ii) an individual's gain (and where applicable, loss) from the disposition (or marking to market) of an asset held for investment that is treated as ordinary income (or ordinary loss). We do not believe that the statute needs to be amended to subject net gains from deemed dispositions or net gains treated as ordinary income to the unearned income Medicare contribution tax.

5. Definition of "undistributed net investment income"

We also request guidance, and note that technical corrections may be required, with respect to the application of Section 1411 to estates and to trusts that are subject to the rules of subparts A through D of part I of subchapter J of chapter one of the Code ("non-grantor trusts" and "Subchapter J").

Under Section 1411(a)(2), a non-grantor trust or an estate will be required to pay the unearned income Medicare contribution tax on the lesser of (1) its "undistributed net investment income" for the taxable year and (2) an amount calculated by reference to its AGI (as defined in section 67(e)) for the taxable year.[26]

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[25] See, e.g., Section 1296 (gain or loss from marking-to-market stock of a PFIC and gain or, to a limited extent, loss from the disposition of such stock, is treated as ordinary income or loss); Section 1258 (all or a portion of capital gain recognized on the disposition or other termination of a position held as part of a conversion transaction is treated as ordinary income); Section 1260 (all or a portion of long-term capital gain from a constructive ownership transaction is treated as ordinary income); and Section 988 (foreign currency gains or losses from a Section 988 transaction (e.g., the disposition of a debt instrument denominated in a foreign currency) generally are treated as ordinary income or loss). See also note 14, above.

[26] As described in note 4, above, a trust or estate will be required to pay the unearned Medicare contribution tax on the lesser of (a) its undistributed net investment income for the taxable year and (b) the excess, if any, of (i) its AGI (as defined in Section 67(e)) for the taxable year over (ii) the dollar amount at which the highest tax bracket in Section 1(e) begins for such taxable year. For 2010, this dollar amount is $11,200.

We assume that in using the term "undistributed net investment income," the drafters of Section 1411 intended to give effect to provisions of Subchapter J that treat a trust or an estate as a conduit by reducing the trust's or estate's taxable income to take into account payments and distributions to trust beneficiaries, with the trust or estate being subject to tax only on the taxable income that is not treated as having been distributed to beneficiaries. For example, to the extent items of "distributable net income" within the meaning of Section 643(a) ("DNI") are treated as having been distributed to the non-charitable beneficiaries of a non-grantor trust or an estate, the trust or estate receives a distribution deduction under Section 651 or 661 as applicable, and the non-charitable beneficiaries are required under Section 652 or 662, as applicable, to include in their gross income the items of DNI distributed to them.

Section 1411, however, contains no definition of "undistributed net investment income," and there is ambiguity about what the term means, raising potential issues as to the appropriate treatment of payments in excess of DNI and items of income paid or set aside for charitable purposes.

a. Distributions in Excess of DNI

In the absence of clarification to the contrary, the language of Section 1411 might be read in a manner that could result in items of net investment income not being subject to the unearned income Medicare contribution tax at either the level of the trust or the estate or the level of its beneficiaries.

One such circumstance is where a non-grantor trust or an estate makes distributions in respect of capital gain to its beneficiaries. As defined in Section 1411(c), the term "net investment income" generally includes net gain attributable to the disposition of property. Based on the definition of net investment income, "undistributed net investment income" would seem to include net gain from a disposition of property that is retained by a non-grantor trust or an estate and would seem to exclude net gain from a disposition of property that is in some fashion identified as having been distributed by a trust or an estate to its beneficiaries.

The DNI of a domestic non-grantor trust or estate, however, generally does not include capital gain, which is generally taxable to the trust or estate regardless of the amounts distributed to the non-charitable beneficiaries.[27] This creates a potential mismatch for Section 1411(a) purposes when a non-grantor trust or estate distributes to its beneficiaries in a particular tax year an amount that is at least equal to its total net investment income (including capital gains) but in excess of its DNI.

For example, if a domestic non-grantor trust earns $100 of dividend income and $50 of capital gain and pays $150 to a non-charitable beneficiary, under the normal rules of Subchapter

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[27] Net capital gain is included in the DNI of a domestic trust or a domestic estate in the limited circumstances described in Section 643(a)(3). Net capital gain is included in the DNI of a foreign trust or a foreign estate in all circumstances. Section 643(e).

J, the beneficiary will include in his or her gross income the $100 in respect of the dividend income; the trust will include both items in its gross income but will receive a distribution deduction for the dividends treated as having been distributed to the beneficiary and will pay tax on $50 of capital gain.[28]

Section 1411 as drafted (and in the absence of further clarification) might be read as providing that items of net investment income identified on a trust's or estate's books and records as having been distributed to beneficiaries (e.g., the $50 of capital gain in the above example) should be treated as having been distributed for Section 1411(a) purposes, irrespective of whether those items of net investment income were includible in DNI. Under such a view, capital gain might not be subject to the unearned income Medicare contribution tax at either the level of the trust or estate or the level of its beneficiaries. Looking first at the entity level, a non-grantor trust or an estate seems to not be subject to tax under Section 1411 in respect of amounts of capital gain identified as having been distributed to a beneficiary. This is because, as described above, "net investment income," as defined in Section 1411(c), generally includes net gain attributable to a disposition of property and therefore the term "undistributed net investment income" seems to exclude net gain from a disposition of property that is in some manner identified as having been distributed by a trust or an estate to its beneficiaries. Therefore, in the example posited, the lesser of AGI under Section 67(e) ($50) and undistributed net investment income appears to be zero.

At the same time, if the gains described above are treated as having been distributed for 1411(a)(2) purposes, they generally will not be subject to the unearned income Medicare contribution tax by the recipient, given that an individual is subject to the tax on the lesser of net investment income and modified AGI. Because capital gain is not included in the DNI of a typical domestic non-grantor trust or domestic estate (other than in the year of the termination of the trust or the estate), capital gain treated as having been distributed from an estate or trust for Section 1411(a)(2) purposes generally will not be included in the beneficiary's gross income and therefore will not be included in the beneficiary's modified AGI.[29]

A similar ambiguity involves whether items of net investment income of a non-grantor trust or estate are subject to the Section 1411 tax in certain cases where the so-called "separate share rule" of Section 663(c) applies. Section 663(c) provides that in the case of a trust or an estate having more than one beneficiary, for purposes of determining DNI, substantially separate and independent shares of different beneficiaries are to be treated as separate trusts. For example, if a single trust has three equal shares, one for each of the settlor's children, Beneficiary A, Beneficiary B, and Beneficiary C, with the income and principal of each share payable to its beneficiary in the discretion of the trustee, the separate share rule will apply for purposes of calculating the trust's DNI.

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[28] For simplicity, the example assumes that the amount realized on the sale of the capital asset is $50 and that the basis in the asset is $0.

[29] Section 643(a)(3), 652, 662.

If the trust in the previous example has interest income of $15,000 in a tax year, the DNI of each separate share of the trust will be one-third of this amount, or $5,000. If the trustee makes a payment of $12,000 to Beneficiary A and does not make any payments to Beneficiary B or C during the tax year, Beneficiary A will include in her gross income an amount that is limited by the DNI of her separate share ($5,000). The trust will receive a distribution deduction for the DNI distributed to Beneficiary A and will be subject to tax on income for which it did not receive a distribution deduction ($10,000).

Once again, in the absence of clarifying action, the portion of the amount paid to Beneficiary A that exceeds her share of the trust's DNI might not be viewed as subject to the unearned income Medicare contribution tax by either the trust or Beneficiary A. At the trust level, the trustee might take the position that $12,000 of the trust's net investment income was distributed to Beneficiary A, and that only $3,000 of such income was not distributed. Accordingly, the trustee might take the position that the trust had only $3,000 of "undistributed net investment income" for purposes of Section 1411.

At the same time, as a result of the operation of the DNI rules, only a portion of the $12,000 that was paid out to Beneficiary A might be subject to tax under Section 1411. As explained above, individuals are subject to the unearned income Medicare contribution tax on the lesser of their net investment income and modified AGI. The inclusion in Beneficiary A's gross income and modified AGI in respect of the distributions she received from the trust is limited to the DNI of her separate share of the trust ($5,000). Accordingly, Beneficiary A is subject to tax under Section 1411 on only $5,000 of her distribution. As a result, of the $15,000 of net investment income earned by the trust, only $8,000 might be subject to tax under Section 1411 ($3,000 by the trust and $5,000 by Beneficiary A).

Putting aside potential issues with respect to the treatment of payments to charitable beneficiaries (discussed below), we assume that Congress intended for the net investment income of a non-grantor trust or an estate, including gain from the disposition of property, to be subject to the unearned income Medicare contribution tax at the level of the trust or estate if the income is not otherwise distributed or deemed distributed to beneficiaries under the normal rules of Subchapter J that result in a corresponding receipt of the income by the beneficiaries. One way to ensure this result would be to clarify, either by a regulation that defines "undistributed net investment income" or by a technical correction to the statute, that any net investment income, including gain attributable to a disposition of property, for which no distribution deduction is allowed under Section 651 or 661, is to be included in the undistributed net investment income of a domestic trust or a domestic estate, regardless of the amount of payments made by the trust or estate (except perhaps, as discussed below, to the extent that a Section 642(c) charitable deduction is otherwise allowed in respect of the relevant net investment income).

b. Charitable deduction

There is also ambiguity as to whether the term "undistributed net investment income" includes amounts paid by a non-grantor trust or an estate to a charitable organization or set-aside for a charitable purpose. As a technical matter, a payment to a charitable organization from a

non-grantor trust or an estate does not result in a deduction to the trust in the same manner as payments or distributions to non-charitable beneficiaries that, as described above, are governed by Sections 651, 652, 661 and 662. Rather, to the extent a non-grantor trust or an estate pays an item of gross income to a charitable organization pursuant to the terms of its governing instrument, the trust or estate receives a charitable deduction under Section 642(c)(1). To the extent an estate sets aside an item of gross income for a charitable purpose pursuant to the terms of its governing instrument for distribution to charity in future tax years, an estate also receives a charitable "set aside" deduction under Section 642(c)(2).[30]

We suggest that guidance be issued clarifying whether amounts of net investment income paid to a charitable organization or set aside for a charitable purpose for which a trust or an estate receives a deduction under Section 642(c) are considered "distributed" for purposes of Section 1411 and therefore reduce the undistributed net investment income of the trust or estate.

In contrast to Sections 651, 652, 661 and 662, which specifically contain the word "distributed," Section 642(c) does not include the word "distributed." Rather, Section 642(c) refers to a "deduction for amounts *paid* to or set aside for a charitable purpose" (emphasis added). However, Section 663(a)(2), which addresses the interaction between the deduction under Section 642(c) and calculations under Sections 661 and 662, refers to amounts for which a trust or an estate receives a charitable deduction under Section 642(c) as "charitable, etc. *distributions*" (emphasis added). In addition, the terms "paid" and "distributed" seem to be used interchangeably in other provisions of Subchapter J.[31]

Sections of the Code outside of Subchapter J also use the terms "distributed" and "distribution" to refer to amounts paid from a non-grantor trust or an estate to a charitable beneficiary. For example, Section 1291(b)(3), which describes various adjustments to be made in determining the amount of an excess distribution of a PFIC, provides that "if a charitable deduction was allowable under section 642(c) to a trust for any distribution of its income, proper adjustments shall be made for the deduction so allowable to the extent allocable to distributions or gain in respect of stock in a passive foreign investment company" (emphasis added).[32] Similarly, the sample forms for non-grantor charitable lead trusts issued by the Internal Revenue

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30 Pooled income funds (discussed below) and certain trusts created on or prior to October 9, 1969 are also entitled to a deduction for amounts of gross income set aside for charitable purposes.

31 See, for example, Section 643(a)(3), which provides the general rule that capital gain is not included in the DNI of a non-grantor trust or an estate. Clause (A) of this Section provides an exception to the general rule in a case where capital gain is "paid, credited or required to be distributed to any [non-charitable] beneficiary." The language of this clause suggests that the term "paid" is synonomous with the term "distributed."

32 See also Sections 2055(e)(2) and 2522(c)(2).

Service, which use the word "distribute" to refer to payments that are made by the trust to charitable organizations.[33]

If the undistributed net investment income of a non-grantor trust or an estate is not reduced by amounts for which the trust or estate receives a Section 642(c) deduction, the Section 1411 tax will reduce amounts of accumulated income and corpus available for future distribution to beneficiaries. Taking into account the treatment of charitable contributions by individuals for Section 1411 purposes and general concepts underlying the income taxation of trusts and estates, this result may or may not be considered appropriate.

Under Section 1411(a), individuals are subject to the unearned income Medicare contribution tax without reduction for amounts they are entitled to deduct under Section 170 in respect of their charitable contributions. If Congress believes that non-grantor trusts and estates should be treated for purposes of the Section 1411 tax in a manner similar to individuals making charitable contributions, then allowing the 642(c) charitable deduction to reduce undistributed net investment income would be inconsistent with that objective. On the other hand, Section 642(c) functions in manner that differs from Section 170, indicating that different policy considerations and concepts of taxation may underlie the charitable deduction available to individuals under Section 170 and the charitable deduction available to non-grantor trusts and estates under Section 642(c).

For example, while individuals are subject under Section 170 to a ceiling on deductible charitable contributions based on a percentage of their adjusted gross income, non-grantor trusts and estates are allowed an unlimited deduction under Section 642(c) for items of gross income paid, or in some cases set aside for eventual payment, to charity. In addition, the deduction available under Section 642(c) is not tied to the amount or fair market value of property contributed to charity, but rather to the identification of specific items of gross income treated as having been paid or set aside for charitable purposes. In keeping with this general tracing concept, and in contrast to the deduction available under Section 170, there is no five year carry forward for excess charitable contributions under Section 642(c), a deduction being available under Section 642(c) only if a specific item of gross income of the relevant tax year can be identified as having be paid or set aside for charitable purposes that year. Under these circumstances, one might reasonably conclude that it would be in keeping with general concepts of taxation under Subchapter J to treat items of gross income paid to charitable beneficiaries for which a deduction is permitted under Section 642(c) as having been distributed from a non-grantor trust or estate for purposes of computing the trust's or estate's undistributed net investment income under Section 1411. Such treatment would, as a conceptual matter, treat payments and distributions to both charitable and non-charitable beneficiaries as carrying out net investment income for Section 1411 purposes (the charitable beneficiary, unlike the non-charitable beneficiary, not being subject to tax under Section 1411 on any of the items of net investment income as to which it is effectively treated as the recipient). At the same time,

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[33] See, e.g., Rev. Proc. 2007-45, 2007-29 IRB 89 (6/22/2007), specifically clause 2. in section 4., annotations .02(2) and .02(7) of section 5. and annotation .05(1) of section 6. See also Rev. Proc. 2007-46, 2007-29 IRB 102; Rev. Proc. 2008-45, 2008-30 IRB 224; Rev. Proc. 2008-46, 2008-30 IRB 238.

however, we also note that differences in treatment for alternative means of benefiting charity, such as by an individual taxpayer funding a trust in lieu of an outright contribution to charity, may have behavioral effects (which may be intended or otherwise consistent with other tax policies and treatment, but at least should be considered).

One's view as to the appropriateness of reducing the undistributed net investment income of a non-grantor trust or an estate in respect of items of net investment income for which the trust or estate receives a Section 642(c) deduction, particularly in the case of the set aside deduction, may also be influenced by whether non-charitable beneficiaries will or may be the ultimate recipients of accumulated income and corpus. Consider, for example, a trust that gives its trustee the discretion to make current distributions of income and/or principal to members of a class consisting of charitable and non-charitable beneficiaries. In this case, non-charitable beneficiaries may, in a manner similar to the benefits they receive in connection with the corresponding reduction in income tax liability from a Section 642(c) deduction, ultimately benefit if undistributed net investment income is reduced in respect of items of net investment income for which the trust receives the corresponding Section 642(c) deduction. Similarly, consider a non-grantor charitable lead annuity trust, a type of trust that provides for fixed annuity payments to one or more charitable beneficiaries, with any trust property remaining at the expiration of the annuity term paid to a non-charitable remainder beneficiary. Because payments to charity from a charitable lead annuity trust are fixed, the trust's non-charitable remainder beneficiary will bear the incidence of the Section 1411 tax if undistributed net investment income is not reduced in respect of items of net investment income which the trust is treated as having paid to charity under Section 642(c) (just as that non-charitable beneficiary would have otherwise borne any related income tax liability if the Section 642(c) deduction in respect of current payments had not been available for income tax purposes). Thus, the incidence of the tax in such a case would not necessarily be an independent reason to reduce undistributed net investment income by such amounts.

Other situations involving a 642(c) charitable deduction, however, may involve the Section 642(c) set aside deduction as a result of the charitable organization being the designated beneficiary of the accumulated income and corpus. For example, consider the case of a pooled income fund. A pooled income fund consists of property transferred by donors who contribute remainder interests to a charitable organization and retain income interests for the lives of beneficiaries living at the time of the transfer. The requirements for a trust to be a pooled income fund are set forth in Section 642(c).[34] If these requirements are satisfied, the pooled income fund will receive an income tax deduction for amounts of DNI that are treated as having been paid to its non-charitable income beneficiaries under Section 661 and a charitable deduction under 642(c) for amounts of net long-term capital gain that are permanently set-aside for the

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[34] The fund be maintained by the charitable remainder beneficiary, and neither a donor nor a beneficiary may be a trustee. As income beneficiaries die, ratable portions of the fund are required to be transferred to the charitable remainder beneficiary.

fund's charitable remainderman.[35] Accordingly, pooled income funds generally pay no income tax. If a pooled income fund is not able to reduce its undistributed net investment income for purposes of Section 1411 by amounts for which it receives a deduction under Section 642(c), less property will be available for distribution to the fund's charitable beneficiary at the termination of the life interests of the income beneficiaries. Similarly, in the case of an estate that has a charitable residuary beneficiary, if amounts set aside for, but not paid out on a current basis to, the charitable beneficiary do not reduce the Section 1411 tax imposed on the estate, the incidence of the unearned income Medicare contribution tax on accumulated items of net investment income will be borne by the charitable residuary beneficiary.

The potential reductions in the amounts passing to charity in the examples in the immediately preceding paragraph may be viewed as being contrary to policies underlying the Section 642(c) set aside deduction or as being incongruous with the treatment of charitable remainder trusts for Section 1411 purposes.[36] On the other hand (and even if undistributed net investment income is reduced by items of net investment income which a trust or estate is treated as having paid to charity under Section 642(c)), it might be argued that undistributed net investment income should not be reduced by items of gross income set aside for payment to charity in a subsequent tax year--for example, by viewing the payment of the Section 1411 tax on accumulated items of net investment income as being no different than the payment of other non-income tax costs that may also reduce the value of property being accumulated for eventual distribution to charity; if that perspective were taken, the reduction in amounts passing to charity in the examples in the immediately preceding paragraph would not itself be a ground to not impose the tax.

Finally, if and to the extent Congress did not intend to subject a non-grantor trust or estate to the unearned income Medicare contribution tax on items of net investment income qualifying for one or both of the charitable deductions available under Section 642(c), additional technical corrections may also be appropriate with respect to the second prong of Section 1411(a)(2) that subjects amounts to tax by reference to a trust's or an estate's adjusted gross income as defined in Section 67(e). Section 67(e) adjusts a trust's adjusted gross income for items of DNI carried out to trust beneficiaries under Sections 651 and 661 but does not adjust for the charitable deduction under Section 642(c).

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[35] No amount of net long-term capital gain of a pooled income fund will be considered permanently set-aside for charitable purposes if, under the terms of the fund's governing instrument and applicable local law, the trustee has the power whether or not exercised, to satisfy the income beneficiaries' right to income by the payment of (1) an amount equal to a fixed percentage of the fair market value of the fund assets or (2) any amount that takes into account unrealized appreciation in the value of the fund assets.

[36] Pooled income funds are similar to charitable remainder trusts that meet the requirements of Section 664, except that charitable remainder trusts (1) pay an annuity amount or a unitrust amount to their non-charitable beneficiaries and (2) do not commingle contributions of multiple donors. The Joint Committee on Taxation Report to Section 1411 specifically provides that the unearned income Medicare contribution tax does not apply to charitable remainder trusts. See JCX-18-10 (March 21, 2010). In addition, charitable remainder trusts are not subject to tax under Section 1411 given that they are exempt from all taxes imposed under Subtitle A of the Code, other than the excise tax on unrelated business taxable income under Section 664(c)(2). See Section 664(c)(1).

6. Application of Section 1411 to foreign estates and trusts

Section 1411(e) provides that the unearned income Medicare contribution tax does not apply to a nonresident alien. The term "nonresident alien" is not defined in Section 1411 or elsewhere in the Code, and it is unclear whether the term refers only to nonresident alien individuals or whether the term also includes foreign estates and trusts.

Section 7701(b)(1)(B) provides that "[a]n *individual* is a nonresident alien if such individual is neither a citizen nor a resident of the United States" (emphasis added). However, this section does not describe the circumstances under which a person other than an individual (e.g., a trust) will be considered a nonresident alien. Some Code sections imply that the term "nonresident alien" includes foreign trusts,[37] but other sections imply that it does not.[38] Moreover, for many purposes of the Code, foreign trusts are treated as nonresident alien individuals. For example, Section 641(b), which describes how the taxable income of an estate or trust is to be computed, provides: "...For purposes of this subsection, a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time."

If Section 1411 is not modified to clarify that foreign non-grantor trusts and foreign estates are not subject to the unearned income Medicare tax, there will be consequences that we believe Congress did not intend. For example, the gross income of a foreign trust or a foreign estate includes U.S. source fixed or determinable annual or periodical ("FDAP") income described in Section 871(a).[39] As a result, certain types of U.S. source FDAP income, such as dividends from U.S. corporations, are included in the gross income of a foreign trust or estate and are included in the AGI of the foreign trust or estate under Section 67(e). If a foreign trust or estate is not treated as a nonresident alien for purposes of the unearned income Medicare contribution tax, the foreign trust or estate could be subject to tax under Section 1411 on U.S. source FDAP income if its AGI exceeds a relatively low threshold ($11,200 for 2010). This would be the case even if the Federal income tax liability of the trust or estate (other than its liability to pay the unearned income Medicare contribution tax) were fully satisfied by withholding and the trust or estate would not need to file a U.S. income tax return in the absence of Section 1411.

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[37] See, e.g., Section 958(b)(1), which provides that "...stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual." The parenthetical suggests not only that a foreign trust is a nonresident alien, but also that a foreign trust is a nonresident alien individual.

[38] See, e.g., Section 684, which, following recent amendment by Section 542(e)(1)(C) of P.L. 107-16, provides rules for a "transfer of property by a United States person to a foreign estate or trust *or* a nonresident alien" (emphasis added). The use of the disjunctive implies that the term nonresident alien does not include a foreign trust or a foreign estate.

[39] See Sections 641(b) and 872(a) and Treas. Reg. § 1.872-1.

At the same time, if it is clarified that foreign trusts and estates are not subject to the unearned income Medicare contribution tax, consideration should be given to the treatment of U.S. beneficiaries who receive distributions of accumulated income from foreign non-grantor trusts. U.S. beneficiaries who receive distributions of accumulated income (referred to as "accumulation distributions") from foreign non-grantor trusts are subject to tax under the so-called "throwback rules" of Sections 665 through 668. These rules generally operate to tax a U.S. beneficiary on an accumulation distribution in an amount intended to approximate the taxes that the beneficiary would have paid had the foreign trust distributed its income as it was earned. A U.S. beneficiary who receives an accumulation distribution from a foreign trust is also subject to an interest charge.

Accumulation distributions from foreign trusts do not appear to be subject to the unearned income Medicare contribution tax. As described above, an individual will be subject to the unearned income Medicare contribution tax on the lesser of (1) his or her net investment income for a taxable year and (2) an amount determined by reference to his or her AGI. Under the rules of Sections 665 through 668, the receipt of an accumulation distribution by a U.S. beneficiary of a foreign trust has no impact on his or her AGI. In addition, because distributions of accumulated income do not retain their character under the throwback rules, it is not clear that such distributions would constitute "net investment income" for purposes of Section 1411. Furthermore, the unearned income Medicare contribution tax will play no role in the calculation of the amount of the throwback tax. In calculating the throwback tax on an accumulation distribution to a U.S. beneficiary, the beneficiary's taxable income for years prior to the accumulation distribution is recomputed to account for the distribution and is subject to tax at a rate that does not include the 3.8% unearned income Medicare contribution tax.[40]

In addressing the interaction between Section 1411 and the throwback rules, consideration should be given to several principles. First, the unearned income Medicare contribution tax should not be imposed on accumulated income allocated to years that precede the effective date of Section 1411. Second, with respect to income allocated to years that follow the effective date of Section 1411, the unearned income Medicare contribution tax should be imposed only on amounts that constitute net investment income. Finally, the throwback rules currently operate to ensure that the throwback tax and interest charge imposed on a beneficiary do not exceed the amount of the accumulation distribution received by him or her. This feature of the current rules should be preserved.

We would be pleased to discuss or further elaborate on the foregoing if that would be helpful.

Respectfully submitted,

Peter H. Blessing
Chair

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40 Section 667(b).

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