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General Comment

see attachment

Attachments

Net Investment Income Tax

REG-130507-11

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**LEGAL PROCESSING DIVISION
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Attention: CC:PA:LPD:PR (REG-130507-11)

**Re: Comments on Proposed Regulations:
Section 1411 Investment Income Tax**

Dear Sir or Madam:

We are writing to you on behalf of the International Cemetery, Cremation and Funeral Association ("ICCFA") in response to Notice of Proposed Rule Making REG-130507-11, requesting comments from interested parties regarding proposed regulations under section 1411 of the Internal Revenue Code (the "Code"), concerning the application of the new 3.8 percent net investment income tax to certain individuals, estates, and trusts.

Founded in 1887, ICCFA is a voluntary Code section 501(c)(6) nonprofit trade association with over 7500 members, including non-profit, for-profit, religious and municipal cemeteries, funeral homes, crematories, monument builders, and third party retailers. ICCFA's

activities include tracking federal and state legislation affecting the death care industry and promoting education through its publications, and by holding seminars, conferences, annual conventions and trade shows. ICCFA also takes an active role in advancing the public interest on funeral industry issues. ICCFA promotes consumer choice, the pre-arrangement of funeral and burial decisions, and open competition among providers of death care services.

The interests of ICCFA's members will be significantly affected by the rules contained in these proposed regulations, specifically the rules contained in Prop. Treas. Reg. § 1.1411-3 concerning the applicability of section 1411 to estates and trusts. Our comments address the application of the section 1411 net investment income tax to the following types of trusts that are widely utilized throughout the death care industry:

1. Qualified funeral trusts described under Code section 685, and
2. Cemetery perpetual care funds described under Code section 642(i).

Our comments are summarized and then addressed in detail below.

OUTLINE OF COMMENTS

- I. The Proposed Regulations Should Specifically Clarify that the Section 1411 Tax Applies to Section 685 Qualified Funeral Trusts on a Per-Beneficiary Basis and Not Based on the Aggregate Income of Each Qualified Funeral Trust**
- II. Congress Never Intended for Section 1411 to Apply to Section 642(i) Cemetery Perpetual Care Funds and the Proposed Regulations Should Therefore Exempt Section 642(i) Trusts from the Investment Income Tax**
 - a. Section 642(i) was added to the Code to address the hybrid nature of this state-law mandated funding vehicle as both a trust for the benefit of individual gravesite owners, as well as an adjunct to the business of a profit-making cemetery
 - b. Imposing the 3.8 percent Medicare investment income tax on the aggregate earnings of perpetual care trusts would contravene the clear purpose of section 1411 of levying a surtax on the unearned income of individual taxpayers and associated non-tax-exempt trusts

- c. Exempting Section 642(i) trusts from the investment income tax falls within the Internal Revenue Service's and Treasury Department's administrative authority, as well as the stated objective of the proposed regulations to promote the fair administration of section 1411, while preventing circumvention of the statute.

DETAILED COMMENTS

I. The Proposed Regulations Should Specifically Clarify that the Section 1411 Tax Applies to Section 685 Qualified Funeral Trusts on a Per-Beneficiary Basis and Not Based on the Aggregate Income of Each Qualified Funeral Trust

Section 1.1411-3(a)(1)(i) of the proposed regulations provides that the tax under section 1411 applies to "all estates and trusts that are subject to the provisions of part I of subchapter J of chapter 1 of subtitle A" of the Code unless specifically exempted in paragraph (b) of that section. In the preamble to the proposed regulations, the Service makes clear its position that this definition applies "even though such trusts may have special computational rules" under part I subchapter J, listing both section 685 qualified funeral trusts and section 642(i) perpetual care trusts as specific examples of such trusts. We respectfully disagree that the "trust or estate" definition under section 1411 is intended to encompass these types of trusts.

One of the many problems with the broad scope of this definition is that it creates an ambiguity under the tax computation provisions of section 1411 as to whether the investment income tax would apply to a qualified funeral trust under section 685 based on the income attributable to such trust's individual beneficiaries or if the tax should be computed based on the aggregate income of the trust. We believe this ambiguity exists in large part because Congress never intended for section 1411 to apply to qualified funeral trusts, as this classification of trusts only exists in subchapter J to serve as a voluntary election intended to simplify the computation and payment of income taxes on what would otherwise be a multitude of relatively small individual grantor trusts. If the Service maintains its position regarding the applicability of

section 1411 to qualified funeral trusts, it should at a minimum clarify the proposed regulations to make clear that the investment income tax for such trusts is computed on a per-beneficiary basis.

Prior to the enactment of section 685 in 1997, a typical pre-need funeral contract under which an individual paid upfront for specified funeral merchandise and services to be provided upon the purchaser's death would have generally resulted in the creation of a grantor trust and the annual income would be taxable to the purchaser.¹ Under state laws governing pre-need funeral contracts, the funeral provider that sold the contract was required to deposit all or a portion of the proceeds of the contract into an income-generating trust account, with the proceeds being paid to the seller upon the purchaser's death. Depending on the requirements of state law and the terms of the contracts, a pre-need contract seller would typically serve as the trustee and administrator of a single trust for the benefit of multiple purchasers.

Recognizing that this grantor trust treatment of pre-need funeral contracts required numerous individual taxpayers to account for the relatively small earnings of their trust interests on their tax returns, Congress enacted section 685 to reduce this recordkeeping burden while seeking to improve compliance with the tax law.² Section 685 allows a pre-need funeral trust that would otherwise be treated as multiple grantor trusts to elect to be taxed as a single entity, with the trustee filing a simplified annual return that reports the aggregate income of the trust accounts attributable to individual pre-need contract beneficiaries. A key feature of section 685 that distinguishes qualified funeral trusts from other trusts taxed under part I of subchapter J and prevents their beneficiaries from being treated less favorably than they would have under prior

¹ See Rev. Rul. 87-127, 1987-2 C.B. 156.

² See H.R. Rep. No. 105-220, at 715 (1997).

law is that section 685(c) applies the trust income tax rates of section 1(e) by treating each beneficiary's interest as a separate trust.

If section 1411 is interpreted to apply to qualified funeral trusts, as indicated in the proposed regulations, it is less than clear from the face of the statute how and whether the section 685(c) per-beneficiary computation rule would be used in the calculation of the Medicare investment income tax. Section 1411(a)(2) provides that the 3.8 percent tax for trusts and estates is assessed on the lesser of:

- (A) the undistributed net investment income for such taxable year, or
- (B) the excess (if any) of --
 - (i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over
 - (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

Viewed in the context of Congress' stated purpose in enacting section 685 – i.e., to ease the recordkeeping burden of trustees who voluntarily elect qualified funeral trust status without significantly effecting the tax treatment of beneficiaries – it would appear that the computation formula under section 1411 would be properly applied on a per-beneficiary basis for qualified funeral trusts. Yet the independent reference to section 1(e) in the second prong of the computation formula, along with the lack of any reference to section 685(c) in either section 1411 or in the proposed regulations, casts potential doubt on this interpretation.

The simplest and most logical solution to this ambiguity would be for the regulations to administratively exempt qualified funeral trusts from the application of section 1411. Alternatively, the Service should amend the proposed regulations to clarify that the entirety of

the computation formula under section 1411(a)(2) is to be applied to qualified funeral trusts by treating each beneficiary's interest as a separate trust, as required under section 685(c).

II. Congress Never Intended for Section 1411 to Apply to Section 642(i) Cemetery Perpetual Care Funds and the Proposed Regulations Should Therefore Exempt Section 642(i) Trusts from the Investment Income Tax

- a. Section 642(i) was added to the Code to address the hybrid nature of this state-law mandated funding vehicle as both a trust for the benefit of individual gravesite owners, as well as an adjunct to the business of profit-making cemeteries**

Qualified funeral trusts under section 685 are just one example of a specialized classification of trusts that, while being subject to income tax under part I of subchapter J, is clearly not the type of individual wealth accumulation vehicle that Congress sought to tax under section 1411. Cemetery perpetual care funds under section 642(i) present another such example that cannot be addressed by merely clarifying the mechanics of the section 1411 tax computation formula. An examination of the history and purpose of section 642(i) reveals ample administrative reasons to exclude perpetual care trusts from the definition of a "trust or estate" under section 1411.

Cemetery perpetual care funds (also known as endowment care funds) are formed by cemetery companies under widespread state and local laws that require a percentage of a cemetery's proceeds from the sale of gravesites be deposited into a trust and that the income of the trust be used for perpetual care and maintenance of the gravesites. In the years preceding Congress' enactment of section 642(i) in 1976, the courts repeatedly grappled with a number of fundamental questions concerning the tax treatment of perpetual care funds established to maintain for-profit taxable cemetery companies, including:

- (1) whether the trusts should be treated as taxable trusts under subchapter J, or whether the trusts are instead eligible for tax-exempt status under Code section 501(c)(13);³ and
- (2) whether income earned by such trusts should be treated as income to the cemetery company.⁴

It is apparent from these early cases that cemetery perpetual care funds have never fit neatly into any particular classification under the Code – let alone subchapter J. This controversy is not surprising given the multitude of interests served by these trusts, ranging from the private interests of individual gravesite purchasers and their families, to the business interests of the cemetery companies, to the public interests of states and local communities in ensuring that under-maintained and abandoned cemeteries do not end up as the government's responsibility.

By 1976, the Service had come to the position that a perpetual care fund established by a taxable cemetery is indeed treated as a taxable trust under subchapter J.⁵ It was also the Service's position that distributions from such funds for the maintenance of gravesites are not entitled to income distribution deductions under Code sections 651 or 661 because the funds do not have any specifically identifiable beneficiaries.⁶ With the enactment of section 642(i) that year, however, Congress made clear that it was not entirely satisfied with the Service's position

³ E.g., *Graceland Cemetery Improvement Fund v. United States*, 515 F.2d 763 (Ct. Cl. 1975); Cf. *John D. Rockefeller Family Cemetery Corp. v. Comm'r*, 63 T.C. 355 (1974).

⁴ E.g., *Comm'r v. Cedar Park Cemetery Ass'n*, 183 F.2d 553 (7th Cir. 1950); *Portland Cremation Ass'n v. Comm'r*, 31 F.2d 843 (9th Cir. 1929); *Green Lawn Memorial Park, Inc. v. McDonald*, 164 F. Supp. 438 (M.D. Pa. 1958).

⁵ See Rev. Rul. 64-217, 1964-2 C.B. 153.

⁶ See, e.g., *Metairie Cemetery Assoc. v. United States*, 282 F.2d 225 (5th Cir. 1960).

on the tax treatment of perpetual care funds. The Senate Finance Committee report on this provision provided the following reasons for the change in law:

Pursuant to State law (in most cases) or legally enforceable by-laws and contracts (in other cases), many perpetual care funds make regular distributions to taxable cemeteries for the exclusive purpose of the care and maintenance of the gravesites of such cemeteries. The Service's position is that the deduction for income distributed to beneficiaries of trusts is not allowable to perpetual care funds because they do not have any ascertainable beneficiaries.

Because distributions by perpetual care funds for the purpose of the care and maintenance of gravesites are essentially equivalent to distributions on behalf of beneficiaries (gravesite owners, heirs, and general public) the committee believes that a limited deduction should be allowed with respect to such distributions.⁷

In addition to statutorily overturning the Service's prior position on subjecting perpetual care funds to the conventional income computation rules of part 1 of subchapter J, the enactment of section 642(i) illuminates Congress' perception of these trusts as being similar in character to the pre-need funeral arrangements that would later be recognized as qualified funeral trusts under section 685. 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. The operative rules of section 642(i) – which allow perpetual care funds a potential annual deduction of up to \$5 multiplied by the aggregate number of applicable gravesites – implicitly recognize the per-beneficiary characteristic that perpetual care funds share with qualified funeral trusts.

Both Congress and the courts have also expressed the view that a perpetual care fund's tax treatment must also take into account its uniquely close relationship with the business of the cemetery company – further distorting any resemblance of these funds to more conventional

⁷ S. Rep. No. 94-1317, at 2 (1976).

trusts that are also subject to part I of subchapter J. For example, in *Graceland Cemetery Improvement Fund v. United States*⁸ – a case cited in the legislative history of section 642(i)⁹ – the Court of Claims upheld the Service’s rejection of a perpetual care fund’s claim of tax-exempt status under section 501(c)(13) on the grounds that the fund “must be considered an adjunct” of the for-profit cemetery company because its “primary function was providing funds for the cemetery company’s activities in maintaining the cemetery”. Likewise, the Senate Finance Committee report on the enactment of section 642(i) expressed agreement with the Service’s position that a payment from a perpetual care fund to a cemetery company for maintenance of gravesites is “taxable to the cemetery company as ordinary income (sec. 61) and is not to be treated as a trust distribution in the hands of the cemetery company”¹⁰ – despite trust and/or contractual provisions that might, in the context of other types of trusts subject to part I of subchapter J, be construed as making the cemetery a beneficiary of the fund.¹¹

b. Imposing the 3.8 percent Medicare investment income tax on the aggregate earnings of perpetual care trusts would contravene the clear purpose of section 1411 in levying a surtax on the unearned income of individual taxpayers and associated non-tax-exempt trusts

Section 1411 is explicitly referred to in the Code as an “unearned income Medicare contribution”, and its structure is consistent with a surtax aimed at increasing the contribution of high-income individuals to the funding of the nation’s Medicare programs. It is only logical for such a surtax to be imposed not only on individual households whose incomes exceed certain thresholds, but also on private trusts, which such households often establish as vehicles for the

⁸ 515 F.2d 763 (Cl. Cl. 1975).

⁹ S. Rep. No. 94-1317, at 2 (1976).

¹⁰ S. Rep. No. 94-1317, at 3 (1976).

¹¹ The validity of this proposition has been subject to continued litigation as recently as this year. *Michigan Memorial Park v. United States*, 111 A.F.T.R. 2d 2013-475 (E.D. Mich. 2013) (upholding earlier court precedents and IRS rulings in finding the cemetery company to be taxable on payments from the perpetual care fund).

management and intergenerational transfer of wealth. The exemptions for distributions from qualified plan trusts under section 1411(c)(5) and for charitable trusts under section 1411(e)(2) are also consistent with the implication that Congress only intended for the trust surtax of section 1411(a)(2) to apply to private trusts of the type that can potentially generate unearned income for high-income individuals. The exemption for income derived from active business interests under sections 1411(c)(4) also underscores Congress' intention of targeting only the income of high-income individuals and not that of operating businesses, as does section 1411's companion Medicare payroll tax provision in Code section 3101(b)(2), which applies only to the individual employee's portion of the FICA tax for Medicare – not to the employer's portion.

Imposing the investment income tax on cemetery perpetual care funds would be inapposite to these purposes that are so clearly evident in the statutory structure of Section 1411 as it applies to trusts and estates. Unlike most any other private taxable trust to which part I of subchapter J applies – with a few notable exceptions including qualified funeral trusts – there is no conceivable way that an individual household could seek to utilize perpetual care funds to accumulate wealth and generate unearned income. To the extent these funds generate income for the benefit of individual gravesite owners, the amount of any income attributable to an individual's beneficial interest in the fund is almost certain to be below the dollar amount of the highest tax bracket under section 1(e) (\$11,950 in 2013).

The applicability of section 1411 to perpetual care trusts appears equally inappropriate when analyzing perpetual care trusts from the perspective of their aggregate income. By law, the only type of person that is ever in a position to receive distributions of income from these funds is a for-profit taxable cemetery company. As Congress, the courts, and the Service have made abundantly clear, such distributions of income from perpetual care funds are inextricably linked

to – and taxable to – the business of the cemetery company, and they are not analogous to a private trust’s distributions to an individual beneficiary. As such, the imposition of section 1411 tax on the aggregate income of a perpetual care fund would effectively be a tax on an operating business that directly conflicts with the basic purposes of the statute.

- c. Exempting Section 642(i) trusts from the investment income tax falls within the Internal Revenue Service’s and Treasury Department’s administrative authority, as well as the stated objective of the proposed regulations to promote the fair administration of section 1411, while preventing circumvention of the statute.**

As correctly noted in the preamble to the proposed regulations, section 1411 contains terms – including “trust” and “estate” – that are commonly used in federal income taxation, but are not otherwise defined in the statute, and there is no indication in the legislative history of section 1411 that Congress intended that every instance where such terms are used have the same meaning ascribed to them for other federal income tax purposes.

While we agree with the general approach that the Service and the Treasury took in attempting to elucidate the meaning of the term “trust or estate” as it is used in section 1411(a)(2), we do not believe the proposed regulations went far enough in this otherwise thoughtful analytical process. The preamble to the proposed regulations explains how, in absence of any explicit rule specifying the particular trusts subject to section 1411, the starting point for this analysis was to adopt the ordinary trust definition of Treasury Regulation section 301.7701-4(a) as the general rule for the scope of section 1411(a)(2). Of course, there is no valid reason why Congress would have intended the Service and Treasury to limit this analysis to a particular classification of trusts delineated under the section 7701 regulations, so the proposed regulations wisely go further in excluding trust categories such as business trusts described under Regulation section 301.7701-2 and eligible entities for purposes of entity classification in

Regulation section 301.7701-3. These exemptions make particular sense, since section 1411 was not intended to be a tax on active business interests.

However, we submit that the proposed regulations fall short in failing to extend this reasoning to certain additional categories of trusts that are taxed under part I of subchapter J – especially those that are subject to special computation rules within part I. As demonstrated in the foregoing sections, the classification of section 642(i) perpetual care trusts under part I of subchapter J was more a product of convenience in statutory drafting – in a situation where Congress was reacting with disfavor to the tax treatment adopted by the Service – than any deliberate manifestation of intent that these funds to be grouped in the same category of conventional private trusts.

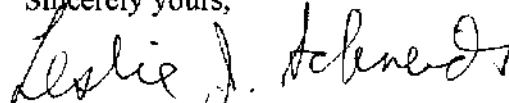
When the history, function, and tax characteristics of cemetery perpetual care funds are objectively compared to those of other types of trusts that are exempted from section 1411, without regard to whether they are subject to part I of subchapter J, we believe it is readily apparent that the legislative purposes and administrative implementation of section 1411 would be best served by exempting perpetual care funds from the investment income tax.

* * *

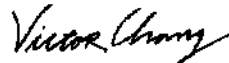
We appreciate this opportunity to comment on these proposed regulations. In the event

you have any questions about these comments, please feel free to contact the undersigned at
(202) 393-7600.

Sincerely yours,



Leslie J. Schneider



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