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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9644]

RIN 1545-BK44

Net Investment Income Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations under section 1411 of the Internal Revenue Code (Code). These regulations provide guidance on the general application of the Net Investment Income Tax and the computation of Net Investment Income. The regulations affect individuals, estates, and trusts whose incomes meet certain income thresholds.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.469-11(b)(3)(iv)(D); 1.1411-1(g);1.1411-2(e);1.1411-3(f);1.1411-4(i);1.1411-5(d);1.1411-6(c);1.1411-8(c);1.1411-9(d); and 1.1411-10(i).

FOR FURTHER INFORMATION CONTACT: David H. Kirk or Adrienne M. Mikolashek at (202) 622-3060 or (202) 317-6852 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545-2227. The collection of information in these final regulations is in §1.1411-10(g). The collection of information in §1.1411-10(g) is necessary for the IRS to determine whether a taxpayer has made an election pursuant to §1.1411-10(g) and to determine whether the amount of tax has been reported and calculated correctly.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

Background

I. In General

This document contains final amendments to 26 CFR part 1 under sections 469 and 1411 of the Internal Revenue Code (Code). Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152, 124 Stat. 1029) (HCERA) added section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012.

On December 5, 2012, the Treasury Department and the IRS published a notice of proposed rulemaking in the **Federal Register** (REG-130507-11; 77 FR 72612) relating to the Net Investment Income Tax. On January 31, 2013, corrections to the proposed regulations were published in the **Federal Register** (78 FR 6781). The Treasury Department and the IRS received numerous comments in response to the proposed regulations. All comments are available at www.regulations.gov or upon request. The Treasury Department and the IRS held a public hearing on the proposed regulations on April 2, 2013.

In addition to these final regulations, the Treasury Department and the IRS are contemporaneously publishing a notice of proposed rulemaking in the **Federal Register** (REG-130843-13) relating to the Net Investment Income Tax.

Public comments on the 2012 proposed regulations identified two issues that the IRS and the Treasury Department will study further and on which the IRS and the Treasury Department request additional comments. Those issues, the treatment of accumulation distributions from foreign trusts and material participation of estates and trusts, are discussed in parts 4.D and 4.F of this preamble, respectively. Comments on those issues should be submitted in writing by **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**, and can be mailed to the Office of Associate Chief Counsel (Passthroughs and Special Industries), Re: REG-130507-11 – Estates/Trusts, CC:PSI:B02, Room 5011, 1111 Constitution Avenue NW., Washington, DC 20224. All comments received will be available for public inspection at www.regulations.gov (IRS REG-130507-11).

II. Statutory Provisions

Section 1402(a)(1) of the HCERA added section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012. Section 1411 imposes a 3.8 percent tax on certain individuals, estates, and trusts. See section 1411(a)(1) and (a)(2). The tax does not apply to a nonresident alien or to a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B). See section 1411(e).

In the case of an individual, section 1411(a)(1) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the individual's net investment income for such taxable year, or (B) the excess (if any) of: (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount. Section 1411(b) provides that the threshold amount is: (1) in the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), $250,000; (2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, $125,000; and (3) in the case of any other individual, $200,000. Section 1411(d) defines modified adjusted gross income as adjusted gross income increased by the excess of: (1) the amount excluded from gross income under section 911(a)(1), over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amount excluded from gross income under section 911(a)(1). Section 1.1411-2 of the final regulations provides guidance on the computation of the net investment income tax for individuals.

4. Comments Regarding the Application of Section 1411 to Estates and Trusts

In general, section 1411(a)(2) imposes on estates and trusts a tax of 3.8 percent on the lesser of their undistributed net investment income or the excess of their adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

A. Exclusion of certain estates and trusts from the application of section 1411

The preamble to the proposed regulations stated that section 1411 applies to ordinary trusts described in §301.7701-4(a) that are subject to the provisions of part 1 of subchapter J of chapter 1 of subtitle A of the Code, even if the trusts have special computational rules within part 1 of subchapter J. The proposed regulation preamble identified four such trusts to which section 1411 will apply: (1) pooled income funds described in section 642(c)(5), (2) cemetery perpetual care funds described in section 642(i), (3) qualified funeral trusts described in section 685, and (4) Alaska Native settlement trusts described in section 646. The Treasury Department and the IRS requested public comments as to whether there may be administrative reasons to exclude one or more of these types of trusts from section 1411. In response, numerous commentators advocated for exclusion or inclusion of the trusts identified above.

i. Pooled Income Funds (PIFs)

Commentators recommended that the final regulations provide that section 1411 not apply to PIFs because doing so would be tantamount to taxing a charity that ultimately receives the property after the expiration of the income interest. Specifically, only the PIF's undistributed short-term gains are subject to tax under chapter 1, and those gains are held for ultimate distribution to charity. The commentators stated that the provisions of the Code dealing with charitable organizations, and contributions to them, should be broadly construed in favor of charitable organizations and their donors and, thus, section 1411 should not apply to PIFs. Furthermore, one commentator stated that treating PIFs in a manner significantly different from charitable remainder trusts is inequitable. The commentator analogized PIFs, operationally, to charitable remainder trusts. However, the commentator acknowledged that, unlike charitable remainder trusts, PIFs, by being taxable on undistributed short-term capital gains, do not escape all instances of federal income taxation. The commentators recommended that the final regulations either: (1) provide that a PIF's short-term capital gains be excluded from net investment income, or (2) exclude PIFs from the application of section 1411 altogether.

The final regulations do not adopt these suggestions. The Treasury Department and the IRS recognize that imposing tax on the PIF will reduce the amount of property the charitable remainderman will receive after the expiration of the income interest. However, section 1411 limits its exclusion to wholly charitable trusts; this group of trusts does not include either charitable remainder trusts or PIFs. While charitable remainder trusts are excluded from section 1411 by the express language of section 664, there is no comparable provision excluding PIFs.

Another commentator recommended that the final regulations provide that the section 642(c) charitable set-aside deduction that is available for a PIF’s long-term capital gains for income tax purposes also reduce a PIF’s net investment income. For purposes of taxation under chapter 1 of the Code, the taxable income of the PIF is limited, generally, to the undistributed short-term capital gains because the PIF will receive an income distribution deduction for the income paid to the income beneficiaries and any long-term capital gains will be offset by the section 642(c)(3) charitable set aside deduction. As is generally true throughout these regulations, the final regulations mirror this treatment under chapter 1 for purposes of section 1411.

ii. Cemetery Perpetual Care Funds

One commentator stated that there is no administrative reason why Cemetery Perpetual Care Funds (Cemetery Trusts) should not be treated the same as other trusts for purposes of section 1411, and accordingly recommended taxing such trusts under section 1411.

Two other commentators advocated for the exclusion of Cemetery Trusts from section 1411 because inclusion of such trusts would be inconsistent with the policy behind section 1411. They stated that Cemetery Trusts are established for consumer protection, and also to ensure that cemetery properties are maintained in perpetuity and do not become an obligation of the government. They noted that, as is the case with a qualified funeral trust, a cemetery perpetual care trust is essentially a collection of many small, individual trusts held for the benefit of unrelated gravesite owners whose only common interest is that they are owed the same promise of future services from the funeral provider or cemetery company. Thus, under section 642(i), the only “beneficiary” is a taxable cemetery company. Therefore, the commentators stated that the imposition of section 1411 tax on the aggregate income of a perpetual care fund would effectively be a tax on an operating business, which directly conflicts with the terms of section 1411.

The Treasury Department and the IRS agree that cemetery trusts should be excluded from section 1411. By benefitting an operating company, these trusts are similar to the business trusts that are excluded from the operation of section 1411. Accordingly, §1.1411-3(b)(1) of the final regulations exclude Cemetery Perpetual Care Funds described in section 642(i) from the application of section 1411.

iii. Electing Alaska Native Settlement Trusts (ANSTs)

Several commentators argued that ANSTs should be excepted from the net investment income tax as a matter of statutory construction and as a matter of tax policy.

Some commentators explained that the usual rules regarding the income taxation of trusts and their beneficiaries do not apply to ANSTs and their beneficiaries, and accordingly, ANSTs should not be viewed as trusts for purposes of section 1411. Specifically, section 646 provides special rules for the taxation of ANSTs at the lowest individual tax rate. Furthermore, section 646 treats all distributions, to the extent of the trust's current and accumulated taxable income, as amounts excludable from the gross income of the recipient beneficiaries. Additionally, section 646 prohibits the trust from claiming a distribution deduction, which is a deduction allowed in computing a trust's income under chapter 1 and also a deduction allowable for purposes of section 1411.

Commentators further explained that the statutory framework for the taxation of ANSTs reflects important policy considerations relating to the beneficiaries of ANSTs, which were expressed in the Congressional findings and declaration of policy in the Alaska Native Claims Settlement Act (Public Law 92-203, 85 Stat. 688) ("ANCSA"). See 43 U.S.C. §1601. The commentators said that those policies include the following: