

after December 31, 2012, in accordance with § 1.1411-1(f).

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**§ 1.1411-4 Definition of net investment income.**

(a) *In general.* For purposes of section 1411 and the regulations thereunder, net investment income means the excess (if any) of—

(1) The sum of—

(i) Gross income from interest, dividends, annuities, royalties, and rents, except to the extent excluded by the ordinary course of a trade or business exception described in paragraph (b) of this section;

(ii) Other gross income derived from a trade or business described in § 1.1411-5; and

(iii) Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent excluded by the exception described in paragraph (d)(4)(i)(A) of this section for gain or loss attributable to property held in a trade or business not described in § 1.1411-5; over

(2) The deductions allowed by subtitle A that are properly allocable to such gross income or net gain (as determined in paragraph (f) of this section).

(b) *Ordinary course of a trade or business exception.* Gross income described in paragraph (a)(1)(i) of this section is excluded from net investment income if it is derived in the ordinary course of a trade or business not described in § 1.1411-5. See § 1.1411-6 for rules regarding working capital. To determine whether gross income described in paragraph (a)(1)(i) of this section is derived in a trade or business, the following rules apply.

(1) In the case of an individual, estate, or trust that owns or engages in a trade or business directly (or indirectly through ownership of an interest in an entity that is disregarded as an entity separate from its owner under § 301.7701-3), the determination of whether gross income described in paragraph (a)(1)(i) of this section is derived in a trade or business is made at the individual, estate, or trust level.

(2) In the case of an individual, estate, or trust that owns an interest in a passthrough entity (for example, a partnership or S corporation), and that entity is engaged in a trade or business, the determination of whether gross income described in paragraph (a)(1)(i) of this section is—

(i) Derived in a trade or business described in § 1.1411-5(a)(1) is made at the owner level; and

(ii) Derived in a trade or business described in § 1.1411-5(a)(2) is made at the entity level.

(3) The following examples illustrate the provisions of this paragraph (b). For purposes of these examples, assume that the taxpayer is a United States citizen, uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

*Example 1. Multiple passthrough entities.* A, an individual, owns an interest in UTP, a partnership, which is engaged in a trade or business. UTP owns an interest in LTP, also a partnership, which is not engaged in a trade or business. LTP receives \$10,000 in dividends, \$5,000 of which is allocated to A through UTP. The \$5,000 of dividends is not derived in a trade or business because LTP is not engaged in a trade or business. This is true even though UTP is engaged in a trade or business. Accordingly, the ordinary course of a trade or business exception described in paragraph (b) of this section does not apply, and A's \$5,000 of dividends is net investment income under paragraph (a)(1)(i) of this section.

*Example 2. Multiple passthrough entities.* B, an individual, owns an interest in UTP2, a partnership, which is not engaged in a trade or business. UTP2 owns an interest in LTP2, also a partnership, which is engaged in a commercial lending trade or business. LTP2 is not engaged in a trade or business described in § 1.1411-5(a)(2). LTP2's trade or business is not a passive activity (within the meaning of section 469) with respect to B. LTP2 earns \$10,000 of interest income from its trade or business which is allocated to B through UTP2. Although UTP2 is not engaged in a trade or business, the \$10,000 of interest income is derived in the ordinary course of LTP2's lending trade or business. Because LTP2 is not engaged in a trade or business described in § 1.1411-5(a)(2) and because LTP2's trade or business is not a passive activity with respect to B (as described in § 1.1411-5(a)(1)), the ordinary course of a trade or business exception described in paragraph (b) of this section applies, and B's

\$10,000 of interest is not included as net investment income under paragraph (a)(1)(i) of this section.

*Example 3. Entity engaged in trading in financial instruments.* C, an individual, owns an interest in PRS, a partnership, which is engaged in a trade or business of trading in financial instruments (as defined in § 1.1411-5(a)(2)). PRS' trade or business is not a passive activity (within the meaning of section 469) with respect to C. In addition, C is not directly engaged in a trade or business of trading in financial instruments or commodities. PRS earns interest of \$50,000, and C's distributive share of the interest is \$25,000. Because PRS is engaged in a trade or business described in § 1.1411-5(a)(2), the ordinary course of a trade or business exception described in paragraph (b) of this section does not apply, and C's \$25,000 distributive share of the interest is net investment income under paragraph (a)(1)(i) of this section.

*Example 4. Application of ordinary course of a trade or business exception.* D, an individual, owns stock in S corporation, S. S is engaged in a banking trade or business (that is not a trade or business of trading in financial instruments or commodities), and S's trade or business is not a passive activity (within the meaning of section 469) with respect to D because D materially participates in the activity. S earns \$100,000 of interest in the ordinary course of its trade or business, of which \$5,000 is D's pro rata share. For purposes of paragraph (b) of this section, the interest income is derived in the ordinary course of S's banking business because it is not working capital under section 1411(c)(3) and § 1.1411-6(a) (because it is considered to be derived in the ordinary course of a trade or business under the principles of § 1.469-2T(c)(3)(ii)(A)). Because S is not engaged in a trade or business described in § 1.1411-5(a)(2) and because S's trade or business is not a passive activity with respect to D (as described in § 1.1411-5(a)(1)), the ordinary course of a trade or business exception described in paragraph (b) of this section applies, and D's \$5,000 of interest is not included under paragraph (a)(1)(i) of this section.

(c) *Other gross income from a trade or business described in § 1.1411-5.* For a trade or business described in § 1.1411-5, paragraph (a)(1)(ii) of this section includes all other gross income (within the meaning of section 61) that is not gross income described in paragraph (a)(1)(i) of this section or net gain described in paragraph (a)(1)(iii) of this section.

(d) *Net gain.* This paragraph (d) describes special rules for purposes of paragraph (a)(1)(iii) of this section.

(1) *Definition of disposition.* For purposes of section 1411 and the regulations thereunder, the term *disposition* means a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition (including a deemed disposition, for example, under section 877A).

(2) *Limitation.* The calculation of net gain may not be less than zero. Losses allowable under section 1211(b) are permitted to offset gain from the disposition of assets other than capital assets that are subject to section 1411.

(3) *Net gain attributable to the disposition of property—(i) General rule.* Net gain attributable to the disposition of property is the gain described in section 61(a)(3) recognized from the disposition of property reduced, but not below zero, by losses deductible under section 165, including losses attributable to casualty, theft, and abandonment or other worthlessness. The rules in subchapter O of chapter 1 and the regulations thereunder apply. See, for example, § 1.61-6(b). For purposes of this paragraph, net gain includes, but is not limited to, gain or loss attributable to the disposition of property from the investment of working capital (as defined in § 1.1411-6); gain or loss attributable to the disposition of a life insurance contract; and gain attributable to the disposition of an annuity contract to the extent the sales price of the annuity exceeds the annuity's surrender value.

(ii) *Examples.* The following examples illustrate the provisions of this paragraph (d)(3). For purposes of these examples, assume that the taxpayer is a United States citizen, uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

*Example 1. Calculation of net gain.* (i) In Year 1, A, an unmarried individual, realizes a capital loss of \$40,000 on the sale of P stock and realizes a capital gain of \$10,000 on the sale of Q stock, resulting in a net capital loss of \$30,000. Both P and Q are C corporations. A has no other capital gain or capital loss in Year 1. In addition, A receives wages of \$300,000 and earns \$5,000 of gross income from interest. For income tax purposes, under section 1211(b), A may use \$3,000 of the net capital loss against other income. Under section 1212(b)(1), the remaining \$27,000 is a capital

loss carryover. For purposes of determining A's Year 1 net gain under paragraph (a)(1)(iii) of this section, A's gain of \$10,000 on the sale of the Q stock is reduced by A's loss of \$40,000 on the sale of the P stock. In addition, A may reduce net investment income by the \$3,000 of the excess of capital losses over capital gains allowed for income tax purposes under section 1211(b).

(ii) In Year 2, A has a capital gain of \$30,000 on the sale of Y stock. Y is a C corporation. A has no other capital gain or capital loss in Year 2. For income tax purposes, A may reduce the \$30,000 gain by the Year 1 section 1212(b) \$27,000 capital loss carryover. For purposes of determining A's Year 2 net gain under paragraph (a)(1)(iii) of this section, A's \$30,000 gain may also be reduced by the \$27,000 capital loss carryover from Year 1. Therefore, in Year 2, A has \$3,000 of net gain for purposes of paragraph (a)(1)(iii) of this section.

*Example 2. Calculation of net gain.* The facts are the same as in *Example 1*, except that in Year 1, A also realizes a gain of \$20,000 on the sale of Rental Property D, all of which is treated as ordinary income under section 1250. For income tax purposes, under section 1211(b), A may use \$3,000 of the net capital loss against other income. Under section 1212(b)(1) the remaining \$27,000 is a capital loss carryover. For purposes of determining A's net gain under paragraph (a)(1)(iii) of this section, A's gain of \$10,000 on the sale of the Q stock is reduced by A's loss of \$40,000 on the sale of the P stock. A's \$20,000 gain on the sale of Rental Property D is reduced to the extent of the \$3,000 loss allowed under section 1211(b). Therefore, A's net gain for Year 1 is \$17,000 (\$20,000 gain treated as ordinary income on the sale of Rental Property D reduced by \$3,000 loss allowed under section 1211).

*Example 3. Section 121(a) exclusion.* (i) In Year 1, A, an unmarried individual, sells a house that A has owned and used as A's principal residence for the five years preceding the sale and realizes \$200,000 in gain. In addition to the gain realized from the sale of A's principal residence, A also realizes \$7,000 in long-term capital gain. A has a \$5,000 short-term capital loss carryover from a year preceding the effective date of section 1411.

(ii) For income tax purposes, under section 121(a), A excludes the \$200,000 gain realized from the sale of A's principal residence from A's Year 1 gross income. In determining A's Year 1 adjusted gross income, A also reduces the \$7,000 capital gain by the \$5,000 capital loss carryover allowed under section 1211(b).

(iii) For section 1411 purposes, under section 121(a), A excludes the \$200,000 gain realized from the sale of A's principal residence from A's Year 1 gross income and, consequently, from A's net investment income. In determining A's Year 1 net gain under paragraph (a)(1)(iii) of this section, A re-

duces the \$7,000 capital gain by the \$5,000 capital loss carryover allowed under section 1211(b).

*Example 4. Section 1031 like-kind exchange.*

(i) In Year 1, A, an unmarried individual who is not a dealer in real estate, purchases Greenacre, a piece of undeveloped land, for \$10,000. A intends to hold Greenacre for investment.

(ii) In Year 3, A enters into an exchange in which A transfers Greenacre, now valued at \$20,000, and \$5,000 cash for Blackacre, another piece of undeveloped land, which has a fair market value of \$25,000. The exchange is a transaction for which no gain or loss is recognized under section 1031.

(iii) In Year 3, for income tax purposes, A does not recognize any gain from the exchange of Greenacre for Blackacre. A's basis in Blackacre is \$15,000 (\$10,000 substituted basis in Greenacre plus \$5,000 additional cost of acquisition). For purposes of section 1411, A's net investment income for Year 3 does not include any realized gain from the exchange of Greenacre for Blackacre.

(iv) In Year 5, A sells Blackacre to an unrelated party for \$35,000 in cash.

(v) In Year 5, for income tax purposes, A recognizes capital gain of \$20,000 (\$35,000 sale price minus \$15,000 basis). For purposes of section 1411, A's net investment income includes the \$20,000 gain recognized from the sale of Blackacre.

(4) *Gains and losses excluded from net investment income—(i) Exception for gain or loss attributable to property held in a trade or business not described in § 1.1411-5—(A) General rule.* Net gain does not include gain or loss attributable to property (other than property from the investment of working capital (as described in § 1.1411-6)) held in a trade or business not described in § 1.1411-5.

(B) *Special rules for determining whether property is held in a trade or business.* To determine whether net gain described in paragraph (a)(1)(iii) of this section is from property held in a trade or business—

(1) A partnership interest or S corporation stock generally is not property held in a trade or business. Therefore, gain from the sale of a partnership interest or S corporation stock is generally gain described in paragraph (a)(1)(iii) of this section. However, net gain does not include certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations as provided in § 1.1411-7.

(2) In the case of an individual, estate, or trust that owns or engages in a trade or business directly (or indirectly

through ownership of an interest in an entity that is disregarded as an entity separate from its owner under § 301.7701-3), the determination of whether net gain described in paragraph (a)(1)(iii) of this section is attributable to property held in a trade or business is made at the individual, estate, or trust level.

(3) In the case of an individual, estate, or trust that owns an interest in a passthrough entity (for example, a partnership or S corporation), and that entity is engaged in a trade or business, the determination of whether net gain described in paragraph (a)(1)(iii) of this section from such entity is attributable to—

(i) Property held in a trade or business described in § 1.1411-5(a)(1) is made at the owner level; and

(ii) Property held in a trade or business described in § 1.1411-5(a)(2) is made at the entity level.

(C) *Examples.* The following examples illustrate the provisions of this paragraph (d)(4)(i). For purposes of these examples, assume the taxpayer is a United States citizen, uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

*Example 1. Gain from rental activity.* A, an unmarried individual, rents a boat to B for \$100,000 in Year 1. A's rental activity does not involve the conduct of a section 162 trade or business, and under section 469(c)(2), A's rental activity is a passive activity. In Year 2, A sells the boat to B, and A realizes and recognizes taxable gain attributable to the disposition of the boat of \$500,000. Because the exception provided in paragraph (d)(4)(i)(A) of this section requires a trade or business, this exception is inapplicable, and therefore, A's \$500,000 gain will be taken into account under § 1.1411-4(a)(1)(iii).

*Example 2. Installment sale.* (i) PRS, a partnership for Federal income tax purposes, operates an automobile dealership. Therefore, with respect to B and C, PRS is not a trade or business described in section 1411(c)(2) and § 1.1411-5. D owns the remaining 20% of PRS. Assume, for purposes of this example, that PRS is a passive activity with respect to D, and therefore is a trade or business described in section 1411(c)(2)(A) and § 1.1411-5(a)(1).

(ii)(A) In Year 0, a year preceding the effective date of section 1411, PRS relocates its dealership to a larger location. As a result of the relocation, PRS sells its old dealership facility to a real estate developer in exchange for \$1,000,000 cash and a \$4,500,000

promissory note, fully amortizing over the subsequent 15 years, and bearing adequate stated interest. PRS reports the sale transaction under section 453. PRS's adjusted tax basis in the old dealership facility is \$1,075,000. Assume for purposes of this example that PRS has \$300,000 of recapture income (within the meaning of section 453(i)); the buyer is not related to PRS, B, C, or D; and the buyer is not assuming any liabilities of PRS in the transaction.

(B) For chapter 1 purposes, PRS has realized gain on the transaction of \$4,425,000 (\$5,500,000 less \$1,075,000). Pursuant to section 453(i), PRS will take into account \$300,000 of the recapture income in Year 0, and the gain in excess of the recapture income (\$4,125,000) will be taken into account under the installment method. For purposes of section 453, PRS's profit percentage is 75% (\$4,125,000 gain divided by \$5,500,000 gross selling price). In Year 0, PRS will take into account \$750,000 of capital gain attributable to the \$1,000,000 cash payment. In the subsequent 15 years, PRS will receive annual payments of \$300,000 (plus interest). Each payment will result in PRS recognizing \$225,000 of capital gain (75% of \$300,000).

(iii)(A) In Year 1, PRS receives a payment of \$300,000 plus the applicable amount of interest. For purposes of chapter 1, PRS recognizes \$225,000 of capital gain. B and C's distributive share of the gain is \$90,000 each and D's distributive share of the gain is \$45,000.

(B) The old dealership facility constituted property held in PRS's trade or business. In the case of section 453 installment sales, section 453 governs the timing of the gain recognition, but does not alter the character of the gain. See § 1.1411-1(a). The determination of whether the gain is attributable to the disposition of property used in a trade or business described in paragraph (d)(4)(i) of this section constitutes an element of the gain's character for Federal tax purposes. As a result, the applicability of paragraph (d)(4)(i) of this section is determined in Year 0 and applies to all gain received on the promissory note during the 15 year payment period. This result is consistent with the section 469 determination of the passive or non-passive classification of the gain under § 1.469-2T(c)(2)(i)(A).

(C) In the case of D, PRS's trade or business is described in section 1411(c)(2)(A) and § 1.1411-5(a)(1). Therefore, the exclusion in paragraph (d)(4)(i) of this section does not apply, and D must include the \$45,000 of gain in D's net investment income.

(D) In the case of B and C, PRS's trade or business is not described in section 1411(c)(2) or § 1.1411-5. Therefore, B and C exclude the \$90,000 gain from net investment income pursuant to paragraph (d)(4)(i) of this section.

(iv) In Year 2, C dies and C's 40% interest in PRS passes to Estate.

(v)(A) In Year 3, PRS receives a payment of \$300,000 plus the applicable amount of interest. For purposes of chapter 1, PRS recognizes \$225,000 of capital gain. B and Estate each have a distributive share of the gain equal to \$90,000 and D's distributive share of the gain is \$45,000.

(B) The calculation of net investment income for B and D in Year 3 is the same as in (iii) for Year 1.

(C) In the case of Estate, the distributive share of the \$90,000 gain constitutes income in respect of a decedent (IRD) under section 691(a)(4) and subchapter K. See § 1.1411-1(a). Assume that Estate paid estate taxes of \$5,000 that were attributable to the \$90,000 of IRD. Pursuant to section 691(c)(4), the amount of gain taken into account in computing Estate's taxable income in Year 3 is \$85,000 (\$90,000 reduced by the \$5,000 of allocable estate taxes). Pursuant to section 691(a)(3) and § 1.691(a)-3(a), the character of the gain to the Estate is the same character as the gain would have been if C had survived to receive it. Although the amount of taxable gain for chapter 1 has been reduced, the remaining \$85,000 retains its character attributable to the disposition of property used in a trade or business described in paragraph (d)(4)(i) of this section. Therefore, Estate may exclude the \$85,000 gain from net investment income pursuant to paragraph (d)(4)(i) of this section.

(ii) *Other gains and losses excluded from net investment income.* Net gain, as determined under paragraph (d) of this section, does not include gains and losses excluded from net investment income by any other provision in §§ 1.1411-1 through 1.1411-10. For example, see § 1.1411-7 (certain gain or loss attributable to the disposition of certain interests in partnerships and S corporations) and § 1.1411-8(b)(4)(ii) (net unrealized appreciation attributable to employer securities realized on a disposition of those employer securities).

(iii) *Adjustment for capital loss carryforwards for previously excluded income.* [Reserved]

(e) *Net investment income attributable to certain entities—(1) Distributions from estates and trusts—(i) In general.* Net investment income includes a beneficiary's share of distributable net income, as described in sections 652(a) and 662(a), to the extent that, under sections 652(b) and 662(b), the character of such income constitutes gross income from items described in paragraphs (a)(1)(i) and (ii) of this section or net gain attributable to items de-

scribed in paragraph (a)(1)(iii) of this section, with further computations consistent with the principles of this section, as provided in § 1.1411-3(e).

(ii) *Distributions of accumulated net investment income from foreign nongrantor trusts to United States beneficiaries.* [Reserved]

(2) *CFCs and PFICs.* For purposes of calculating net investment income, additional rules in § 1.1411-10(c) apply to an individual, an estate, or a trust that is a United States shareholder that owns an interest in a controlled foreign corporation (CFC) or that is a United States person that directly or indirectly owns an interest in a passive foreign investment company (PFIC).

(3) *Treatment of income from common trust funds.* [Reserved]

(f) *Properly allocable deductions—(1) General rule—(i) In general.* Unless provided elsewhere in §§ 1.1411-1 through 1.1411-10, only properly allocable deductions described in this paragraph (f) may be taken into account in determining net investment income.

(ii) *Limitations.* Any deductions described in this paragraph (f) in excess of gross income and net gain described in section 1411(c)(1)(A) are not taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1.

(2) *Properly allocable deductions described in section 62—(i) Deductions allocable to gross income from rents and royalties.* Deductions described in section 62(a)(4) allocable to rents and royalties described in paragraph (a)(1)(i) of this section are taken into account in determining net investment income.

(ii) *Deductions allocable to gross income from trades or businesses described in § 1.1411-5.* Deductions described in section 62(a)(1) allocable to income from a trade or business described in § 1.1411-5 are taken into account in determining net investment income to the extent the deductions have not been taken into account in determining self-employment income within the meaning of § 1.1411-9.

(iii) *Penalty on early withdrawal of savings.* Deductions described in section 62(a)(9) are taken into account in determining net investment income.

(iv) *Net operating loss.* The total section 1411 NOL amount of a net operating loss deduction allowed under section 172 is allowed as a properly allocable deduction in determining net investment income for any taxable year. See paragraph (h) of this section for the calculation of the total section 1411 NOL amount of a net operating loss deduction.

(v) *Examples.* The following examples illustrate the provisions of this paragraph (f)(2). For purposes of these examples, assume the taxpayer is a United States citizen, uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

*Example 1.* (i) A, an individual, is a 40% shareholder in SCo, an S corporation. SCo is engaged in a trade or business described in section 1411(c)(2)(A). SCo is the only passive activity owned by A. In Year 1, SCo reported a loss of \$11,000 to A which was comprised of gross operating income of \$29,000 and operating deductions of \$40,000. A's at risk amount at the beginning of Year 1 is \$7,000. There were no other events that affected A's at risk amount in Year 1.

(ii) For purposes of calculating A's net investment income, A's \$29,000 distributive share of SCo's gross operating income is income within the meaning of section 1411(c)(1)(A)(ii).

(iii) As a result of A's at risk limitation, for chapter 1 purposes, A may only deduct \$7,000 of the operating deductions in excess of the gross operating income. The remaining \$4,000 deductions are suspended because A's amount at risk at the end of Year 1 is zero.

(iv) For purposes of section 469, A has passive activity gross income of \$29,000 and passive activity deductions of \$36,000 (\$40,000 of operating deductions allocable to A less \$4,000 suspended under section 465). Because A has no other passive activity income from any other source, section 469 limits A's passive activity deductions to A's passive activity gross income. As a result, section 469 allows A to deduct \$29,000 of SCo's operating deductions and suspends the remaining \$7,000.

(v) For purposes of calculating A's net investment income, A has \$29,000 of properly allocable deductions allowed by section 1411(c)(1)(B) and paragraph (f)(2)(ii) of this section.

*Example 2.* (i) Same facts as *Example 1*. In Year 2, SCo reported net income of \$13,000 to A, which was comprised of gross operating income of \$43,000 and operating deductions of \$30,000. There were no other events that affected A's at risk amount in Year 2.

(ii) For purposes of calculating A's net investment income, A's \$43,000 distributive share of gross operating income is income within the meaning of section 1411(c)(1)(A)(ii).

(iii) Pursuant to section 465(a)(2), A's deductions attributable to the gross income of SCo include the \$30,000 deduction allocable to A in Year 2 plus the \$4,000 loss that was suspended and carried over to Year 2 from Year 1 pursuant to section 465(a)(2). Under section 465(a)(2), the \$4,000 of losses from Year 1 are treated as deductions from the activity in Year 2. As a result, A's net operating income from SCo in Year 2 is \$9,000 (\$43,000 - \$30,000 - \$4,000) in Year 2. A's amount at risk at the end of Year 2 is \$9,000.

(iv) For purposes of section 469, A has passive activity gross income of \$43,000. A's passive activity deductions attributable to SCo are the sum of the Year 2 operating deductions allocable to A from S (\$30,000), deductions formerly suspended by section 465 (\$4,000), and passive activity losses suspended by section 469 (\$7,000). Therefore, in Year 2, A has passive activity deductions of \$41,000. Because A's passive activity gross income exceeds A's passive activity deductions, section 469 does not limit any of the deductions in Year 2. At the end of Year 2, A has no suspended passive activity losses.

(v) Although A's distributive share of Year 2 deductions allocable to SCo's operating income was \$30,000; the operative provisions of sections 465 and 469 do not change the character of the deductions when such amounts are suspended under either section. Furthermore, section 465(a)(2) and §§ 1.469-1(f)(4) and 1.469-2T(d)(1) treat amounts suspended from prior years as deductions in the current year. See § 1.1411-1(a). Therefore, for purposes of calculating A's net investment income, A has \$41,000 of properly allocable deductions allowed by section 1411(c)(1)(B) and paragraph (f)(2)(ii) of this section.

(3) *Properly allocable deductions described in section 63(d).* In determining net investment income, the following itemized deductions are taken into account:

(i) *Investment interest expense.* Investment interest (as defined in section 163(d)(3)) to the extent allowed under section 163(d)(1). Any investment interest not allowed under section 163(d)(1) is treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year. The following example illustrates the provisions of this paragraph. For purposes of this example, assume that the taxpayer uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

(A) In Year 1, A, an unmarried individual, pays interest of \$4,000 on debt incurred to purchase stock. Under § 1.163-8T, this interest is allocable to the stock and is investment interest within the meaning of section 163(d)(3). A has no investment income as defined by section 163(d)(4). A has \$10,000 of income from a trade or business that is a passive activity (as defined in § 1.1411-5(a)(1)) with respect to A. For income tax purposes, under section 163(d)(1), A may not deduct the \$4,000 investment interest in Year 1 because A does not have any section 163(d)(4) net investment income. Under section 163(d)(2), the \$4,000 investment interest is a carryforward of disallowed interest that is treated as investment interest paid by A in the succeeding taxable year. Similarly, for purposes of determining A's Year 1 net investment income, A may not deduct the \$4,000 investment interest.

(B) In Year 2, A has \$5,000 of section 163(d)(4) net investment income. For both income tax purposes and for determining section 1411 net investment income, A's \$4,000 carryforward of interest expense disallowed in Year 1 may be deducted in Year 2.

(ii) *Investment expenses.* Investment expenses (as defined in section 163(d)(4)(C)).

(iii) *Taxes described in section 164(a)(3).* State, local, and foreign income, war profits, and excess profit taxes described in section 164(a)(3) that are allocable to net investment income pursuant to paragraph (g)(1) of this section. Except to the extent specifically expected from section 275(a)(4), foreign income, war profits, and excess profit taxes are not allowed as deductions under section 164(a)(3) in determining net investment income if the taxpayer claims the benefit of the foreign tax credit under section 901 with respect to the same taxable year. For rules applicable to refunds of taxes described in this paragraph, see paragraph (g)(2) of this section.

(iv) *Items described in section 72(b)(3).* In the case of an amount allowed as a deduction to the annuitant for the annuitant's last taxable year under section 72(b)(3), such amount is allowed as a properly allocable deduction in the same taxable year if the income from

the annuity (had the annuitant lived to receive such income) would have been included in net investment income under paragraph (a)(1)(i) of this section (and not excluded from net investment income by reason of § 1.1411-8).

(v) *Items described in section 691(c).* Deductions for estate and generation-skipping taxes allowed by section 691(c) that are allocable to net investment income; provided, however, that any portion of the section 691(c) deduction described in section 691(c)(4) is taken into account instead in computing net gain under paragraph (d) and not under this paragraph (f)(3)(v).

(vi) *Items described in section 212(3).* Amounts described in section 212(3) and § 1.212-1(1) to the extent they are allocable to net investment income pursuant to paragraph (g)(1) of this section.

(vii) *Amortizable bond premium.* A deduction allowed under section 171(a)(1) for the amortizable bond premium on a taxable bond (for example, see § 1.171-2(a)(4)(i)(C) for the treatment of a bond premium carryforward as a deduction under section 171(a)(1)).

(viii) *Fiduciary expenses.* In the case of an estate or trust, amounts described in § 1.212-1(i) to the extent they are allocable to net investment income pursuant to paragraph (g)(1) of this section.

(4) *Loss deductions*—(i) *General rule.* Losses described in section 165, whether described in section 62 or section 63(d), are allowed as properly allocable deductions to the extent such losses exceed the amount of gain described in section 61(a)(3) and are not taken into account in computing net gain by reason of paragraph (d) of this section.

(ii) *Examples.* The following examples illustrate the provisions of this paragraph (f)(4). For purposes of these examples, assume the taxpayer is a United States citizen, uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

*Example 1.* (i) A, an unmarried individual, owns an interest in PRS, a partnership for Federal income tax purposes. PRS is engaged in a trading business described in section 1411(c)(2)(B) and § 1.1411-5(a)(2) and has made a valid and timely election under section 475(f)(2). A's distributive share from PRS in Year 1 consists of \$125,000 of interest and dividends and \$60,000 of ordinary losses from

the trading business. In addition to A's investment in PRS, A sold undeveloped land in Year 1 for a long-term capital gain of \$50,000. A has no capital losses carried over from a preceding year.

(i) For purposes of chapter 1, A includes the \$125,000 of interest and dividends, \$60,000 of ordinary loss, and \$50,000 of long-term capital gain in the computation of A's adjusted gross income.

(iii) For purposes of calculating net investment income, A includes the \$125,000 of interest and dividends. Pursuant to paragraph (d) of this section, A takes into account the \$60,000 of ordinary loss from PRS and the \$50,000 of long term capital gain in the computation of A's net gain. A's losses (\$60,000) exceed A's gains (\$50,000). Therefore, A's net gain under paragraph (d) of this section is zero. Additionally, A is allowed a deduction under paragraph (f)(4)(i) of this section for \$10,000 (the amount of ordinary losses that were allowable under chapter 1 in excess of the amounts taken into account in computing net gain). A's net investment income in Year 1 is \$115,000.

*Example 2.* (i) In Year 1, T, a nongrantor trust, incurs a capital loss of \$5,000 on the sale of publicly traded stocks. In addition, T receives \$17,000 of interest and dividend income. T has no capital losses carried over from a preceding year.

(ii) For purposes of chapter 1, T includes the \$17,000 of interest and dividends and only \$3,000 of the capital loss in the computation of adjusted gross income. The remaining \$2,000 capital loss is carried over to Year 2.

(iii) For purposes of calculating net investment income, T includes the \$17,000 of interest and dividends in net investment income. Pursuant to paragraph (d) of this section, T takes into account the \$3,000 capital loss allowed by chapter 1. T's losses (\$3,000) exceed T's gains (\$0). Therefore, T's net gain under paragraph (d) of this section is zero. However, T is allowed a deduction under paragraph (f)(4)(i) of this section for \$3,000 (the amount of losses that were allowable under chapter 1 in excess of the amounts taken into account in computing net gain). T's net investment income in Year 1 is \$14,000.

*Example 3.* (i) In Year 1, B, an unmarried individual, incurs a short-term capital loss of \$15,000 on the sale of publicly traded stocks. B also receives annuity income of \$50,000. In addition, B disposes of property used in his sole proprietorship (which is not a trade or business described in section 1411(c)(2) or § 1.1411-5(a) for a gain of \$21,000. Pursuant to section 1231, the gain of \$21,000 is treated as a long-term capital gain for purposes of chapter 1. B has no capital losses carried over from a preceding year.

(ii) For purposes of chapter 1, B includes the \$50,000 of annuity income in the computation of adjusted gross income. The \$21,000 long-term capital gain is offset by the

\$15,000 short-term capital loss, so B includes \$6,000 of net long-term capital gain in the computation of adjusted gross income.

(iii) For purposes of calculating net investment income, B includes the \$50,000 of annuity income in net investment income. Pursuant to paragraph (d)(4)(i) of this section, B's net gain does not include the \$21,000 long-term capital gain because it is attributable to property held in B's sole proprietorship (a nonpassive activity). Pursuant to paragraph (d) of this section, T takes into account the \$15,000 capital loss allowed by chapter 1. B's losses (\$15,000) exceed B's gains (\$0). Therefore, A's net gain under paragraph (d) of this section is zero. However, B is allowed a deduction under paragraph (f)(4)(i) of this section for \$15,000 (the amount of losses that were allowable under chapter 1 in excess of the amounts taken into account in computing net gain). B's net investment income in Year 1 is \$35,000.

(5) *Ordinary loss deductions for certain debt instruments.* An amount treated as an ordinary loss by a holder of a contingent payment debt instrument under § 1.1275-4(b) or an inflation-indexed debt instrument under § 1.1275-7(f)(1).

(6) *Other deductions.* Any other deduction allowed by subtitle A that is identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter) as properly allocable to gross income or net gain under this section.

(7) *Application of limitations under sections 67 and 68.* Any deductions described in this paragraph (f) that are subject to section 67 (the 2-percent floor on miscellaneous itemized deductions) or section 68 (the overall limitation on itemized deductions) are allowed in determining net investment income only to the extent the items are deductible for chapter 1 purposes after the application of sections 67 and 68. For this purpose, section 67 applies before section 68. The amount of deductions subject to sections 67 and 68 that may be deducted in determining net investment income after the application of sections 67 and 68 is determined as described in paragraph (f)(7)(i) and (f)(7)(ii) of this section.

(i) *Deductions subject to section 67.* The amount of miscellaneous itemized deductions (as defined in section 67(b)) tentatively deductible in determining net investment income after applying



section 67 (but before applying section 68) is the lesser of:

(A) The portion of the taxpayer's miscellaneous itemized deductions (before the application of section 67) that is properly allocable to items of income or net gain included in determining net investment income, or

(B) The taxpayer's total miscellaneous itemized deductions allowed after the application of section 67, but before the application of section 68.

(ii) *Deductions subject to section 68.* The amount of itemized deductions allowed in determining net investment income after applying sections 67 and 68 is the lesser of:

(A) The sum of the amount determined under paragraph (f)(7)(i) of this section and the amount of itemized deductions not subject to section 67 that are properly allocable to items of income or net gain included in determining net investment income, or

(B) The total amount of itemized deductions allowed after the application of sections 67 and 68.

(iii) *Itemized deductions.* For purposes of paragraph (f)(7)(ii), itemized deductions do not include any deduction described in section 68(c).

(iv) *Example.* The following example illustrates the provisions of this paragraph (f)(7). For purposes of these examples, assume the taxpayer is a United States citizen, uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

(A) A, an unmarried individual, has adjusted gross income in Year 1 as follows:

Wages .....	\$1,600,000
Interest income .....	400,000
Adjusted gross income	2,000,000

In addition, A has the following items of expense qualifying as itemized deductions:

Investment expenses .....	\$70,000
Job-related expenses .....	30,000
Investment interest expense .....	75,000
State income taxes .....	120,000

A's investment expenses and job-related expenses are miscellaneous itemized deductions. In addition, A's investment interest expense and investment expenses are properly allocable to net investment income (within

the meaning of this section). A's job-related expenses are not properly allocable to net investment income. Of the state income tax expense, A applied a reasonable method pursuant to paragraph (g)(1) of this section to properly allocate \$20,000 to net investment income.

(B) A's 2-percent floor under section 67 is \$40,000 (2% of \$2,000,000). For Year 1, assume the section 68 limitation starts at adjusted gross income of \$200,000. The section 68 overall limitation disallows \$54,000 of A's itemized deductions that are subject to section 68 (3% of the excess of the \$2,000,000 adjusted gross income over the \$200,000 limitation threshold).

(C)(1) A's total miscellaneous itemized deductions allowable before the application of section 67 is \$100,000 (\$70,000 in investment expenses plus \$30,000 in job-related expenses), and the total miscellaneous deductions allowed after the application of section 67 is \$60,000 (\$100,000 minus \$40,000).

(2) The amount of the miscellaneous itemized deductions properly allocable to net investment income after the application of section 67 is \$60,000 (the lesser of \$70,000 in investment expenses that are deductible as a miscellaneous itemized deduction and properly allocable to net investment income or \$60,000 of miscellaneous itemized deductions allocable to net investment income allowed after the application of section 67).

(D)(1) The amount of itemized deductions allocable to net investment income after applying section 67 to deductions that are also miscellaneous itemized deductions but before applying section 68 is \$155,000. This amount is the sum of \$60,000 of miscellaneous itemized deductions determined in (C)(2), plus \$20,000 in state income tax properly allocable to net investment income, plus \$75,000 of investment interest expense. However, under section 68(c)(2), the \$75,000 deduction for investment interest expenses is not subject to the section 68 limitation on itemized deductions and is excluded from the computation under § 1.1411-4(f)(7). Thus, the amount of itemized deductions allocable to net investment income and subject to section 68, after

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applying section 67 but before applying section 68, is \$80,000.

(2) A's total itemized deductions allowed subject to the limitation under section 68 and after application of section 67, but before the application of section 68, are the following:

Miscellaneous itemized deductions .....	\$60,000
State income tax .....	120,000
	180,000
Deductions subject to section 68 .....	180,000

(3) Of A's itemized deductions that are subject to the limitation under section 68, the amount allowed after the application of section 68 is \$126,000 (\$180,000 minus the \$54,000 disallowed in (B)).

(E) Under paragraph (f)(7)(ii) of this section, the amount of itemized deductions allowed in determining net investment income after applying sections 67 and 68 is the lesser of \$80,000 (the sum of \$60,000 determined under paragraph (C)(2) and \$20,000 state income tax allocable to net investment income) or \$126,000 (determined under (D)(3)). Therefore, A's itemized deductions that are properly allocable to net investment income are \$155,000 (\$80,000 of properly allocable itemized deductions subject to section 67 or 68 plus \$75,000 of investment interest expense (which is not subject to either section 67 or section 68 limitations)).

(g) *Special rules*—(1) *Deductions allocable to both net investment income and excluded income.* In the case of a properly allocable deduction described in section 1411(c)(1)(B) and paragraph (f) of this section that is allocable to both net investment income and excluded income, the portion of the deduction that is properly allocable to net investment income may be determined by taxpayers using any reasonable method. Examples of reasonable methods of allocation include, but are not limited to, an allocation of the deduction based on the ratio of the amount of a taxpayer's gross income (including net gain) described in § 1.1411-4(a)(1) to the amount of the taxpayer's adjusted gross income (as defined under section 62 (or section 67(e) in the case of an estate or trust)). In the case of an estate or trust, an allocation of a deduction pursuant to rules described in § 1.652(b)–

3(b) (and § 1.641(c)–1(h) in the case of an ESBT) is also a reasonable method.

(2) *Recoveries of properly allocable deductions*—(i) *General rule.* If a taxpayer is refunded, reimbursed, or otherwise recovers any portion of an amount deducted as a section 1411(c)(1)(B) properly allocable deduction in a prior year, and such amount is not otherwise included in net investment income in the year of recovery under section 1411(c)(1)(A), the amount of the recovery will reduce the taxpayer's total section 1411(c)(1)(B) properly allocable deductions in the year of recovery (but not below zero). The preceding sentence applies regardless of whether the amount of the recovery is excluded from gross income by reason of section 111.

(ii) *Recoveries of items allocated between net investment income and excluded income.* In the case of a refund of any item that was deducted under section 1411(c)(1)(B) in a prior year and the gross amount of the deduction was allocated between items of net investment income and excluded income pursuant to paragraph (g)(1) of this section, the amount of the reduction in section 1411(c)(1)(B) properly allocable deductions in the year of receipt under this paragraph (g)(2) is the total amount of the refund multiplied by a fraction. The numerator of the fraction is the amount of the total deduction allocable to net investment income in the prior year to which the refund relates. The denominator of the fraction is the total amount of the deduction in the prior year to which the refund relates.

(iii) *Recoveries with no prior year benefit.* For purposes of this paragraph (g)(2), section 111 applies to reduce the amount of any reduction required by paragraph (g)(2)(i) of this section to the extent that such previously deducted amount did not reduce the tax imposed by section 1411. To the extent a deduction is taken into account in computing a taxpayer's net operating loss deduction under paragraph (h) of this section, section 111(c) applies. Except as provided in the preceding sentence, for purposes of this paragraph (g)(2), no reduction of section 1411(c)(1)(B) properly allocable deductions is required in

a year when such recovered item is attributable to an amount deducted in a taxable year—

(A) Preceding the effective date of section 1411, or

(B) In which the taxpayer was not subject to section 1411 solely because that individual's (as defined in § 1.1411-2(a)) modified adjusted gross income (as defined in § 1.1411-2(c)) does not exceed the applicable threshold in § 1.1411-2(d) or such estate's or trust's (as defined in § 1.1411-3(a)(1)(i)) adjusted gross income does not exceed the amount described in section 1411(a)(2)(B)(ii) and § 1.1411-3(a)(1)(ii)(B)(2).

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (g)(2). For purposes of these examples, assume the taxpayer is a United States citizen, uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

*Example 1. Recovery of amount included in income.* A, an individual, is a 40% limited partner in LP. LP is a passive activity to A. In Year 1, A's distributable share of section 1411(c)(1)(A)(ii) income and properly allocable deductions described in § 1.1411-4(f)(2)(ii) were \$50,000 and \$37,000, respectively. In Year 2, LP received a refund of a properly allocable deduction described in § 1.1411-4(f)(2)(ii). A's distributable share of the recovered deduction is \$2,000. Since the \$2,000 recovery constitutes gross income described in section 1411(c)(1)(A)(ii) in Year 2, A does not reduce any properly allocable deductions attributable to Year 2.

*Example 2. State income tax refund.* In Year 1, D, an individual, allocated \$15,000 of taxes out of a total of \$75,000 to net investment income under paragraph (f)(3)(iii) of this section. D received no tax benefit from the deduction in Year 1 for chapter 1 purposes due to the alternative minimum tax, but it did reduce D's section 1411 tax. In Year 3, D received a refund of \$5,000. For chapter 1 purposes, D excludes the \$5,000 refund from gross income in Year 3 by reason of section 111. In Year 3, D allocated \$30,000 of state income taxes out of a total of \$90,000 to net investment income under paragraph (f)(3)(iii) of this section. Although the refund is excluded from D's gross income, D must nonetheless reduce Year 3's section 1411(c)(1)(B) properly allocable deductions by \$1,000 ( $\$5,000 \times (\$15,000/\$75,000)$ ). D's allocation of 33 $\frac{1}{3}$ % of section 164(a)(3) taxes in Year 3 to net investment income is irrelevant to the calculation of the amount of the reduction required by this paragraph (g)(2).

*Example 3. State income tax refund with no prior year benefit.* Same facts as Example 2, except in Year 1, D's section 1411(c)(1)(B) properly allocable deductions exceeded D's section 1411(c)(1)(A) income by \$300. As a result, D was not subject to section 1411 in Year 1. Pursuant to paragraph (g)(2)(iii) of this section, D does not reduce Year 3's section 1411(c)(1)(B) properly allocable deductions for recoveries of amounts to the extent that such deductions did not reduce the tax imposed by section 1411. Therefore, D must reduce Year 3's section 1411(c)(1)(B) properly allocable deductions by \$700 (\$1,000 less \$300).

(3) *Deductions described in section 691(b).* For purposes of paragraph (f) of this section, properly allocable deductions include items of deduction described in section 691(b), provided that the item otherwise would have been deductible to the decedent under § 1.1411-4(f). For example, an estate may deduct the decedent's unpaid investment interest expense in computing its net investment income because section 691(b) specifically allows the deduction under section 163, and § 1.1411-4(f)(3)(i) allows those deductions as well. However, an estate or trust may not deduct a payment of real estate taxes on the decedent's principal residence that were unpaid at death in computing its net investment income because, although real estate taxes are deductible under section 164 and specifically are allowed by section 691(b), the real estate taxes would not have been a properly allocable deduction of the decedent under § 1.1411-4(f).

(4) *Amounts described in section 642(h).* For purposes of the calculation of net investment income under this section, one or more beneficiaries succeeding to the property of the estate or trust, within the meaning of section 642(h), shall—

(i) Treat excess capital losses of the estate or trust described in section 642(h)(1) as capital losses of the beneficiary in the calculation of net gain in paragraph (d) and paragraph (f)(4) of this section, as applicable, in a manner consistent with section 642(h)(1);

(ii) Treat excess net operating losses of the estate or trust described in section 642(h)(1) as net operating losses of the beneficiary in the calculation of net investment income in paragraphs (f)(2)(iv) and (h) of this section in a

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manner consistent with section 642(h)(1); and

(iii) Treat the deductions described in paragraph (f) of this section (other than those taken into account under paragraph (g)(4)(i) or (ii) of this section) that exceed the gross investment income described in paragraph (a)(1) of this section (after taking into account any modifications, adjustments, and special rules for calculating net investment income in section 1411 and the regulations thereunder) of a terminating estate or trust as a section 1411(c)(1)(B) deduction of the beneficiary in a manner consistent with section 642(h)(2).

(5) *Treatment of self-charged interest income.* Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

(6) *Treatment of certain nonpassive rental activities—(i) Gross income from rents.* To the extent that gross rental income described in paragraph (a)(1)(i) of this section is treated as not derived from a passive activity by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), such gross rental income is deemed to be derived in the ordinary course of a trade or business within the

meaning of paragraph (b) of this section.

(ii) *Gain or loss from the disposition of property.* To the extent that gain or loss resulting from the disposition of property is treated as nonpassive gain or loss by reason of § 1.469-2(f)(6) or as a consequence of a taxpayer grouping a rental activity with a trade or business activity under § 1.469-4(d)(1), then such gain or loss is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.

(7) *Treatment of certain real estate professionals—(i) Safe Harbor.* In the case of a real estate professional (as defined in section 469(c)(7)(B)) that participates in a rental real estate activity for more than 500 hours during such year, or has participated in such real estate activities for more than 500 hours in any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year, then—

(A) Such gross rental income from that rental activity is deemed to be derived in the ordinary course of a trade or business within the meaning of paragraph (b) of this section; and

(B) Gain or loss resulting from the disposition of property used in such rental real estate activity is deemed to be derived from property used in the ordinary course of a trade or business within the meaning of paragraph (d)(4)(i) of this section.

(ii) *Definitions—(A) Participation.* For purposes of establishing participation under this paragraph (g)(7), any participation in the activity that would count towards establishing material participation under section 469 shall be considered.

(B) *Rental real estate activity.* The term *rental real estate activity* used in this paragraph (g)(7) is a rental activity within the meaning of § 1.469-1T(e)(3). An election to treat all rental real estate as a single rental activity under § 1.469-9(g) also applies for purposes of this paragraph (g)(7). However, any rental real estate that the taxpayer grouped with a trade or business activity under § 1.469-4(d)(1)(i)(A) or (d)(1)(i)(C) is not a rental real estate activity.

(iii) *Effect of safe harbor.* The inability of a real estate professional to satisfy the safe harbor in this paragraph (g)(7) does not preclude such taxpayer from establishing that such gross rental income and gain or loss from the disposition of property, as applicable, is not included in net investment income under any other provision of section 1411.

(B) *Treatment of former passive activities*—(i) *Section 469(f)(1)(A) losses.* Losses allowed in computing taxable income by reason of the rules governing former passive activities in section 469(f)(1)(A) are taken into account in computing net gain under paragraph (d) of this section or as properly allocable deductions under paragraph (f) of this section, as applicable, in the same manner as such losses are taken into account in computing taxable income (as defined in section 63). The preceding sentence applies only to the extent the net income or net gain from the former passive activity (as defined in section 469(f)(3)) is included in net investment income.

(ii) *Section 469(f)(1)(C) losses.* Losses allowed in computing taxable income by reason of section 469(f)(1)(C) are taken into account in computing net gain under paragraph (d) of this section or as properly allocable deductions under paragraph (f) of this section, as applicable, in the same manner as such losses are taken into account in computing taxable income (as defined in section 63).

(iii) *Examples.* The following examples illustrate the provisions of this paragraph (g)(8). For purposes of these examples, assume the taxpayer is a United States citizen, uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

*Example 1.* (i) B, an individual taxpayer, owns a 50% interest in SCorp, an S corporation engaged in the trade or business of retail clothing sales. B also owns a single family rental property, a passive activity. B materially participates in the retail sales activity of SCorp, but B has \$10,000 of suspended losses from prior years when the retail sales activity of SCorp was a passive activity of B. Therefore, the retail sales activity of SCorp is a former passive activity within the meaning of section 469(f)(3).

(ii) In Year 1, B reports \$205,000 of wages, \$7,000 of nonpassive net income, \$500 of interest income (attributable to working capital) from SCorp's retail sales activity, and \$1,000 of net rental income from the single family rental property. B's Year 1 modified adjusted gross income (as defined in § 1.1411-2(c)) is \$205,500; which includes \$205,000 of wages, \$500 of interest income, \$7,000 of nonpassive income from SCorp, \$7,000 of section 469(f)(1)(A) losses, \$1,000 of passive income from the single family rental property and \$1,000 of section 469(f)(1)(C) losses.

(iii) For purposes of the calculation of B's Year 1 net investment income, B includes the \$500 of interest income and \$1,000 of net passive income from the single family rental property. The \$7,000 of nonpassive income from SCorp's retail sales activity is excluded from net investment income because the income is not attributable to a trade or business described in § 1.1411-5. Therefore, pursuant to the rules of paragraph (g)(8)(i) of this section, the \$7,000 of section 469(f)(1)(A) losses are not taken into account in computing B's net investment income. However, pursuant to the rules of paragraph (g)(8)(ii) of this section, the \$1,000 of passive losses allowed by reason of section 469(f)(1)(C), which are allowed as a deduction in Year 1 by reason of B's \$1,000 of passive income from the single family rental property are allowed in computing B's net investment income. As a result, B's net investment income is \$500 (\$500 of interest income plus \$1,000 of passive rental income less \$1,000 of section 469(f)(1)(C) losses). Although the \$500 of interest income is attributable to SCorp and includable in B's net investment income, such income is not taken into account when calculating the amount of section 469(f)(1)(A) losses allowed in the current year. Therefore, such income is not taken into account in computing the amount of section 469(f)(1)(A) losses allowed by reason of paragraph (g)(8)(i) of this section. Pursuant to section 469(b), B carries forward \$2,000 of suspended passive losses attributable to SCorp's retail sales activity to Year 2.

*Example 2.* Same facts as *Example 1*. In Year 2, B materially participates in the retail sales activity of SCorp, and disposes of his entire interest in SCorp for a \$9,000 long-term capital gain. Pursuant to § 1.469-2T(e)(3), the \$9,000 gain is characterized as nonpassive income. Pursuant to section 469(f)(1)(A), the remaining \$2,000 of suspended passive loss is allowed because the \$9,000 gain is treated as nonpassive income. Assume that under section 1411(c)(4) and § 1.1411-7, B takes into account only \$700 of the \$9,000 gain in computing net investment income for Year 2. Pursuant to paragraph (g)(8)(i) of this section, B may take into account \$700 of the \$2,000 loss allowed by section 469(f)(1)(A) in computing net investment income for Year 2.

Pursuant to paragraph (g)(8)(i) of this section, B may not deduct the remaining \$1,300 passive loss allowed for chapter 1 in calculating net investment income for Year 2.

(9) *Treatment of section 469(g)(1) losses.* Losses allowed in computing taxable income by reason of section 469(g) are taken into account in computing net gain under paragraph (d) of this section or as properly allocable deductions under paragraph (f) of this section, as applicable, in the same manner as such losses are taken into account in computing taxable income (as defined in section 63).

(10) *Treatment of section 707(c) guaranteed payments.* [Reserved]

(11) *Treatment of section 736 payments.* [Reserved]

(12) *Income and deductions from certain notional principal contracts.* [Reserved]

(13) *Treatment of income or loss from REMIC residual interests.* [Reserved]

(h) *Net operating loss—(1) General rule.* For purposes of paragraph (f)(2)(iv) of this section, the total section 1411 NOL amount of a net operating loss deduction for a taxable year is calculated by first determining the applicable portion of the taxpayer's net operating loss for each loss year under paragraph (h)(2) of this section. Next, the applicable portion for each loss year is used to determine the section 1411 NOL amount for each net operating loss carried from a loss year and deducted in the taxable year as provided in paragraph (h)(3) of this section. The section 1411 NOL amounts of each net operating loss carried from a loss year and deducted in the taxable year are then added together as provided in paragraph (h)(4) of this section. This sum is the total section 1411 NOL amount of the net operating loss deduction for the taxable year that is allowed as a properly allocable deduction in determining net investment income for the taxable year. For purposes of this paragraph (h), both the amount of a net operating loss for a loss year and the amount of a net operating loss deduction refer to such amounts as determined for purposes of chapter 1.

(2) *Applicable portion of a net operating loss.* In any taxable year beginning after December 31, 2012, in which a taxpayer incurs a net operating loss, the

applicable portion of such loss is the lesser of:

(i) The amount of the net operating loss for the loss year that the taxpayer would incur if only items of gross income that are used to determine net investment income and only properly allocable deductions are taken into account in determining the net operating loss in accordance with section 172(c) and (d); or

(ii) The amount of the taxpayer's net operating loss for the loss year.

(3) *Section 1411 NOL amount of a net operating loss carried to and deducted in a taxable year.* The section 1411 NOL amount of each net operating loss that is carried from a loss year that is allowed as a deduction is the total amount of such net operating loss carried from the loss year allowed as a deduction under section 172(a) in the taxable year multiplied by a fraction. The numerator of the fraction is the applicable portion of the net operating loss for that loss year, as determined under paragraph (h)(2) of this section. The denominator of the fraction is the total amount of the net operating loss for the same loss year.

(4) *Total section 1411 NOL amount of a net operating loss deduction.* The section 1411 NOL amounts of each net operating loss carried to and deducted in the taxable year as determined under paragraph (h)(3) of this section are added together to determine the total section 1411 NOL amount of the net operating loss deduction for the taxable year that is properly allocable to net investment income.

(5) *Examples.* The following examples illustrate the provisions of this paragraph (h). For purposes of these examples, assume the taxpayer is a United States citizen, uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

*Example 1.* (i)(A) In Year 1, A, an unmarried individual, has the following items of income and deduction: \$200,000 in wages, \$50,000 in gross income from a trade or business of trading in financial instruments or commodities (as defined in §1.1411-5(a)(2)) (trading activity), \$10,000 of dividends, \$1,000,000 in loss from his sole proprietorship (which is not a trade or business described in §1.1411-

5), \$12,000 of non-business investment expenses, and \$250,000 in trading loss deductions. As a result, for income tax purposes A sustains a section 172(c) net operating loss of \$1,000,000. A makes an election under section 172(b)(3) to waive the carryback period for this net operating loss.

(B) For purposes of section 1411, A's net investment income for Year 1 is the excess (if any) of \$60,000 (\$50,000 trading activity gross income plus \$10,000 dividend income) over \$262,000 (\$250,000 trading loss deductions plus \$12,000 nonbusiness expenses).

(C) The amount of the net operating loss for Year 1 determined under section 172 that A would incur if only items of gross income that are used to determine net investment income and only properly allocable deductions are taken into account is \$200,000. This amount is the excess of \$250,000 trading loss deductions, over \$50,000 trading activity gross income. Under section 172(d)(4), in determining the net operating loss, the \$12,000 nonbusiness expenses are allowed only to the extent of the \$10,000 dividend income. The \$200,000 net operating loss determined using only properly allocable deductions and gross income items used in determining net investment income is less than A's actual net operating loss for Year 1 of \$1,000,000, and accordingly the applicable portion for Year 1 is \$200,000. The ratio used to calculate section 1411 NOL amounts of A's Year 1 net operating loss is \$200,000 (net operating loss determined using only properly allocable deductions and gross income items used in determining net investment income)/\$1,000,000 (net operating loss), or 0.2.

(i) For Year 2, A has \$250,000 of wages, no gross income from the trading activity, \$300,000 of income from his sole proprietorship, and \$10,000 in trading loss deductions. For income tax purposes, A deducts \$540,000 of the net operating loss carried over from Year 1. In addition, under § 1.1411-2(c), the \$540,000 net operating loss will be allowed as a deduction in computing A's Year 2 modified adjusted gross income. Because A's modified adjusted gross income is \$0, A is not subject to net investment income tax. For purposes of A's net investment income calculation, the section 1411 NOL amount of the \$540,000 net operating loss from Year 1 that A deducts in Year 2 is \$108,000 (\$540,000 multiplied by 0.2 (the fraction determined based on the applicable portion of the net operating loss in the loss year)). The amount of the Year 1 net operating loss carried over to Year 3 is \$460,000. For purposes of A's net investment income calculation, this net operating loss carryover amount includes a section 1411 NOL amount of \$92,000 (\$460,000 multiplied by 0.2). The section 1411 NOL amount may be applied in determining A's net investment income in Year 3.

(iii)(A) For Year 3, A has \$400,000 of wages, \$200,000 in trading gains which are gross in-

come from the trading activity, \$250,000 of income from his sole proprietorship, and \$10,000 in trading loss deductions. For income tax purposes, A deducts the remaining \$460,000 of the net operating loss from Year 1. In addition, under § 1.1411-2(c), the \$460,000 net operating loss deduction reduces A's Year 3 modified adjusted gross income to \$380,000.

(B) A's section 1411 NOL amount of the net operating loss deduction for Year 3 is \$92,000, which is the \$460,000 net operating loss deduction for Year 3 multiplied by 0.2.

(C) A's net investment income for Year 3 before the application of paragraph (f)(2)(iv) of this section is \$190,000 (\$200,000 in gross income from the trading activity, minus \$10,000 in trading loss deductions). After the application of paragraph (f)(2)(iv) of this section, A's net investment income for Year 3 is \$98,000 (\$190,000 minus \$92,000, the total section 1411 NOL amount of the net operating loss deduction).

*Example 2.* (i) The facts for Year 1 are the same as in *Example 1*.

(ii)(A) For Year 2, A has \$100,000 in wages, \$200,000 in gross income from the trading activity, \$15,000 of dividends, \$250,000 in losses from the sole proprietorship, \$10,000 of non-business investment expenses, and \$355,000 in trading loss deductions. As a result, for income tax purposes A sustains a section 172(c) net operating loss of \$300,000. A makes an election under section 172(b)(3) to waive the carryback period for the Year 2 net operating loss.

(B) For purposes of section 1411, A's net investment income for Year 2 is the excess (if any) of \$215,000 (\$200,000 trading activity gross income plus \$15,000 dividend income) over \$365,000 (\$355,000 trading loss deductions plus \$10,000 nonbusiness expenses).

(C) The amount of the net operating loss for Year 2 determined under section 172 that A would incur if only items of gross income that are used to determine net investment income and only properly allocable deductions are taken into account is \$150,000. This amount is the excess of \$365,000 (\$355,000 trading loss deductions plus \$10,000 nonbusiness expenses) over \$215,000 (\$200,000 trading activity gross income plus \$15,000 dividend income). Under section 172(d)(4), in determining the net operating loss, the \$10,000 nonbusiness expenses are allowed in full against the \$15,000 dividend income. The \$150,000 net operating loss determined using only properly allocable deductions and gross income items used in determining net investment income is less than A's actual net operating loss for Year 2 of \$300,000, and accordingly the applicable portion is \$150,000. The ratio used to calculate the section 1411 NOL amount of A's Year 2 net operating loss is \$150,000 (the applicable portion)/\$300,000 (net operating loss), or 0.5.

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(iii) For Year 3, A has \$250,000 of wages, no gross income from the trading activity, \$300,000 of income from his sole proprietorship, and \$10,000 in trading loss deductions. For income tax purposes, A deducts \$540,000 of the net operating loss from Year 1. In addition, under § 1.1411-2(c), the \$540,000 net operating loss will be allowed as a deduction in computing A's Year 3 modified adjusted gross income. Because A's modified adjusted gross income is \$0, A is not subject to net investment income tax. The section 1411 NOL amount of the \$540,000 net operating loss from Year 1 that A deducts in Year 3 is \$108,000 (\$540,000 multiplied by 0.2 (the fraction used to calculate the section 1411 NOL amount of the net operating loss)), and this is also the total section 1411 NOL amount for Year 3. The amount of the Year 1 net operating loss carried over to Year 4 is \$460,000. This net operating loss carryover amount includes a section 1411 NOL amount of \$92,000 (\$460,000 multiplied by 0.2) that may be applied in determining net investment income in Year 4. None of the Year 2 net operating loss is deducted in Year 3 so that the \$300,000 Year 2 net operating loss (including the section 1411 NOL amount of \$150,000) is carried to Year 4.

(iv)(A) For Year 4, A has \$150,000 of wages, \$450,000 in trading gains which are gross income from the trading activity, \$250,000 of income from his sole proprietorship, and \$10,000 in trading loss deductions. For income tax purposes, A deducts the remaining \$460,000 of the net operating loss carryover from Year 1 and the \$300,000 net operating loss carryover from Year 2, for a total net operating loss deduction in Year 4 of \$760,000. In addition, under § 1.1411-2(c), the \$760,000 net operating loss deduction reduces A's Year 4 modified adjusted gross income to \$80,000.

(B) A's total section 1411 NOL amount of the net operating loss deduction for Year 4 is \$242,000, which is the sum of the \$92,000 (\$460,000 net operating loss carryover from Year 1 and deducted in Year 4 multiplied by 0.2 (the ratio used to calculate the section 1411 NOL amount of the Year 1 net operating loss)) plus \$150,000 (\$300,000 net operating loss carryover from Year 2 and deducted in Year 4 multiplied by 0.5 (the ratio used to calculate the section 1411 NOL amount of the Year 2 net operating loss)).

(C) A's net investment income for Year 4 before the application of paragraph (f)(2)(iv) of this section is \$440,000 (\$450,000 in gross income from the trading activity, minus \$10,000 in trading loss deductions). After the application of paragraph (f)(2)(iv) of this section, A's net investment income for Year 4 is \$198,000 (\$440,000 minus \$242,000, the total section 1411 NOL amount of the Year 4 net operating loss deduction).

(i) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012, in accordance with § 1.1411-1(f).

[T.D. 9644, 78 FR 72424, Dec. 2, 2013, as amended at 79 FR 18160, Apr. 1, 2014]

### § 1.1411-5 Trades or businesses to which tax applies.

(a) *In general.* A trade or business is described in this section if such trade or business involves the conduct of a trade or business, and such trade or business is either—

(1) A passive activity (within the meaning of paragraph (b) of this section) with respect to the taxpayer; or

(2) The trade or business of a trader trading in financial instruments (as defined in paragraph (c)(1) of this section) or commodities (as defined in paragraph (c)(2) of this section).

(b) *Passive activity*—(1) *In general.* A passive activity is described in this section if—

(i) Such activity is a trade or business; and

(ii) Such trade or business is a passive activity with respect to the taxpayer within the meaning of section 469 and the regulations thereunder.

(2) *Application of income recharacterization rules*—(i) *Income and gain recharacterization.* To the extent that any income or gain from a trade or business is recharacterized as “not from a passive activity” by reason of § 1.469-2T(f)(2), § 1.469-2(f)(5), or § 1.469-2(f)(6), such trade or business does not constitute a passive activity within the meaning of paragraph (b)(1)(ii) of this section solely with respect to such recharacterized income or gain.

(ii) *Gain recharacterization.* To the extent that any gain from a trade or business is recharacterized as “not from a passive activity” by reason of § 1.469-2(c)(2)(iii) and does not constitute portfolio income under § 1.469-2(c)(2)(iii)(F), such trade or business does not constitute a passive activity within the meaning of paragraph (b)(1)(ii) of this section solely with respect to such recharacterized gain.

(iii) *Exception for certain portfolio recharacterizations.* To the extent that