NEW YORK STATE BAR ASSOCIATION
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May 15, 2013

The Honorable Mark Mazur
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Steven Miller
Acting Commissioner
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The Honorable William J. Wilkins
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Re: New York State Bar Association Tax Section Report on the Proposed Regulations under Section 1411

Dear Messrs. Mazur, Miller and Wilkins:

I am pleased to submit the enclosed New York State Bar Association Tax Section Report on the regulations proposed under Section 1411 of the Internal Revenue Code (the "Code") on December 3, 2012 (the "Proposed Regulations").

Section 1411 was enacted in 2010 and became effective this year. The statute is relatively short, but drafting regulations to implement it raises complex and difficult issues, and we commend the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") for the Proposed Regulations. We understand that Treasury and the IRS intend to finalize the regulations before the end of 2013 and we support that and hope that this Report assists you.[1] We are also available to provide any additional assistance that you think might be helpful.

[1] This Report does not address provisions of the Proposed Regulations relating to investments in controlled foreign corporations and passive investment companies, which are being addressed in a companion report.

The key to Section 1411 is the definition of net investment income ("NII"), and a principal focus of the Proposed Regulations are rules for determining the items of gross income that are included or excluded from the computation of NII and the availability of and limitations on the use of deductions in computing NII.[2] An important aspect of Section 1411 is its explicit cross reference to the definition of a passive activity in Section 469 for purposes of determining whether income is included or excluded from NII.

The Report makes several recommendations and comments regarding the computation of NII, including the following:

- Many important aspects of how the Proposed Regulations work are explained only in the preamble to the Proposed Regulations (the "Preamble"). We recommend that the substantive portions of the Preamble (with whatever modifications are made) be reflected in the text of the final regulations (the "Final Regulations"). (Section IV.a.)[3]

- We recommend that the Final Regulations clarify the manner in which NII is computed by explaining (i) that properly allocable deductions do not need to be assigned among the three categories of income and that properly allocated deductions are aggregated and deducted from the sum of the amounts in the three categories, including Category 3; (ii) that notwithstanding the separation of the computation of NII into three categories, in the case of items that could be in Category 1 or Category 2, there is no consequence to which category they are placed in (although the proper category would be Category 1), and that in the case of income that could be in Category 2 or Category 3, the proper category would be Category 3 and that this is important because it may impact the amount of total NII; (iii) all Category 1-Type Income, including income derived from Section 1411 Businesses,[4] is in Category 1, unless excluded because derived in the ordinary course of Non-Section 1411 Businesses.[5] (Section IV.b.)

- We recommend that the Final Regulations clarify how the ordinary course of trade or business exception for Category 1-Type Income applies by explicitly identifying what rules govern the

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[2] NII is generally equal to the sum of three categories of income ("Category 1 Income", "Category 2 Income", and "Category 3 Net Gains") reduced by deductions properly allocable to such income. Category 1 and Category 2 include only items of gross income, whereas Category 3 includes items of gross income and items of loss.

[3] These parenthetical section references are to sections of the Report.

[4] A "Section 1411 Business" means a trade or business the income from which is subject to Section 1411.

[5] A "Non-Section 1411 Business" means a trade or business the income from which is not subject to Section 1411.

determination of whether income is "derived in the ordinary course" of a business (and selecting common law rules rather than the Treas. Reg. § 1.469-2T rules (which under Section 469 treat certain types of income as being income from a passive activity)). (Section IV.c.1.)

- A Section 1411 Business includes a trade or business that is a passive activity with respect to the taxpayer (within the meaning of Section 469 or the regulations thereunder) (a "Section 1411 469 Business"). Section 469 and the regulations thereunder have significant and complex special rules that (i) recharacterize income that would otherwise be treated as derived from a Section 469 passive activity as income that is not derived from a passive activity, and (ii) recharacterize what would otherwise be a Section 469 passive activity as not a Section 469 passive activity. We recommend that the Final Regulations clarify which (if any) of the Section 469 regulations' special recharacterization rules apply in determining what is a Section 1411 469 Business and what income is treated as derived from that business (for purposes of computing NII). While we recognize that the Section 1411 statute defines passive activity by reference to Section 469's definition of a passive activity, we believe that given the differing purposes of Section 469 and Section 1411, strict adherence to the recharacterization regulations under Section 469 is not required in applying Section 1411, and that strict adherence could potentially result in unwarranted exclusions of income from the scope of NII. (Section IV.c.2.)

- We recommend that the Final Regulations clarify the extent to which the so-called "self-charged interest rule" in the Section 469 regulations applies for Section 1411 purposes and the consequences of it applying. (Section IV.c.3.)

- We recommend that the Final Regulations address how guaranteed payments by a partnership for the use of capital, within the meaning of Section 707(c), are treated in the Section 1411 context. (Section IV.c.4.)

- We recommend removing or modifying the rule that puts all of the trading gains derived by a Section 1411 Trading Business[6] in Category 2 Income (while all of its trading losses are included in Category 3 Net Gain). We believe that such gains should be in Category 3 Net Gain. (Section IV.d.)

- We recommend that the Final Regulations clarify how Category 3 Net Gain is computed by describing the rules in more detail. The Final Regulations also should address ordering rules for how capital losses and capital loss carryforwards are used or absorbed and rules for how taxpayers should "track" the amount of capital loss carryforwards that are available to be used in computing Category 3 Net Gains. (Section IV.e.1.)

- We recommend that the Final Regulations expressly state that for a deduction to be properly allocable to income included in NII, the deduction need not be recognized in the same taxable year as the gross income or net gain is recognized. We also recommend that the Final Regulations confirm that negative adjustments pursuant to Treas. Reg. § 1.1275-4(b)(6),

[6] A "Section 1411 Trading Business" means a trade or business of trading in financial instruments or commodities.

treated as ordinary loss pursuant to that regulation, will be treated as properly allocable deductions and not items taken into account in computing Category 3 Net Gain. (Section IV.e.3.)

- We agree with the Proposed Regulations that a taxpayer who claims a foreign tax credit is not, under the words of the Code, permitted to claim a deduction for foreign income taxes in computing NII or a credit for foreign income taxes in computing the tax due under Section 1411. We believe, however, that there is a strong argument that taking the Section 1411 tax into account under Sections 901 and 904 may be required under certain U.S. tax treaties in computing the credit allowable for taxes paid to those treaty partners. On the other hand, we also believe that Congress has the power to enact a statute that overrides treaty obligations but we think it is unclear if Congress intended to do that here. We also think it is unclear whether Treasury and the IRS have the authority to issue regulations that would follow the treaties but contradict the terms of Sections 901, 904 and Section 1411. (Section IV.f.)

- Notional principal contract ("NPC") periodic income does not fit within Category 1-Type Income as defined in the Proposed Regulations, and the Preamble seems to confirm this. We recommend that Treasury and the IRS consider expanding the definition of Category 1 Income to pick up NPC periodic income, securities lending fee income and other similar items, through a specific or "similar items" rule. In the event that Treasury and the IRS do not believe that they can expand the definition of Category 1 Income by regulation to cover these items, we recommend that the Final Regulations include a specific anti-abuse rule to protect against attempts to exploit these exclusions. (Section IV.g.1.)

- We recommend including in the text of the regulations the statement in the Preamble explaining that Category 1-Type Income includes amounts treated as dividends under chapter 1 of the Code, including amounts treated as dividends under subchapter C, Section 1248, Section 1368(c)(2) and Treas. Reg. § 1.367(b)-2(e)(2). (Section IV.g.2.)

- We recommend that the Final Regulations include an explicit statement that whether an activity is a trade or business is to be determined, in all cases, at the entity level. (Section IV.h.)

- While the Proposed Regulations permit individuals, estates and trusts to regroup certain activities, they do not permit Section 469 entities to regroup. The enactment of Section 1411 may cause Section 469 entities to reconsider their prior grouping decisions for the same reasons that their individual shareholders or partners would want to regroup. We recommend that the Final Regulations extend the one-time regrouping right to Section 469 entities. (Section IV.i.)

Section 1411(c)(4) addresses how to determine the amount of NII resulting from a sale or other disposition of an interest in a partnership or S corporation. The Proposed Regulations provide extensive rules addressing this issue. The Report makes the following recommendations and comments with respect to those provisions of the Proposed Regulations:

- In computing the amount of NII resulting from the sale of an interest in a partnership or S corporation, we recommend that the Final Regulations follow more closely the approach set out in Section 1411(c)(4) in place of the approach of the Proposed Regulations, and that the special rule for valuing goodwill be replaced with a rule that any goodwill in the entity be

treated as attributable to the business(es) it is actually attributable to and that it be valued using commonly accepted valuation methods. (Sections IV.j.1. and 2.)

- With respect to the statement (relating to the computation of NII) that must be included in the tax return filed by the transferor of a partnership interest or S corporation stock, we recommend that the Final Regulations contain an unambiguous rule requiring an entity to provide the information necessary for the statement if (i) the transferor requests such information in writing and (ii) the transferor advises the entity of its passive or active status with respect to each trade or business of the entity. We also recommend that a transferor be permitted to group and net assets for purposes of this statement. Finally, if our recommendation regarding the method of computing NII under Section 1411(c)(4) is not adopted, we recommend that the statement be required to include only information regarding the deemed sale of Non-Section 1411 Business assets rather than all of the entity's asset. (Section IV.j.3.)

The Proposed Regulations provide that net operating loss deductions carried forward from prior years may not be taken into account in computing NII. This issue is not addressed explicitly in the statute and the Preamble solicits comments on this approach. The Preamble also solicits comments on the treatment of suspended losses that are permitted to be deducted under Section 469(g)(1) on disposition of a passive activity. Our recommendations relating to these issues include:

- We believe that it would be more appropriate to permit an NOL deduction in this context than to deny it, and we also believe it would be possible to establish administrable rules which would be no more complex that those otherwise encountered in other carryover contexts. (Section IV.e.2.)

- We recommend that suspended passive losses triggered under Section 469(g)(1) be treated as properly allocable deductions, except that any portion of a suspended loss that is a Section 165 loss should be taken into account as a component of Category 3 Net Gains. (Section IV.e.4.)

The legislative history to Section 1411 makes it clear that the Section 1411 Medicare contribution tax was intended by Congress to parallel the other two existing hospital insurance taxes imposed on earned income of individuals (*i.e.*, the 3.8% tax imposed on wages by Sections 3101 and 3111 (the "FICA HI tax") and the 3.8% tax imposed on self-employment income by Section 1401 (the "NESE HI tax")). There is no statement in the legislative history or elsewhere that indicates that all income of U.S. individuals was intended to be subject to one of these three Medicare contribution taxes. Nevertheless, it is clear that Congress intended the Section 1411 tax to apply only to income that was not subject to the other two Medicare taxes. In the Report, we discuss classes of income realized by individuals that historically have not been subject to the FICA HI tax or the NESE HI tax, and also may not be subject to the Section 1411 tax; and we then provide comments on whether we think this was intentional.

In the final section of the Report we address the application of Section 1411 to one type of income: income derived by managers of investment vehicles that are classified as partnerships for U.S. tax purposes (namely, investment funds and hedge funds). One reason that we focus on this type of income is that Section 1411 explicitly includes in NII income "derived from …a trade or business of trading in financial instruments or commodities," yet income derived by the managers of these businesses (and other similar businesses) may not be included in NII.

The managers of the investment funds and hedge funds often receive fee income (separate and apart from their carried interest) for providing management services to the fund. This fee income may, in some cases, be excluded from NESE under the exception for income derived as a limited partner (*i.e.*, Section 1402(a)(13) or an S corporation shareholder). Under the Proposed Regulations, this fee income may also not be included in NII. Some members of our committee are of the view that an individual should not be able to take the position (i) that he or she is a "limited partner" under Section 1402(a)(13) as to a stream of income and (ii) at the same time that the same income is derived from a Section 162 trade or business as to which he or she is a material participant (and thus it is not income from a Section 469 passive activity as to the individual and therefore is not included in NII). In other words, that an individual should not be able to be both a "limited partner" for Section 1402(a)(13) purposes and a "material participant" for Section 1411 with respect to the income from the same activity since this would be contrary to the apparent purpose of the statute.[7]

This is a controversial issue and there are many different views as to whether this is appropriate, and those who view it as inappropriate have differing views as to what possible responses are available to Treasury and the IRS under the current statutory provisions. In the Report, we try to set out those views in the hope that this will assist Treasury and the IRS in deciding what, if any, action to take.

Another issue we address is the possibility that some hedge fund managers may convert what was previously carried interest income and which would be included in NII into a component of the management fee which presumably would not be included in NII (or in the NESE HI tax base). Again, we discuss whether this is a concern and possible ways to address it if it is.

As closing comments, we express our concerns that the implementation of Section 1411 has proven to be far more complicated than we think Congress intended or expected. We urge the tax writing committees to consider whether statutory amendments to Section 1411 might be appropriate in order to remove what we believe are unintended complexities and in order to simplify the computation of NII. We would be pleased to assist in any way that we can.

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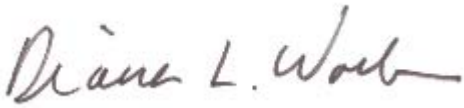
[7] This issue is not limited to managers of funds, but in the case of managers of funds it raises unique issues due to the fact that Section 1411 explicitly includes in NII income derived from a trading business.

We very much appreciate your consideration of our recommendations and look forward to continuing to work with you.

Respectfully submitted,



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